Weekly Commentary

25 October 2016

Past the worst

Last week, we received updates on the Consumer Price Index and dairy prices – two factors that have an important bearing on the outlook for the New Zealand economy and the future path of interest rates. Annual CPI inflation softened in the September quarter, but should rise gradually from here. Nonetheless, it will be a slow return to the Reserve Bank's 2% target midpoint, and a November OCR cut looks likely. Meanwhile, we've revised our milk price forecast higher to $5.30, as wet weather dampens New Zealand milk production.

Consumer prices rose by 0.2% in the September quarter, resulting in annual inflation slowing to 0.2% from 0.4% in June. And while inflation has now eluded the Reserve Bank's target band of 1% to 3% for two years, this doesn't fundamentally change the picture for the Reserve Bank, as they had forecast a slowdown in September quarter inflation in the August Monetary Policy Statement.

The soft outturn in September reflected temporary factors such as a decline in fuel prices and the second of two large reductions in ACC levies. But just as inflation in September was held down by temporary factors, inflation should soon pick up as previous disinflationary factors drop out of the annual calculation. Indeed, our early calculations have annual inflation picking up to 1% in the December quarter. If this forecast came to fruition it would no doubt provide the Reserve Bank some relief that CPI inflation was finally back in the band.

However, this would only be the beginning of the road for the Reserve Bank, with the return to the 2% midpoint still shaping up as being uncomfortably slow. And inflation expectations, to the extent they are backward looking, could take a further hit from September's soft result. This would make it that much harder to get inflation back to target. For those reasons, the Reserve Bank has more or less committed itself to a further OCR cut, most likely in November. Beyond that, the case for additional easing in 2017 looks less compelling, especially compared to a few months ago, given the range of data pointing to the continuation of solid growth. But a lot can change between now and next year, and the Reserve Bank will want to keep their options open.

The Reserve Bank has the most control over domestic components of inflation, and will be watching these closely to see if continued strong growth is indeed translating into inflationary pressure. In the September quarter CPI, price pressures were most pronounced in the housing components. New dwellings prices in particular continued to surge, especially in Auckland, to be up 6.3% from a year ago. This is not surprising given the acceleration in construction activity, which rose 10% in the first half of this year alone. And when coming off an already-high level, this sort of growth is difficult to deliver without pushing up against capacity constraints. Indeed, construction firms are reporting that finding skilled staff is the most difficult it's been since 2003. If anything, the rates of inflation so far have been muted compared to these reported strains on capacity. But at some point, something has to give. In order for firms to scale up to meet demand, they will need to bid up wages to source the appropriate staff, which will eventually translate to further pressure on prices.

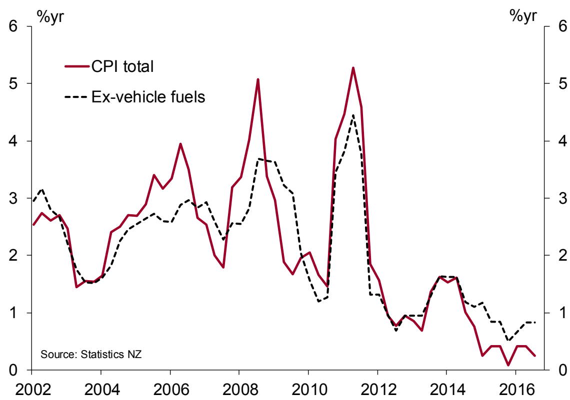
Past the worst continued

Part of the surge in construction has reflected the need to house New Zealand's rapidly growing population. This has been boosted by a record level of net migration, which has shown no signs of slowing just yet. In September, the monthly net inflow picked up to the highest on record, dragging annual net migration to a new record of 70,000. There was a big lift in non-New Zealand arrivals in the month, in particular from the UK, so it will be interesting to see if this is sustained.

For some time, we have been expecting annual net migration to slow gradually from mid-year as foreigners who arrived on temporary work or student visas over the past three years start to depart. And certainly arrivals of those on student visas have slowed noticeably on tighter enforcement of entrance criteria. However, for now, this is being swamped by a lift in arrivals of those on work visas. More people simply means more demand for a wide range of goods and services, and strong net migration will continue to boost growth for a while yet.

Global dairy prices have also held up better than we expected, edging 1.4% higher in last week's GlobalDairyTrade auction. A key catalyst for this lift in prices was a reduction in Fonterra's offerings on the GDT platform. The volume of product offered over the next 12 months is 3% lower than previously forecast, with the remainder of this year's events taking the largest hit. This reduction reflects a recent spell of wet weather in New Zealand that has dampened milk production in some regions. Most notably, Waikato's milk production (which accounts for nearly a quarter of New Zealand's total production) in October has been running about 10% below the same period last year.

CPI inflation



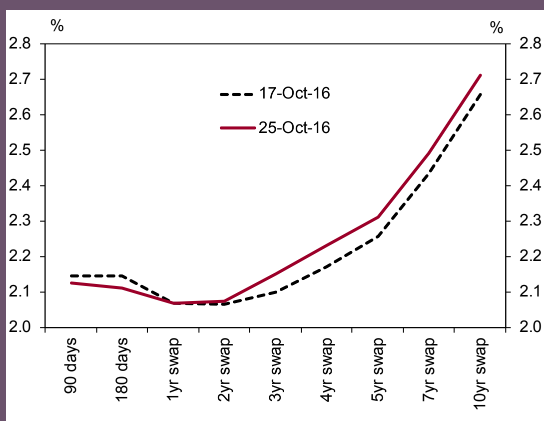
The change in the supply outlook for the next couple of months has led us to revise our milk price forecast higher from $5 to $5.30 – broadly in line with Fonterra's $5.25 forecast. Our $5 forecast was predicated on prices partially retracing their recent big run up by the end of this year. And although the demand picture remains soggy, reduced volumes over the next couple of months will help to put a floor under prices. Regardless, farmers will take a cautious approach to spending with a lot of balance sheet repair ahead.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value probably lies in the two-year rate or shorter terms. Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the next four or five years. That said, fixing for a longer term does offer the borrower greater stability.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates, such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



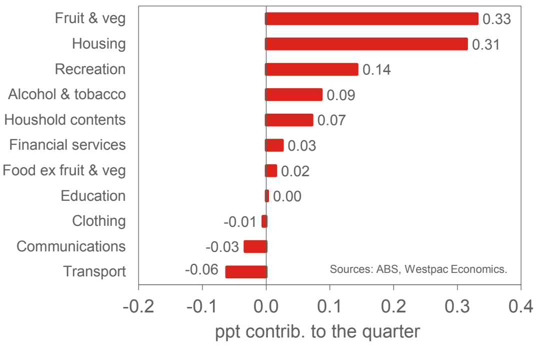
The week ahead

Aus Q3 Consumer Price Index

Oct 26 Last: 0.4%, WBC f/c: 0.9%
Mkt f/c: 0.5%, Range: 0.2% to 0.9%

- Westpac's forecast for 0.9%qtr lifts the annual pace to 1.5%yr from 1.0%yr. September is traditionally a stronger quarter (mostly due to the annual price resetting for administrated prices) with the ABS seasonal factor worth 0.3ppts. This results in the seasonally adjusted CPI rising a smaller 0.6%qtr.
- Key to the solid rise is the strong price gains for food, housing (mostly via utilities) and recreation. Helping to hold the gains down in the quarter were falling prices for auto fuel, communication and clothing & footwear.
- Our core inflation forecast is 0.4%qtr lifting the annual pace to 1.6%yr from 1.5%yr. The six month annualised pace of the average of the core measures is forecast to lift to 1.7%yr from 1.3%yr which is still below the target band.

Contributions 2016Q3 CPI forecast

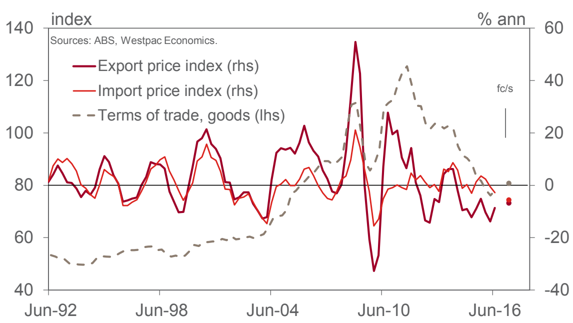


Aus Q3 import price index

Oct 27, Last: –1.0%, WBC f/c: –1.5%
Mkt f/c: –0.8%, Range: –2.0% to +0.7%

- For September, the price of import goods is expected to decline by 1.5%. That would be the fourth consecutive drop in import prices and brings the annual fall to around 5.5%.
- The weakening of import prices reflects: lower energy prices (2015 Q4 and 2016 Q1) and the recent rebound in the currency.
- In the September quarter, lower energy prices and a firmer currency are together reducing the cost of imports. Singapore gasoline prices fell by around 5% in USD terms in the period, to be more than 20% lower than a year ago. The AUD rose to 63.7 on a TWI basis in the quarter, up about 1.5%, to be around 3.7% above the level of a year earlier.

Import & export goods prices

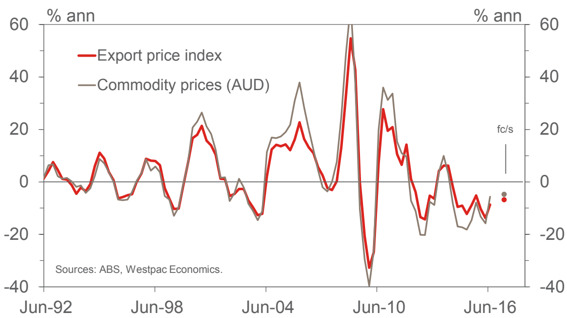


Aus Q3 export price index

Oct 27, Last: 1.4%, WBC f/c: 2.0%
Mkt f/c: 2.0%, Range: 0.5% to 7.5%

- Export prices have recovered of late, breaking the downward trend that began from late 2011. Commodity prices have bounced in response to stronger demand from China, following policy stimulus, and boosted by some supply constraints.
- The export price index is expected to rise by 2.0% in the quarter. That follows a 1.4% increase in June. This would still see export prices lower over the year, down by almost 7%.
- In the period, commodity prices rose, increasing by 4% in USD terms (on the RBA index) and up by more than this on the Westpac index. Partially offsetting this, the currency was firmer in the quarter, rising 1.7% to US75.8¢. The terms of trade for goods, on these estimates, increases by 3.5% in the quarter to be around 1% lower over the year.

Commodity prices & export price index

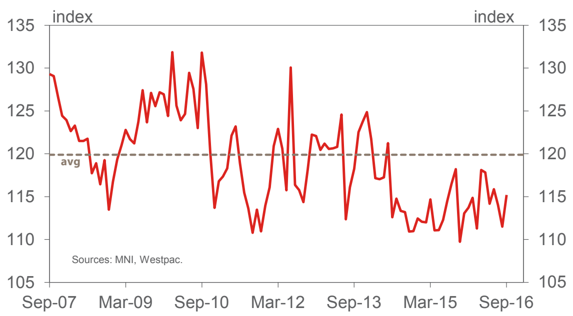


Chn Oct Westpac–MNI Consumer Sentiment

Oct 26, Last: 115.2

- The **Westpac MNI China Consumer Sentiment Indicator** recovered somewhat in September, posting a 3.3% rise to 115.2. That is slightly better than the average read over the last 12 months but still well below the long run average of around 120. Some of the Aug-Sep variation appeared to be a hit and recovery from severe weather events.
- The October survey was in the field over the first half of the month. The economic data flow has been a touch better with housing markets in particular showing some broadening in momentum. The latest GDP and industrial data show conditions in Q3 were broadly similar to those in Q2.

Westpac MNI China CSI



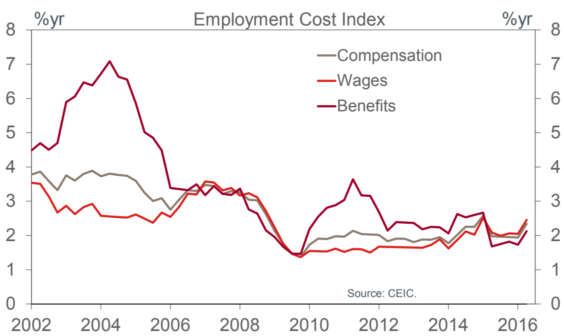
The week ahead

US Q3 employment cost index

Oct 28, Last: 0.6%, WBC 0.6%, Mkt f/c: 0.6%

- Growth in total compensation on an ECI basis has improved over the past year, from 2.0%yr to 2.3%yr at June 2016. However, that is still a relatively subdued pace of growth.
- Growth in wages only is a little stronger at 2.5%yr. Arguably it would be considerably stronger if the skew in job creation toward lower-income occupations was not as significant. In contrast, benefit growth has hindered growth in total compensation over the past year, 2.1%yr. This is principally the result of the services sector, 1.0%yr; although benefit growth for goods producing firms has also now slowed to 1.7%yr.
- Come Q3, another 0.6% gain in total compensation is likely. Downside risks continue to surround growth in benefits, but the annual gain for wages should remain solid near 2.5%yr. We are unlikely to see signs of a wage breakout anytime soon.

Wage pressures a key metric for policy stance

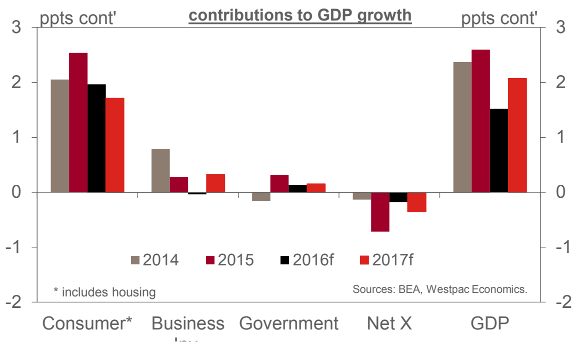


US Q3 GDP

Oct 28, Last: 1.4%, WBC 2.5%, Mkt f/c: 2.5% (annls'd)

- US GDP growth disappointed expectations throughout the first half of 2016, Q1's 0.8% annualised result was followed by 1.4% in Q2. The first half of 2016 therefore recorded growth of 1.1% annualised, less than half that seen in early 2015.
- Of the key components, household consumption remains robust; dwelling investment and government spending broadly flat; and business investment weak.
- Q3 is likely to see an improvement in the growth pace, again centred on the consumer. However, business investment; dwelling investment; and public demand will, at best, be neutral for growth (and more likely will subtract from it). Having been a negative through the first half, inventories should provide a positive contribution. To our 2.5% forecast, the Atlanta and NY Federal Reserve 'nowcasts' imply moderate downside risks.

US growth depends on consumer



Data calendar

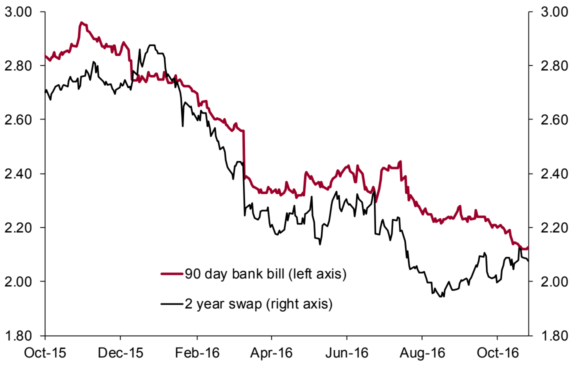
		Last	Market median	Westpac forecast	Risk/Comment
Tue 25					
Eur	ECB president Draghi speaking	–	–	–	Speaking at DIW Institute in Berlin.
Ger	Oct IFO business climate	109.5	109.6	–	Expectations remain materially below current conditions.
UK	BoE Governor Carney speaking	–	–	–	Speaking to the House of Lords on Brexit and the BOE.
US	Aug S&P/C-S 20 city house prices	-0.01%	0.15%	–	Both key measures of price activity...
	Aug S&P/CS home price index %yr	5.0%	5.1%	–	... continue to point to sustained, solid momentum.
	Oct conf. board consumer confidence	104.1	101.0	–	Solid, above the long-run average.
	Oct Richmond Fed manufacturing index	-8	-4	–	Points to softness in regional manufacturing activity.
	Fedspeak	–	–	–	Lockhart speaks on lending and investing in community development.
Wed 26					
Aus	Q3 CPI	0.4%	0.5%	0.9%	Fruit & veg, housing & recreation adding to a seasonally strong quarter.
	Q3 underlying CPI (avg RBA measures)	0.5%	0.4%	0.4%	The six month annualised pace lifts but still sub 2%yr.
Chn	Oct Westpac-MNI China Consumer Sent'	115.2	–	–	A better month but still below average, weather impacted in Aug.
US	Sep wholesale inventories (prov.)	-0.2%	0.1%	–	Modest end demand means inventories to remain a risk to growth.
	Oct Markit services PMI (prov.)	52.3	52.3	–	Moderate momentum continues.
	Sep new home sales	-7.6%	-1.2%	–	Remain highly volatile, but industry optimistic given jobs and rates.
Thu 27					
NZ	Sep trade balance, $m	-1,264	-1,150	-1,400	Plane import expected in the month to drive deterioration in trade deficit.
Aus	Q3 export goods price index	1.4%	2.0%	2.0%	Export prices up for a 2nd qtr, on commodity price bounce.
	Q3 import goods price index	-1.0%	-0.8%	-1.5%	Import prices down for a 4th qtr, lower energy & higher AUD.
Chn	Sep industrial profits %yr	–	–	–	Commodity and steel prices aiding profitability in industrial sector.
Eur	Sep M3 money supply %yr	5.1%	5.0%	–	Credit detail also due.
UK	Q3 GDP	0.7%	0.3%	0.3%	Activity has slowed following the referendum, esp. in the service sector.
US	Sep durable goods orders (prov.)	0.1%	0.1%	–	Weak investment an enduring problem for US economy.
	Initial jobless claims	260k	–	–	At historically weak level.
	Sep pending home sales	-2.4%	1.2%	–	A little weaker than existing sales recently, which it leads.
	Oct Kansas City Fed manufacturing index	6	–	–	Sep improvement points to stabilisation after prolonged weakness.
Fri 28					
Aus	Q3 PPI	0.1%	–	0.8%	Upstream price pressures very subdued rising just 1.0%yr.
Eur	Oct business climate indicator	0.45	0.49	–	Has been relatively steady in recent months.
	Oct economic confidence	104.9	104.9	–	Labour market continues to aid consumer.
Ger	Oct CPI (provisional)	0.1%	0.1%	–	Prices were flat in Sep.
US	Q3 employment cost index	0.6%	0.6%	0.6%	Steady growth continues; no sign of a wages breakout.
	Q3 GDP, annual'sd	1.4%	2.5%	2.5%	Growth to improve, but nowhere near that previously anticipated.
	Oct Uni. of Michigan sentiment, final	87.9	88.1	–	Broadly stable of late at robust level.

New Zealand forecasts

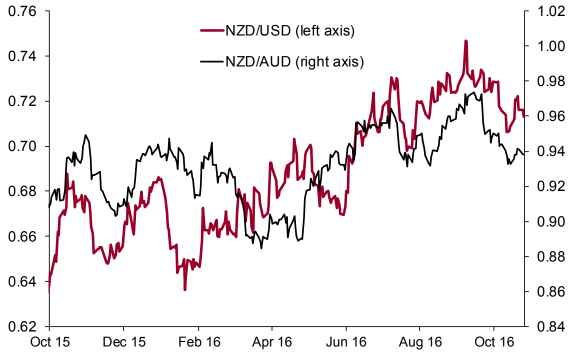
Economic Forecasts	March years				Calendar years			
% change	2015	2016	2017f	2018f	2014	2015	2016f	2017f
GDP (Production) ann avg	3.6	2.5	3.8	3.1	3.8	2.5	3.6	3.4
Employment	3.2	2.0	3.9	1.6	3.6	1.4	4.7	2.0
Unemployment Rate % s.a.	5.4	5.2	5.0	4.5	5.5	5.0	5.1	4.6
CPI	0.3	0.4	1.2	1.7	0.8	0.1	1.0	1.7
Current Account Balance % of GDP	-3.5	-3.1	-3.3	-3.8	-3.2	-3.4	-3.1	-3.9

Financial Forecasts	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.00	2.10	2.10	2.10	2.10	2.00
5 Year Swap	2.30	2.40	2.50	2.50	2.50	2.50
10 Year Bond	2.50	2.50	2.60	2.70	2.80	2.80
NZD/USD	0.70	0.69	0.67	0.65	0.63	0.62
NZD/AUD	0.95	0.95	0.94	0.94	0.93	0.91
NZD/JPY	72.1	69.7	69.7	68.3	66.2	65.7
NZD/EUR	0.64	0.64	0.64	0.63	0.61	0.60
NZD/GBP	0.56	0.56	0.55	0.53	0.51	0.51
TWI	75.7	75.2	73.8	72.2	70.3	69.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 25 October 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.00%	2.00%
30 Days	2.13%	2.18%	2.20%
60 Days	2.13%	2.20%	2.21%
90 Days	2.13%	2.19%	2.23%
2 Year Swap	2.08%	2.09%	2.02%
5 Year Swap	2.31%	2.26%	2.17%

NZ foreign currency mid-rates as at Tuesday 25 October 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7130	0.7180	0.7248
NZD/EUR	0.6557	0.6419	0.6456
NZD/GBP	0.5835	0.5788	0.5588
NZD/JPY	74.31	74.15	73.26
NZD/AUD	0.9382	0.9437	0.9509
TWI	77.03	76.91	77.04

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015	2016f	2017f
Australia						
Real GDP % yr	3.6	2.0	2.7	2.4	3.0	3.0
CPI inflation % annual	2.2	2.7	1.7	1.7	1.5	1.8
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.8
Current Account % GDP	-4.4	-3.4	-3.0	-4.7	-3.3	-4.2
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.5	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.2	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.9	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.6	-2.7	-2.6
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.6	0.5
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.6	1.2
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.6	0.6
China						
Real GDP %yr	7.7	7.7	7.3	6.9	6.5	6.2
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.7	3.7	3.9
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.2	3.4
Forecasts finalised 14 October 2016						

Interest Rate Forecasts	Latest	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.74	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.29	2.20	2.20	2.30	2.45	2.65	2.75	2.80
International								
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125	1.125	1.375
US 10 Year Bond	1.75	1.70	1.80	2.00	2.10	2.25	2.35	2.40
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40

Exchange Rate Forecasts	Latest	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
AUD/USD	0.7630	0.74	0.73	0.71	0.69	0.68	0.68	0.68
USD/JPY	104.20	103	101	104	106	105	106	106
EUR/USD	1.0900	1.10	1.07	1.05	1.04	1.03	1.03	1.03
AUD/NZD	1.0640	1.06	1.06	1.06	1.06	1.08	1.10	1.11

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