

Weekly Commentary

26 April 2016



When doves cry

The highlight of the coming week will be the RBNZ's April interest rate review. We expect that the RBNZ will keep the OCR at the current record low of 2.25%, but that the accompanying policy statement will strengthen the easing bias the RBNZ espoused in March. However, the RBNZ is facing an increasingly nuanced balancing act. The housing market has picked up and inflation is showing signs of bottoming out. But at the same time, the NZD continues to defy gravity and mortgage rates have not fallen as far as expected following March's OCR cut. Complicating matters is that simmering away in the background are worrying signs for financial stability.

In March, the RBNZ cut the OCR and indicated that "further policy easing may be required." We had expected that we would see one more OCR reduction, probably in June. But there has always been some question around the timing of that cut.

Developments over the past few weeks have generally been inflation positive. In particular, while inflation remains low at an annual rate of 0.4%, the details of the March outturn were a little stronger than the RBNZ anticipated. There has been some pick up in the non-tradable components of inflation, and core inflation measures have been stable or a little higher than last year. Barring further significant volatility in oil prices, it appears increasingly likely that inflation has bottomed out.

On top of this, as we've previously discussed, housing market data for March were very strong. The REINZ house sales data showed that the Auckland market has exploded back into life, with prices almost back to the levels seen prior to last year's changes in lending restrictions. Prices in the rest of the country have also continued to march higher.

But balanced against the above conditions have been a couple of key developments. First, is the continued strength in the NZD, which will tend to suppress inflation.

Second, the RBNZ has not achieved the reduction in mortgage rates that it sought, with only modest declines following the March OCR reduction. However, global credit markets are currently calming, meaning bank funding costs may soon fall. And, given the recent heat in the housing market, it's debatable how much lower mortgage rates actually need to go.

Weighing up these factors, we're not convinced that the hurdle for an April cut has been cleared, particularly considering that the financial market developments driving the need to cut could prove fickle.

In addition, there is a more tactical reason why June is still looking like the more likely date for the next OCR reduction. Cutting next week would take the OCR down to the previously-forecast low point of 2%. Thus the Reserve Bank's policy guidance will reveal whether or not they now expect the OCR to fall below 2%. If the RBNZ signals no further OCR reduction, the exchange rate will rise. Conversely, cutting the OCR while maintaining an easing bias would be signalling that the RBNZ now intends to cut the OCR below 2%. This would be a very big step, and not one we believe that the RBNZ is ready to take just yet.

We therefore conclude that the RBNZ is more likely to remain on hold – we assign roughly 25% odds to a cut.

When doves cry continued

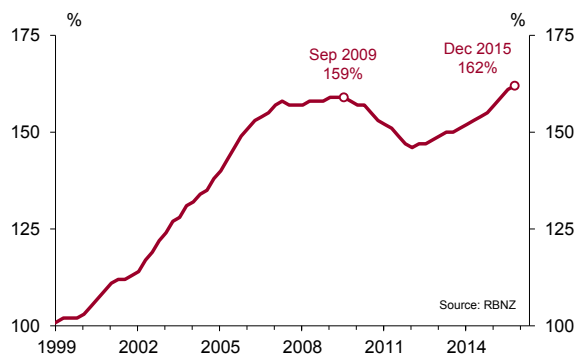
That said, we certainly expect the RBNZ's commentary to acknowledge the balance of recent developments, and to provide a firmer easing signal – perhaps the RBNZ will describe further easing as “likely in the coming months”, to keep markets focussed on falling interest rates.

And while we are forecasting only one more OCR reduction, we must admit that the risk of the OCR eventually falling below 2% is mounting.

Complicating matters for the RBNZ are growing household debt levels. The current extended period of low interest rates has boosted demand in the economy, making it less expensive for households to fund consumption spending, and pushing asset prices (particularly house prices) higher. However, this boost to demand is occurring via households' increased appetite for debt. As discussed in our recent report,¹ the amount of debt households are carrying has risen to levels equivalent to 162% of their annual disposable incomes. That's higher than the peaks reached prior to the financial crisis.

With interest rates currently very low, debt is serviceable for now. However, the increase in debt levels raises important concerns for the economy over the coming years. Most notably, the eventual repayment of debt will be a drag on growth. In addition, higher debt levels mean the economy is more vulnerable to unfavourable developments in economic or financial conditions – including possible

Household debt as a share of disposable incomes (incl. investment housing)



future increases in interest rates, as households have less of a buffer from changes in economic conditions.

For the RBNZ, these conditions will require a delicate balancing act between its monetary policy and macroprudential aims. In terms of monetary policy, the RBNZ is bound to keep the OCR at low levels due to the weakness in inflation. However, this will inevitably lead to higher asset prices and debt levels. Consequently, we're unlikely to see any easing in macroprudential settings anytime soon. In fact, there is a risk that we could see some tightening in macroprudential settings in coming years.

¹ Available here: <http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Household-debt-levels-now-higher-than-before-the-financial-crisis-April-2016.pdf>

Fixed vs Floating for mortgages

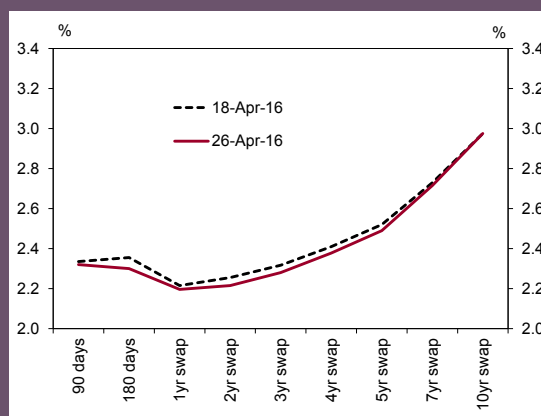
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but even those looking to fix may want to wait a while longer.

For borrowers with a deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years.

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



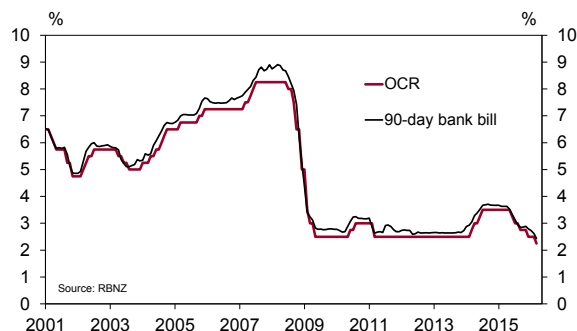
The week ahead

RBNZ Apr OCR review

Apr 28, Last: 2.25%, Westpac f/c: 2.25%, Mkt f/c: 2.25%

- Since March, economic developments have been mostly inflation-positive while financial market developments have been inflation-negative. The balance between the two leans in favour of further OCR reductions this year.
- However, we think that tactical considerations argue against a cut as soon as this month. Unless the case for further action is overwhelming, the RBNZ has tended to defer making judgements about a change of stance until a full forecast round and Monetary Policy Statement.
- The RBNZ's statement is likely to signal that further easing is likely, with some pointed comments about the strength of the exchange rate in particular

NZ OCR and 90-day rate

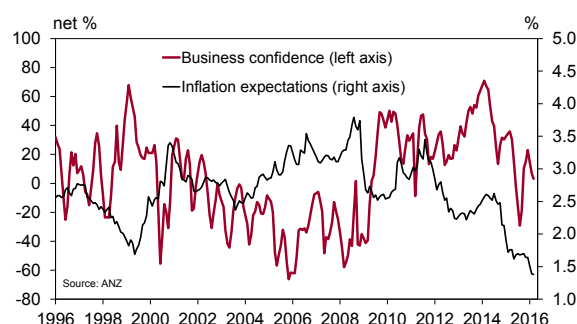


NZ Apr business confidence

Apr 29, Last: 3.2

- Business sentiment weakened further in March, although firms were actually slightly more upbeat about their own prospects. The agricultural sector is particularly downbeat as a result of low dairy prices, while the construction and services sectors have remained positive.
- The RBNZ's surprise OCR cut came in the midst of the March survey period, so its impact on confidence is likely to be more fully reflected in the April survey.
- Inflation expectations for the year ahead remained at a record low in March. This measure tends not to move much outside of reacting to CPI releases. Next month's survey will reveal how firms reacted to the slightly higher than expected, but still very weak, inflation print in the March quarter.

NZ business confidence and inflation expectations

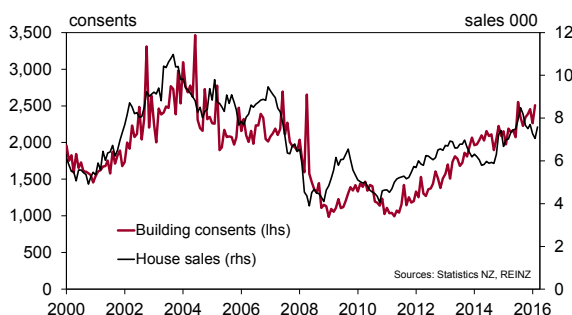


NZ Mar building consents

Apr 29, Last: 10.8%, Westpac f/c: -4.0%

- Last month saw an exceptionally strong rise in residential building consents, led by a surprising surge in Canterbury and a lump in Auckland multi-unit consents.
- We expect some consolidation this month in overall residential consents, particularly as Canterbury rebuild-related consents return to more moderate levels.
- Auckland consents will likely fall slightly after last month's bump in multi-unit consents, but the growth path will remain firmly up, consolidating February's 23% year-on-year growth.

NZ housing activity



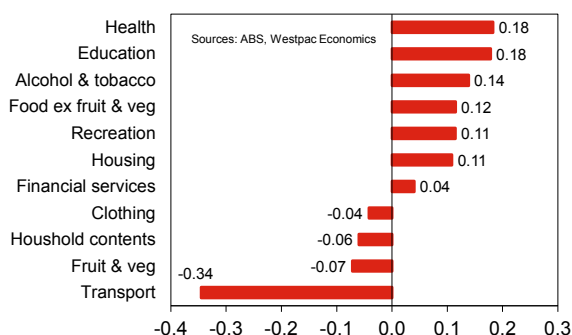
Aus Q1 Consumer Price Index

April 27, Last: 0.4% (avg RBA core 0.5%), WBC f/c: 0.4% (0.6%)

Mkt f/c: 0.2% (0.5%), Range: 0.0% to 0.5% (0.4% to 0.6%)

- The headline CPI lifted 0.4% in Q4 compared to Westpac's and the market's 0.3% forecasts. The annual rate is reported as 1.7%yr compared to 1.5%yr in Q3. The core measures, which are seasonally adjusted and exclude extreme moves, rose 0.5%qtr on par with the market's expectation.
- Westpac is forecasting a modest 0.4%qtr rise (1.9%yr) in the headline CPI in the March quarter. March is a seasonally softer quarter and in 2016 will have the added impact of falling petrol and fruit prices.
- Core inflation is forecast to increase by 0.6%qtr, which will see annual core CPI inflation hold around the bottom of the RBA's inflation target band.

Contributions 2016Q1 CPI forecast



The week ahead

Aus Q1 import price index

Apr 28, Last: -0.3%, WBC f/c: -2.5%
Mkt f/c: -0.9%, Range: -2.5% to 0.0%

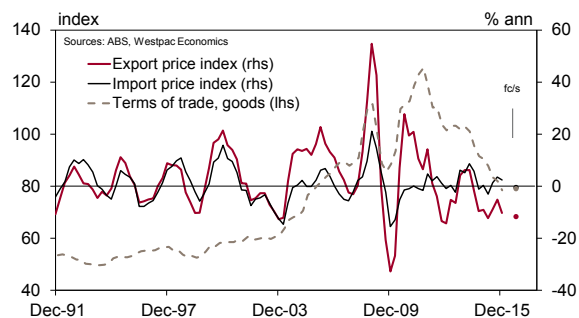
- The import price index is forecast to fall by 2.5% in the March quarter to be 0.5% lower than a year ago.
- Sharply lower energy prices is the key source of lower import prices, with oil declining by 20% in the quarter and falling by 36% over the past year.
- The currency was not a significant factor in the quarter, with the TWI advancing by only 0.6%, to 61.9. However, over the past year, the currency weakened, placing modest upward pressure on import prices.

Aus Q1 export price index

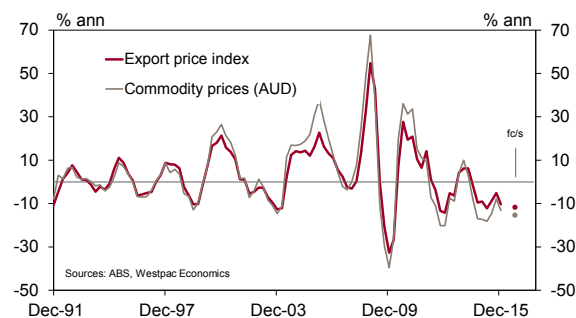
Apr 28, Last: -5.4%, WBC f/c: -2.3%
Mkt f/c: -1.5%, Range: -2.9% to 4.0%

- Export prices have been hit by the slump in global commodity prices, a trend that carried into 2016.
- The export price index is forecast to fall by 2.3% in the March quarter, to be 11.7% lower than a year ago.
- Commodity prices fell by 2.5% in US dollar terms in the opening quarter of 2016 and fell 22% over the past year. While the Australian dollar was flat in the quarter, at US72¢.
- The terms of trade for goods, on these estimates, edges 0.2% higher in the quarter but is still 9.5% lower over the past year.
- Note, quarterly movements in the export price deflator (BoP) and the export price index can diverge, as occurred in Q1 2015 - with outcomes of -2.9% and -1.3% respectively.

Import & export prices (excluding services)



Commodity prices & export price index



Aus Mar private sector credit

Apr 29, Last: 0.6%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.5% to 0.6%

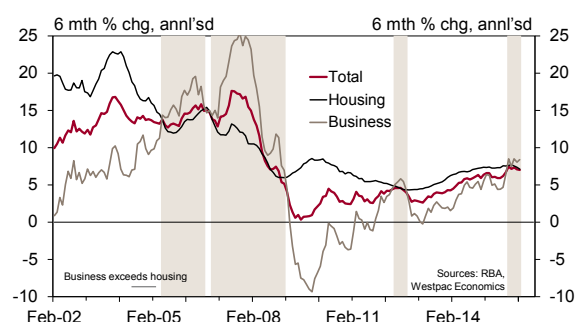
- Credit to the private sector is beginning to lose a little momentum as lending conditions tighten somewhat. For March, we expect credit to grow by 0.5%, matching the average of the past four months, but down from 0.7% on average for the four months to October.
- Housing has cooled as lending conditions have tightened, including a rise in mortgage rates. In February, housing credit grew by 0.5%, 7.3%/yr, moderating from a 7.8% annualised pace in the three months to October.
- As to business credit, we anticipate a more modest gain in March than the 0.7% February result given mixed commercial finance outcomes of late. This contrasts to the 0.9% average gain for the four months to October, which was inflated by valuation effects associate with the falling currency.

Chn Apr Westpac-MNI Consumer Sentiment

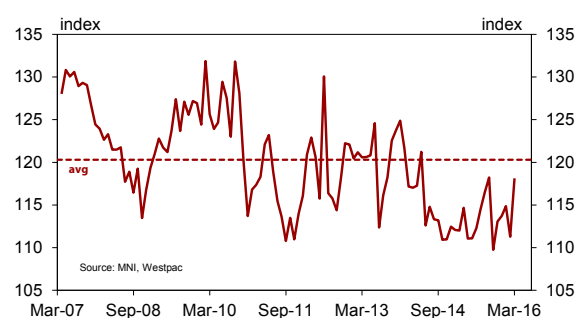
Apr 27, Last: 118.1

- The **Westpac MNI China Consumer Sentiment Indicator** posted a solid recovery in March, rising 6.8pts to 118.1, up from 111.3 in February. The lift takes the Index back near its most recent high in September and to the second highest level since May 2014. That said, the average read over the last 3mths is still 4.3% below the average over the survey's 9 year history.
- The April survey - in the field April 1-15 - follows a better run of economic data (although at 6.7%, Q1 GDP growth was on expectations), and more signs of a broadening but still very lopsided housing upswing. With the Q1 detail in the national accounts again highlighting the importance of the consumer to China's growth at the moment, sentiment is a critical barometer of economic momentum

Credit momentum



Westpac MNI China CSI



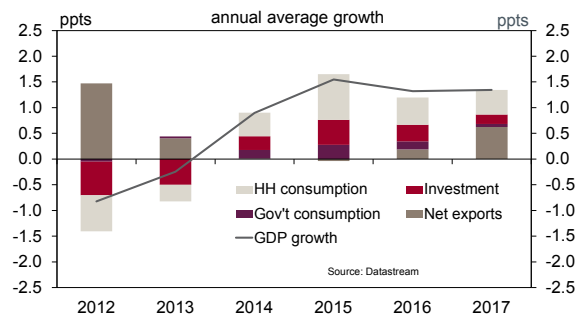
The week ahead

Q1 Euro Area GDP

Apr 29, Last: 0.3%, WBC 0.3%

- The ECB's 'decisive' policy action has clearly had a noticeable impact on activity.
- Yet weak global growth and an unwillingness amongst businesses to invest in greater capacity has continued to hold back momentum.
- As we head into 2016, a greater willingness to invest needs to be seen amongst firms, with flow-on consequences for employment.
- If as we expect this does not happen, then growth is likely to disappoint - we expect an annual gain of 1.3% against 2015's 1.6% outcome.
- For Q1, we expect a gain of 0.3%. The market is a little more positive at 0.4%.

Euro Area growth modest; risk to downside

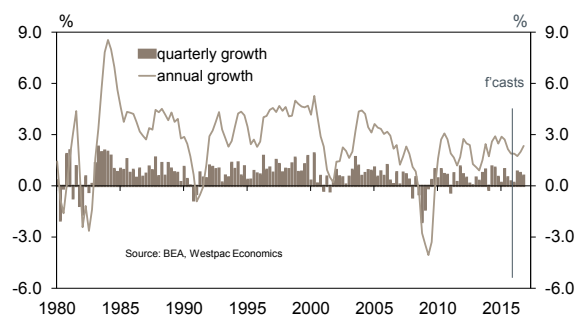


Q1 US GDP

Apr 28, Last: 1.4% (annualised), WBC 0.7%

- Even after the upward revision in the second estimate, Q4 GDP growth was a soft outcome. Growth in private domestic demand was better, albeit not stellar at 1.6%.
- Of the components of domestic demand, business investment was the weakest, -2.1% annualised. Government spending was flat; while household consumption slowed to 2.4% annualised compared to 3.3% in the prior six months.
- Partial data for Q1 unfortunately points to a further deterioration, principally due to ongoing weakness in investment, and a clear deceleration in household consumption growth.
- All told, we expect a 0.7% annualised gain in Q1; annual growth will be broadly unchanged at 2.0%/yr.

US GDP outlook depends on consumer

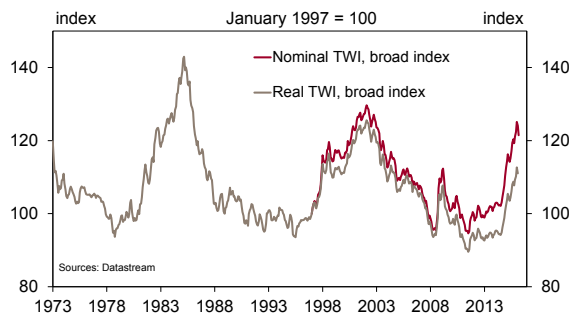


March US FOMC meeting

Apr 26-27, Last: 0.375%, WBC 0.375%

- These are testing times for the FOMC. The labour market is unquestionably strong - robust job growth is continuing even with the unemployment rate at full employment levels. Underlying inflation is also giving support to further rate hikes, the core CPI printing at 2.2%/yr in March.
- Against progress on both mandates stands the impact of weak global growth and associated USD strength. Initially the impact of both was confined to manufacturing, but the ISM's have since evinced a deterioration in services as well.
- The FOMC is acutely aware of the risks to consumption and investment that weak global growth pose. Their prioritisation of these risks over employment and inflation comes as a result of the asymmetric capability of policy near the lower bound. More time is necessary for growth to firm (again) and global risks to recede before the normalisation process can continue.

USD gains on global risks, liquidity & rates



Data calendar

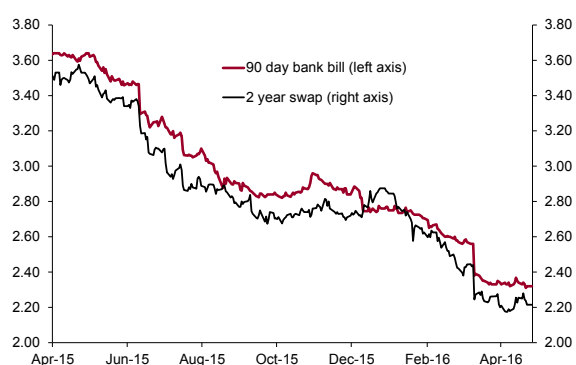
		Last	Market median	Westpac forecast	Risk/Comment
Mon 25					
Aus/NZ	ANZAC Day public holiday	-	-	-	Lest we forget.
Ger	Apr IFO business climate survey	106.7	107.0	-	Confidence in outlook is flagging.
US	Mar new home sales	2.0%	1.6%	-	Housing sales (existing and new) both seeing trend flatten.
	Apr Dallas Fed index	-13.6	-9.0	-	Manufacturing weak.
Tue 26					
US	Mar durable goods orders	-3.0%	1.9%	-	Core orders to remain weak.
	Feb S&P/CS home price index	0.8%	0.8%	-	Annual growth solid around 5-6%/yr.
	Apr Markt service PMI	51.3	52.5	-	Services also being impacted by USD and soft global demand.
	Apr consumer confidence index	96.2	95.6	-	Conference board measure.
	Apr Richmond Fed index	22	10	-	Surged higher last month, risk of some correction.
Wed 27					
NZ	Mar trade balance, \$m	339	401	550	Seasonal peak for export volumes but prices remain soft.
Aus	Q1 CPI	0.4%	0.2%	0.4%	Falling fuel & fruit added to a seasonally soft quarter. However, a weaker
	Q1 average core CPI measures	0.5%	0.5%	0.6%	AUD is still being passed through to clothing & household goods prices.
Chn	Mar industrial profits %yr	-4.7%	-	-	Volatile and weak, but coming off lows.
	Apr Westpac-MNI China Consumer Sent.	118.1	-	-	Bounced in March but volatile and (mostly) weak over the last 12mths.
Eur	Mar M3 money supply %yr	-	-	-	Credit data also due.
UK	Q1 GDP	0.6%	0.4%	0.4%	Some softening in activity has been seen, especially in manufacturing.
US	Mar pending home sales	3.5%	0.2%	-	Sales trend flattening across US housing market.
	FOMC policy decision, midpoint	0.375%	0.375%	0.375%	Global uncertainty offsets jobs and inflation - for now.
Thu 28					
NZ	RBNZ Official Cash Rate announcement	2.25%	2.25%	2.25%	Housing market balanced against the NZD; easing bias remains.
Aus	Q1 import price index	-0.3%	-0.9%	-2.5%	Import prices led lower by tumbling global oil prices.
	Q1 export price index	-5.4%	-1.5%	-2.3%	Export prices hit by falling commodity prices.
Eur	Apr economic confidence	103.0	-	-	Across all indicators...
	Apr business climate indicator	0.11	-	-	... there has been a...
	Apr consumer confidence	-9.3	-	-	... clear loss of optimism over outlook.
Ger	Apr CPI	0.8%	-0.1%	-	Even with historically low unemployment, inflation nonexistent.
UK	Apr Nationwide house prices	0.8%	0.4%	-	House price growth likely to be dampened by stamp duty increase.
US	Initial jobless claims	247k	-	-	Jobless claims have fallen to a 42 year low.
	Q1 GDP	1.4%	0.7%	0.7%	Soft consumer the worry for FOMC.
	Apr Kansas City Fed index	-6	-	-	Lingering at low levels.
Fri 29					
NZ	Mar building consents	10.8%	-	-4.0%	Some consolidation expected after exceptional growth last month.
	Apr business confidence	3.2	-	-	Weakness in the rural sector, domestically focused sectors firmer.
Aus	Q1 PPI	0.3%	-	-	1.9%/yr in 2015, imported at 7.6% (lower AUD), domestic subdued 1.3%.
	Mar private sector credit	0.6%	0.5%	0.5%	In Feb, 6.6%/yr. Housing sector cooling, business credit robust gains.
	RBA Assist. Governor Financial Markets	-	-	-	Guy Debelle, ACI World Congress, Jakarta, topic tba, 1:45 pm AEST.
Eur	Mar unemployment rate	10.3%	10.3%	10.3%	Very (very) slow progress being made.
	Apr CPI %yr	-0.1%	0.1%	-	Ex food and energy, inflation still well below target at 1.0%/yr.
	Q1 GDP	0.3%	0.4%	0.3%	Consumer optimism coming under pressure; investment?
UK	Apr GfK consumer sentiment	0	-1	-	Upcoming Brexit vote could weigh on confidence.
	Mar net mortgage lending £bn	3.6b	3.7b	-	Low mortgage rates are supportive...
	Feb mortgage approvals	73.9k	74.5k	-	...but stamp duty increases may dampen demand.
US	Q1 employment cost index	0.6%	0.6%	0.6%	Wages growth stuck in a rut....
	Mar personal income	0.2%	0.3%	0.3%	... total personal income follows suit.
	Mar personal spending	0.2%	0.2%	0.3%	Feels like it has been too weak; a little more momentum come March?
	Mar PCE deflator	-0.1%	0.1%	0.2%	Core pressures robust, seeing annual growth near target.
	Apr ISM Milwaukee	57.8	-	-	Has risen strongly in recent months.
	Apr Chicago PMI	53.6	53.0	-	A number of factor sector gauges have softened recently.
	Apr Uni. of Michigan sentiment	89.7	90.2	-	Uni. Of Michigan measure.
	Fedspeak	-	-	-	Kaplan speaks in London.
Sun 1					
Chn	Apr manufacturing PMI	50.2	50.2	-	Surprised in March; Apr to see consolidation.
	Apr non-manufacturing PMI	53.8	-	-	Employment crucial for aggregate growth.

New Zealand forecasts

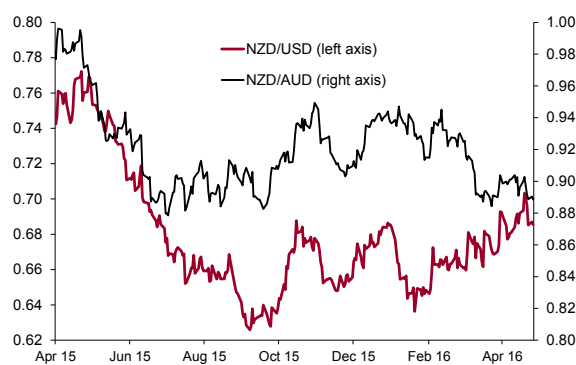
Economic Growth Forecasts	March years				Calendar years				
	% change	2014	2015	2016f	2017f	2014	2015	2016f	2017f
GDP (Production) ann avg		2.7	3.6	2.4	2.8	3.7	2.5	2.8	2.6
Employment		3.8	3.2	1.4	2.5	3.6	1.4	2.7	1.5
Unemployment Rate % s.a.		6.0	5.8	5.8	5.6	5.8	5.3	5.6	5.9
CPI		1.5	0.3	0.3	1.1	0.8	0.1	0.7	2.2
Current Account Balance % of GDP		-2.5	-3.4	-3.2	-3.4	-3.1	-3.1	-3.4	-3.7

Financial Forecasts	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.10	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.10	2.10	2.10	2.10	2.10	2.10
5 Year Swap	2.60	2.70	2.80	2.90	3.00	3.10
10 Year Bond	3.00	3.10	3.20	3.40	3.50	3.60
NZD/USD	0.65	0.65	0.62	0.62	0.62	0.62
NZD/AUD	0.88	0.88	0.87	0.87	0.86	0.85
NZD/JPY	71.5	72.8	71.3	72.1	74.2	74.4
NZD/EUR	0.60	0.60	0.58	0.58	0.58	0.57
NZD/GBP	0.47	0.47	0.45	0.45	0.45	0.44
TWI	69.3	69.5	67.4	67.3	67.3	66.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 26 April 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.26%	2.26%	2.30%
60 Days	2.31%	2.31%	2.32%
90 Days	2.32%	2.33%	2.34%
2 Year Swap	2.22%	2.19%	2.26%
5 Year Swap	2.49%	2.46%	2.58%

NZ foreign currency mid-rates as at Tuesday 26 April 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6855	0.6809	0.6729
NZD/EUR	0.6084	0.5968	0.6009
NZD/GBP	0.4733	0.4822	0.4721
NZD/JPY	76.25	73.59	76.29
NZD/AUD	0.8886	0.9024	0.8919
TWI	72.48	72.12	71.86

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.5	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	2.1	2.3
Unemployment %	5.3	5.8	6.2	5.8	5.5	5.3
Current Account % GDP	-4.4	-3.4	-3.0	-4.6	-4.3	-3.9
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	2.0	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.3	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.7	4.5
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.7
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.3	1.3
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	2.2	2.2
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	3.9	4.1
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.3	3.5

Forecasts finalised 15 Apr 2016

Interest Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.27	2.30	2.30	2.30	2.30	2.30
10 Year Bond	2.62	2.60	2.75	2.75	2.90	3.10
International						
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125
US 10 Year Bond	1.85	2.00	2.15	2.25	2.50	2.80
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
AUD/USD	0.7754	0.74	0.74	0.71	0.71	0.72
USD/JPY	109.99	110	112	115	117	120
EUR/USD	1.1301	1.09	1.08	1.07	1.06	1.07
AUD/NZD	1.1202	1.14	1.14	1.15	1.15	1.17

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