

Weekly Commentary

26 September 2016



Sticking to the script

The RBNZ left the OCR on hold at its September review, but continued to signal a reduction in coming months. The key question is how far will rates fall? A cut to 1.75% in November is highly likely. But with positive signs for domestic economic activity, there are questions about whether further reductions are required. The missing piece of the picture, however, remains inflation.

The Reserve Bank stuck to the script at its September interest rate review. As expected, the OCR was left on hold at 2%. In addition, the policy guidance section of the media release was identical to August: *“Our current projections and assumptions indicate that further policy easing will be required to ensure that future inflation settles near the middle of the target range. We will continue to watch closely the emerging economic data.”*

“Will be required” is about as strong as the RBNZ’s language gets. It’s a clear signal that, barring major developments, low inflation will prompt the RBNZ to cut the OCR again. We expect this will occur in November when the RBNZ next publishes a full set of projections, with the OCR expected to be cut to a new record low of 1.75%.

The question is whether November will mark the low point in the cutting cycle. The RBNZ’s most recent published interest rate forecast (released in August) straddled the line between one and two more cuts. In other words, they definitely see the need for one more cut, and a further reduction *might* be required. Whether that second cut eventuates will be dependent on how the economy is faring. So how are things shaping up?

Since the RBNZ last published forecasts, GDP figures for the first half of the year have confirmed that the economy has been trucking along broadly as they had assumed.

More importantly, recent data has pointed to a firming in economic conditions through the second half of the year.

Most notably, the past few months have seen a sharp rebound in global dairy prices. Although prices paused for breath at the most recent auction, they are now up 23% since the RBNZ last published its forecasts and a whopping 45% since their low point in February (including a solid lift in the price of whole milk powder). These strong gains in dairy prices have been underpinned by an evolving demand/supply balance. Production has fallen in key producing regions, including New Zealand, Australia and Europe. At the same time, demand in China has firmed.

In response to gains in international prices, Fonterra has upgraded its forecast payout for the coming year to \$5.25/kg (previously \$4.75). We’re a bit more circumspect about the durability of recent prices gains, but have also recently upgraded our payout forecast to \$5/kg. This improvement in dairy prices will obviously be a welcome development for many in rural communities; though after several years of very low returns, many farmers will still find their financial positions squeezed.

We’re also seeing some positive signs for household spending. Through the middle part of the year, there was a pickup in per-capita spending. On top of this, there has been a modest lift in consumer confidence, with the

Sticking to the script continued

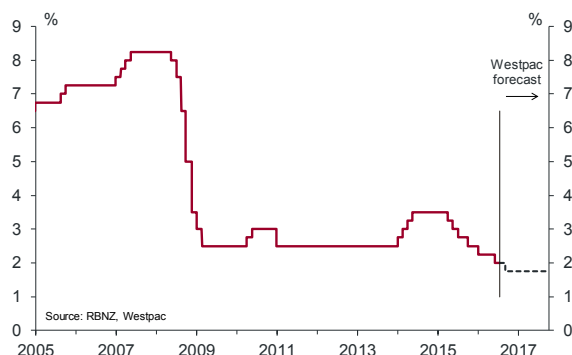
Westpac McDermott-Miller consumer confidence index pushing up in September. In part, this likely to be due to the improvements in dairy prices which will support incomes and spending in rural regions, and which are expected to flow through to stronger spending in the economy more generally.

Finally, net migration has remained very strong, with a net inflow of 69,100 people over the past year. That's providing a powerful shot in the arm for retail spending, with more bodies in stores. We still expect annual net migration to slow gradually in coming years from current record levels. Foreigners who have arrived on temporary work or student visas over the past three years will start to depart. In addition, an improving Australian economy is expected to entice New Zealanders across the Tasman over time. But this will take time, meaning annual net migration will remain at elevated levels for a while yet.

Putting it all together, the activity outlook is looking at least as robust, if not stronger, than it was at the time of the August MPS.

But while activity indicators have remained firm, the bottom line for the RBNZ is still inflation. And that's where the challenge lies. In annual terms, inflation has been below the bottom of the RBNZ's target band for two years now. It is expected to pick up above 1% in coming months as the impact of weaker oil prices abates. However, with the NZ dollar continuing to linger at higher than expected levels, imported inflation is likely to remain subdued for some time.

Westpac OCR forecast



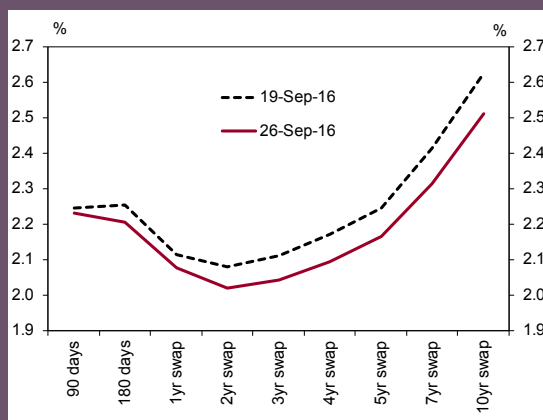
So where does this leave the RBNZ? With inflation likely to pick up and domestic economic conditions firming, the RBNZ is facing an uncomfortably slow return to the inflation target rather than a sustained undershoot. And that calls for incremental moves rather than drastic action. Consequently, a November rate cut followed by an extended pause seems appropriate. But the RBNZ will be wary of shutting the door on future rate cuts, which would risk sending the New Zealand dollar even higher. Crucial to the RBNZ's thinking will be inflation expectations. Consequently, we'll be keeping a close eye on this week's business survey and other indicators ahead of the next interest rate decision.

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



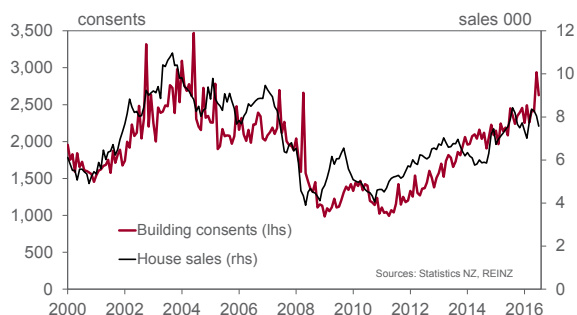
The week ahead

NZ Aug building consents

Sep 30, Last: -10.5%, Westpac f/c: -4.0%

- Residential building consents sank 10.5% in July, but that followed an extraordinary revised estimate of 22% growth in June.
- We expect residential consents to fall back again this month toward the 2,500 mark, which will still be up on the same month a year ago.
- The trend is expected to remain upward, with annual new build residential consents expected to reach nearly 29,400.

NZ housing activity



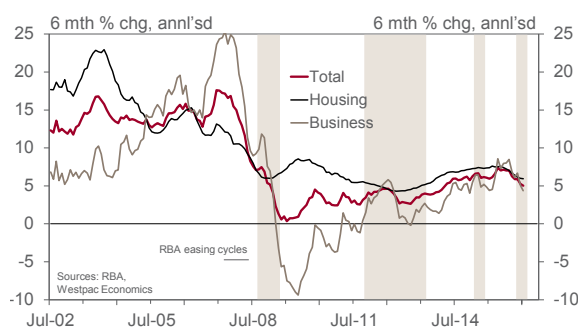
Aus Aug private sector credit

Sep 30, Last: 0.4%, WBC f/c: 0.4%

Mkt f/c: 0.5%, Range: 0.4% to 0.6%

- Credit to the private sector lost momentum over the past year. A 0.6% average pace in Q3 2015 gave way to a 0.5% rate in Q4 2015 and Q1 2016, slowing further to 0.4% in Q2 2016. Key to this slower pace were: tighter lending conditions in the housing market during the second half of 2015; and businesses delaying borrowing plans ahead of the July Federal election.
- In July, credit grew by 0.4%, with housing a soft 0.5% and business credit advancing 0.3%, reversing a 0.2% decline. For August, we expect credit to expand by 0.4%. RBA rate cuts in May and August will provide a boost to housing. That said, the impact may be relatively modest by historical standards, given the late stage of the cycle. On business, recent weakness in commercial finance points to the soft spot in business credit extending for another month.

Credit: a loss of momentum

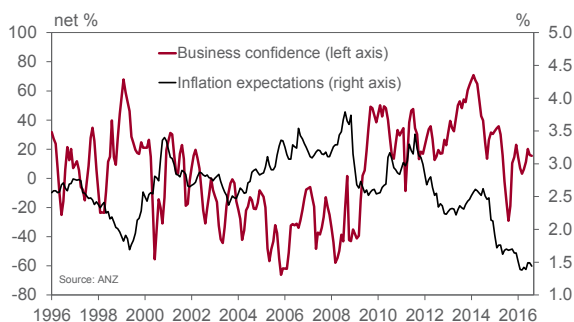


NZ Sep business confidence

Sep 30, Last: 15.5

- Business confidence held steady in August and the underlying activity metrics ticked up, suggesting that growth remained solid in Q3 following 0.9% growth in both Q1 and Q2.
- Confidence in the beleaguered agricultural sector perked up in August off the back of strong gains in dairy prices. This improvement in confidence should have further to run, reflecting additional price gains and an upgrade to Fonterra's milk price forecast for 2016/17.
- Despite solid growth, inflation pressures outside of housing and construction have been subdued. In August, the survey's two inflation gauges fell, with firms' pricing intentions hitting a four-year low. Further weakness in inflation indicators will increase the Reserve Bank's angst about returning inflation to 2% in a timely fashion.

NZ business confidence and inflation expectations

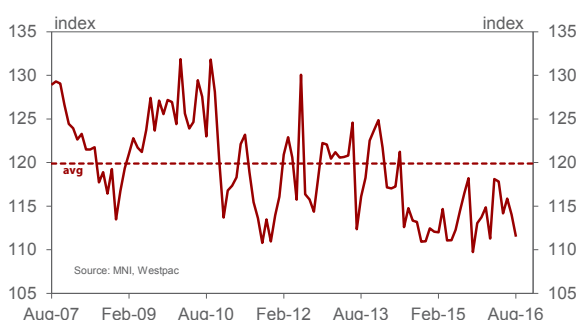


Chn Sep Westpac-MNI Consumer Sentiment

Sep 28, Last: 111.5

- The **Westpac-MNI China Consumer Sentiment** Indicator fell a further 2.2% in August to 111.5, down from 114.0 in July and 115.9 in June. The Indicator is now back near its most recent low in February, and close to the 9 year low seen in October 2015. Note that the August survey was likely affected by weather events, with flooding affecting 24 of China's 36 provinces.
- The September survey was in the field in the first half of the month. The economic data flow has been a touch better over the last month, with manufacturing surveys showing a slight lift and trade; industrial production; retail sales and credit data all posting slight upside surprises. Housing markets also showed renewed momentum. However, continued weakness in the CPI highlights that material slack remains in the economy.

Westpac MNI China CSI



The week ahead

US Aug personal income and spending

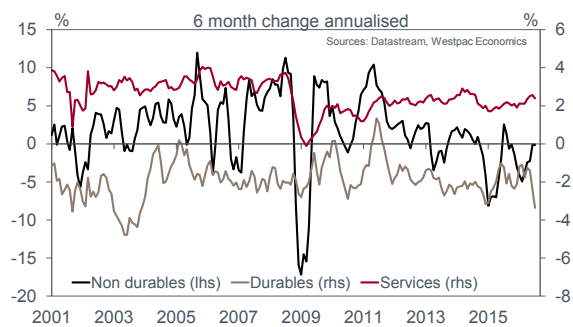
Sep 30, personal income Last: 0.4%, WBC 0.3%

Sep 30, personal spending Last: 0.3%, WBC 0.2%

Sep 30, PCE deflator Last: 0.0%, WBC 0.2%

- Increased participation over the past year has helped to moderate wage pressures. However, July still saw a 0.4% gain, leaving annual growth at a healthy 3.3%yr. Come August, income growth is likely to moderate to 0.3% but annual growth will be sustained near its Jul level. Confidence and wealth are also supportive of marginal consumption. Yet, as per August retail sales, households continue to show a restrained approach to spending. Gains for services are likely to mitigate some of the softness in goods consumption, but spending growth will still slow to 0.2%. Inflation has continued to disappoint, principally due to the impact of energy prices and the USD. But underlying growth in service prices remains robust. In August, expect headline and core prices to both rise around 0.2%.

Durables/nondurables offset services



Data calendar

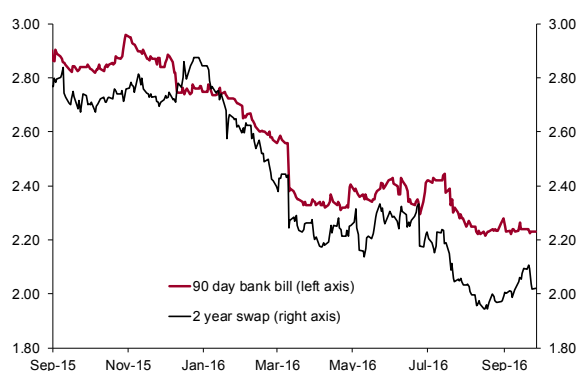
		Last	Market median	Westpac forecast	Risk/Comment
Mon 26					
NZ	Q3 Westpac-MM employment confidence	101.5	-	-	Concerns around job security saw confidence nudge down in Q2.
	Aug trade balance, \$mn	-433	-735	-730	Seasonal drop in dairy and meat exports to underpin monthly deficit.
Eur	ECB President Draghi	-	-	-	Speaking in front of European Parliament Economic Affairs Committee.
Ger	Sep IFO business climate survey	106.2	106.2	-	Disparity between current conditions and confidence persists.
US	Aug new home sales	12.4%	-8.8%	-7.0%	July surge to (at least) partially reverse.
	Sep Dallas Fed index	-6.2	-3.0	-	Employment and capex expectations fell sharply in August.
	Fedspeak	-	-	-	Tarullo on stress testing; Kaplan Q&A.
Tue 27					
Chn	Aug industrial profits, %yr	11.0%	-	-	Commodity prices supportive, but modest growth to continue.
Eur	Aug M3 money supply, %yr	-	-	-	Credit data also due.
US	Jul S&P/CS home price index, %yr	5.1%	5.0%	-	House price gains continue at robust pace.
	Sep Markt service PMI (flash)	51.0	51.0	-	ISM and Markit measures both fell sharply in August.
	Sep consumer confidence	101.1	98.5	-	Remains a little above long-run average. Conference Board measure.
	Sep Richmond Fed index	-11	-2	-	Subdued but some bounce expected after last month's sharp fall.
	Fedspeak	-	-	-	Vice Chair Fischer on "Why Study Economics?".
Wed 28					
Aus	RBA Assist Governor, Financial System	-	-	-	Malcolm Edey, AFR Retail Summit, Melbourne, 10:20am.
Chn	Sep Westpac-MNI China Consumer Sent.	111.5	-	-	Weakness aggravated by weather events in August.
UK	Sep Nationwide house prices	0.6%	-	-	Housing demand has softened, but limited supply supporting prices.
US	Aug durable goods orders	4.4%	-1.1%	-2.2%	Total bounced in July; to partially reverse in August. Core still weak.
	FOMC Chair Yellen	-	-	-	Testifies before House Panel on Bank Supervision.
	Fedspeak	-	-	-	Bullard and Evans.
Thu 29					
Eur	Sep economic confidence	103.5	-	-	Sustained by ECB...
	Sep consumer confidence (final)	-8.5%	-	-	... and slow gains for labour market.
Ger	Sep CPI, %yr	0.3%	0.5%	-	Recent weak monthly outcomes hindering upward trend.
UK	Aug mortgage approvals	60.9k	59.8k	-	Approvals have eased off & the housing market has softened.
US	Aug wholesale inventories	0.0%	0.0%	-	Remains a risk for growth through H2 2016.
	Q2 GDP (final)	1.1%	1.3%	1.2%	Little change anticipated in third estimate.
	Initial jobless claims	252k	-	-	Remain at historically low level.
	Fedspeak	-	-	-	Mester; George; Harker; Lockhart; Powell and Kashkari.
	Aug pending home sales	1.3%	-0.1%	-	Has been a little weaker than existing sales, which it leads.
Fri 30					
NZ	Aug building permits	-10.5%	-	-4.0%	Further moderation expected after very strong June result.
	Sep ANZ business confidence	15.5	-	-	Points to continued firm growth, but limited pressure on prices.
Aus	Aug private sector credit	0.4%	0.5%	0.4%	Momentum slowed around Federal election time, centred on business.
Chn	Sep Caixin manufacturing PMI	50.0	50.1	-	Caixin and NBS PMI narrative in sync: momentum absent.
	Q2 current account balance	59.4	-	-	External demand soft; but Chinese consumers' import demand on rise.
Eur	Aug unemployment rate	10.1%	10.0%	-	Still very high, and taking a long time to come down.
	Sep CPI %yr (flash)	0.2%	0.3%	-	Core inflation better at 0.8%yr, but still way below target.
UK	Sep GfK consumer sentiment	-7	-4	-	Despite post-Brexit fall, confidence remains at firm levels.
	Q2 GDP (final)	0.6%	0.6%	0.6%	Growth was firm ahead of the Brexit vote.
	Q2 current account balance, £bn	-32.0	-31.0	-	Lower GDP growth will narrow the deficit in time.
US	FOMC Chair Yellen	-	-	-	Address to Minority Banking Conference via video link.
	Aug personal income	0.4%	0.2%	0.3%	Wages slowly gaining traction...
	Aug personal spending	0.3%	0.2%	0.2%	... confidence and wealth also supportive...
	Aug PCE deflator	0.0%	0.2%	0.2%	... but inflation to take time.
	Sep Chicago PMI	51.5	53.0	-	Much stronger than other regional surveys.
	Sep Uni. of Michigan sentiment, final	89.8	89.8	-	Remains a little above its long-run average.
	Fedspeak	-	-	-	Kaplan speaks in Dallas.
Sat 1					
Chn	Sep manufacturing PMI	50.4	-	-	External demand and construction key concerns...
	Sep non-manufacturing PMI	53.5	-	-	... despite more robust outcomes, employment still under pressure.

New Zealand forecasts

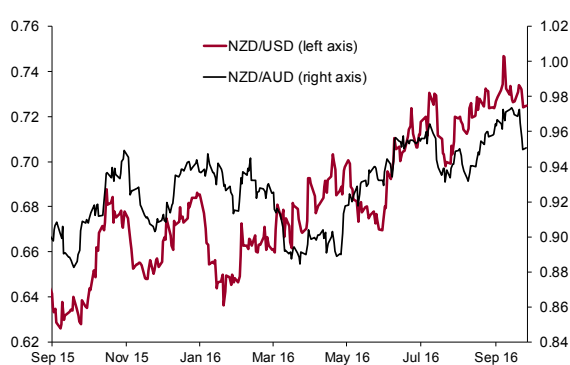
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2014	2015	2016f
GDP (Production) ann avg	3.6	2.5	3.5	2.9	3.8	2.5	3.4	3.1
Employment	3.2	2.0	3.9	1.6	3.6	1.4	4.7	2.0
Unemployment Rate % s.a.	5.4	5.2	5.0	4.5	5.5	5.0	5.1	4.6
CPI	0.3	0.4	1.1	1.7	0.8	0.1	0.9	1.6
Current Account Balance % of GDP	-3.5	-3.1	-3.3	-3.7	-3.2	-3.4	-3.0	-3.8

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	0.71	0.69	0.67	0.65	0.63	0.62
NZD/AUD	0.96	0.95	0.94	0.94	0.93	0.91
NZD/JPY	72.4	69.7	67.7	66.3	65.5	64.5
NZD/EUR	0.65	0.64	0.64	0.63	0.61	0.59
NZD/GBP	0.55	0.54	0.53	0.52	0.50	0.48
TWI	76.6	75.2	73.7	72.1	70.2	69.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 26 September 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.00%	2.00%
30 Days	2.20%	2.12%	2.08%
60 Days	2.21%	2.18%	2.16%
90 Days	2.23%	2.24%	2.24%
2 Year Swap	2.02%	2.04%	2.00%
5 Year Swap	2.17%	2.18%	2.09%

NZ foreign currency mid-rates as at Monday 26 September 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7248	0.7321	0.7225
NZD/EUR	0.6456	0.6515	0.6458
NZD/GBP	0.5588	0.5517	0.5508
NZD/JPY	73.26	75.11	73.65
NZD/AUD	0.9509	0.9704	0.9570
TWI	77.04	78.17	77.10

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	1.2	2.0
Unemployment %	5.3	5.8	6.2	5.8	5.7	5.6
Current Account % GDP	-4.4	-3.4	-3.0	-4.7	-3.5	-4.5
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.6	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	4.8	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	6.4	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 16 September 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	1.73	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.02	2.15	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	1.63	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	0.7647	0.74	0.73	0.71	0.69	0.68	0.68	0.68
USD/JPY	100.87	102	101	101	102	102	103	104
EUR/USD	1.1206	1.10	1.07	1.05	1.04	1.03	1.03	1.03
AUD/NZD	1.0468	1.04	1.06	1.06	1.06	1.08	1.10	1.11

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