Weekly Commentary

13 March 2017

A little less glossy

Recent developments signal a little less momentum in the economy than we had previous been expecting. The pace of growth appears to have slowed in late 2016, partly due to temporary factors. There's also been some less favourable developments in the dairy and building sectors in early 2017. Nevertheless, the underlying picture for the economy still looks solid, although it is heavily influenced by population growth.

Recent indicators suggest that the economy rounded out 2016 in decent shape, but that growth eased back late in the year. After the heady 1.1% pace of growth in September, we expect December's GDP figures (out this Thursday) will show that quarterly growth slowed to 0.5%. That's a bit weaker than we'd been expecting previously, and would be lower than the 1% gain the RBNZ forecast at the time of its last policy statement in February. Market pricing for rate hikes has already been pared back a fair bit over the past month; a softer growth outturn might see markets further discount the possibility of rate hikes within the next year.

Two key areas that have weighed on GDP growth are primary production and manufacturing. Damp spring conditions hampered milk production, while a very slow start to the slaughter season restrained food manufacturing. On top of this, forestry production eased back a bit after surging in September, while a fall in oil extraction is likely to see mining GDP continue on its recent downtrend.

On the plus side of the economy, we expect construction will again be one of the main contributors to growth, with a 1.9% gain in building levels in December. Increased demand stemming from strong population growth is expected also to show through in a range of service sectors.

That said, the momentum in construction seems to have slowed more recently. Late-2016 saw some very large declines in the number of new dwellings consented, and there was only a very modest 0.8% lift in January. This has left the number of new dwellings consented in the three months to January down 13% compared with the preceding three months, consistent with some easing in building activity in coming months.

Of note has been issuance in Auckland, where the number of new dwellings consented has been edging down for several months. Over the past year, only around 10,000 new dwellings were approved in Auckland – still short of what's needed to keep pace with the region's surging population. Some of this softness is likely to be temporary, reflecting teething issues associated with new building regulations (i.e. the Unitary Plan). We expect building levels will rise over the course of the year.

Turning to the fortunes of the dairy sector, we've recently seen some renewed downward pressure on global dairy prices. This follows an improvement in domestic supply conditions and firmer production out of Europe. As a result, we've revised down our forecast payout for this season from \$6.20/kgMS to \$5.90/ kgMS – slightly below Fonterra's forecast for \$6.00/kgMS. We've also revised our forecasts for next season down from \$6.50/kgMS to \$6.10/kgMS.

While the dairy payout isn't looking quite as strong as we had been expecting, conditions in the dairy sector are nonetheless looking much better than they did the last couple of seasons. Prices are still around 35% higher than in

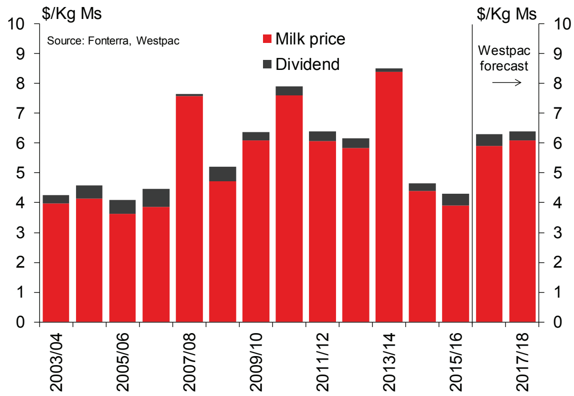
A little less glossy continued

mid-2016. That should take most farmers back into the black after two seasons when many found themselves in negative cash-flow territory. And, with global supply still well shy of last year's peak and demand steady, prices should remain at healthy levels for some time. Nevertheless, we don't expect that spending in rural communities will come roaring back just yet, with farmers expected to focus on debt repayment and delayed maintenance.

While we have seen some softening in economic conditions, we don't want to get overly pessimistic. As we've previously discussed, the NZ economy is on very stable footing. In fact, smoothing through quarterly volatility, we're still looking at an economy growing at an annual pace of around 3% and conditions look positive for 2017. With migration inflows and tourist arrivals hitting new record highs in January, 'people power' remains an important factor continuing to boost demand. In addition, despite the recent softness in consents, there is still a very large amount of building work planned over the coming year.

One note of caution is the slowdown in the housing market. Housing wealth tends to have a strong connection with domestic spending. But with mortgages rates on the rise, we're expecting a markedly slower rate of growth in house prices this year; this will put a dampener on household spending.

Fonterra payout history and forecasts



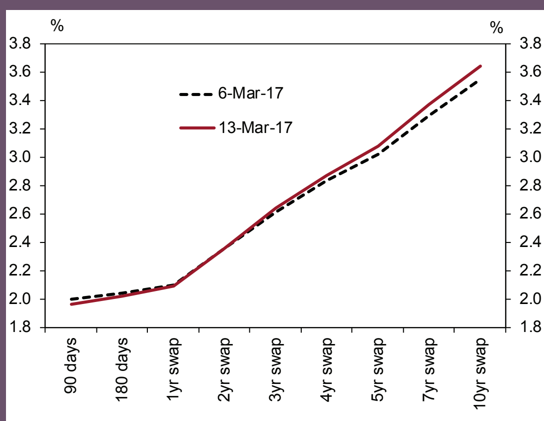
On a related note, the latest figures from the RBNZ show that in the year to December, household debt rose to levels equivalent to 168% of households' disposable incomes – a fresh record high. For now, debt servicing costs remain low at 8.6% of household disposable incomes. However, over time debt repayment is likely to be become a drag on activity. In addition, with high levels of debt, the economy is more vulnerable to an external shock.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three- to five-year rates seem high relative to where we think short-term rates are going to go over that time. That said, these rates are most likely to be pressured higher by global market trends, so borrowers who prefer the security of a longer term still have a chance to lock in at historically quite low levels.

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



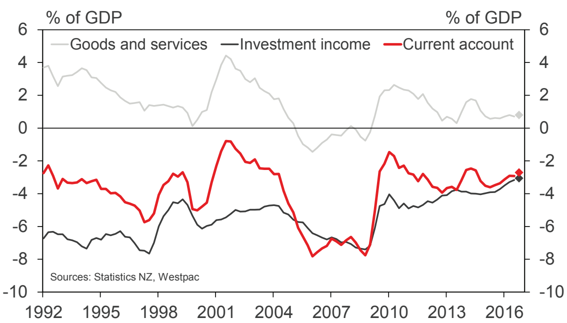
The week ahead

NZ Q4 current account

15 Mar, last: -2.9%, WBC f/c: -2.7%, Mkt f/c: -2.7%

- We expect the current account deficit to narrow to 2.7% of GDP, the smallest deficit since September 2014.
- A couple of factors are contributing to the improved balance. After being surprisingly subdued though the middle of 2016, tourism exports are expected to bounce back; also, on the goods side, declines in import prices are helping to keep New Zealand's import bill contained.
- For the investment income balance, higher profits by overseas-owned firms are expected to contribute to a deterioration in the quarterly deficit. However, on an annual basis, the deficit is still expected to narrow to 3.1%. This deficit is small relative to history, helped by low interest rates that have reduced interest payments on New Zealand's offshore debt and improved national savings.

Annual current account balance

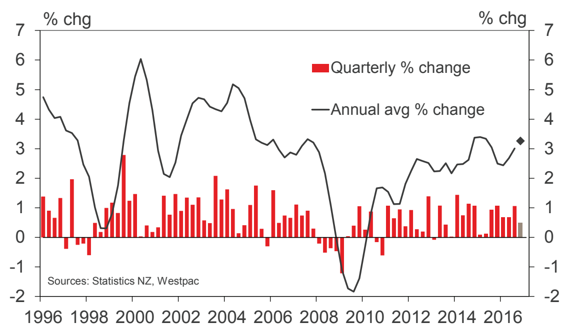


NZ Q4 GDP

16 Mar, Last: 1.1%, WBC f/c: 0.5%, Mkt f/c: 0.7%

- After the strong 1.1% rise in GDP in the September quarter, we're forecasting that quarterly GDP growth slowed to 0.5% in December. Smoothing through the quarterly volatility, this would see annual growth in calendar 2016 rise slightly to 3.2%, with familiar factors including population growth, tourism and construction continuing to support growth.
- By sector, construction is again expected to be one of the larger contributors to growth in the quarter, with personal services also expected to record strong gains. Meanwhile, declines in manufacturing and primary production (including falls in milk production, forestry and oil extraction) are expected to drag on growth.

Production-based GDP

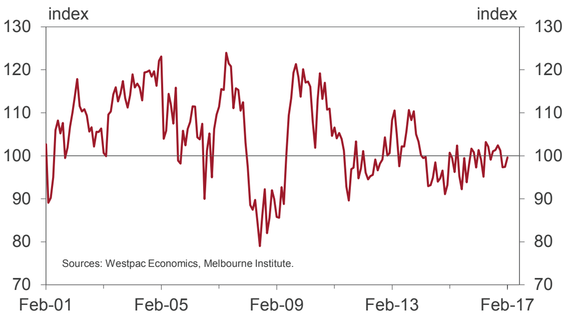


Aus Mar Westpac-MI Consumer Sentiment

Mar 15 Last: 99.6

- The **Westpac-Melbourne Institute Consumer Sentiment Index** rose 2.3% in February, from 97.4 in January to 99.6. Despite another modest lift, the Index is still below its Oct-Nov level and (just) in pessimistic territory.
- This month's survey is in the field March 6-11. Factors that may influence confidence include: the Q4 national accounts which showed a solid rebound from Q3's surprise contraction; signs that the pick-up in Sydney and Melbourne housing markets has carried into 2017; but a mixed month for financial markets (AUD down slightly and ASX about flat, despite US markets being 2% higher versus a month ago).

Consumer Sentiment Index

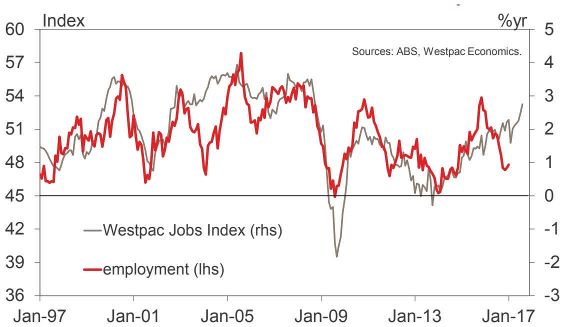


Aus Feb Labour Force - total employment '000

Mar 16, Last: 13.7k, WBC f/c: 20.0k
Mkt f/c: 16.5k, Range: –2.0k to 30.0k

- January provided a disappointing update on the labour market, with the fall in the unemployment rate the result of a decline in participation. Also, the return of female/part-time employment at the expense of male/full-time employment suggests the recovery in manufacturing may have run its course.
- In the month, the Labour Force Survey reported a 13.7k rise in total employment compared to market expectations of 10k and Westpac's 20k. The annual pace lifted a touch from 0.8%yr to 0.9%yr, but that is still well under the pace that our Jobs Index suggests it should be at – circa 1¾%yr to 2%yr.
- Business surveys continued to strengthen in early 2017, and our Job Index is now pointing to employment growth of around 2¾%yr by Q3. Our 20k forecast lifts the annual pace to 1.2%yr.

Westpac jobs index



The week ahead

Aus Feb Labour Force - unemployment%

Mar 16, Last: 5.7%, WBC f/c: 5.7%
Mkt f/c: 5.7%, Range: 5.6% to 5.8%

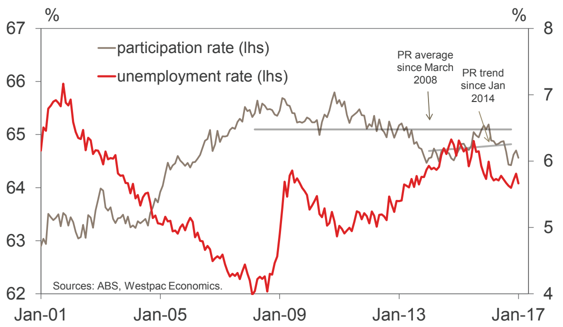
- A trend decline in participation has made us cautious when interpreting the unemployment rate. Our own research suggests the decline is both cyclical (i.e. weak employment conditions resulting in declining participation) and structural (i.e. a lump of retirees exiting the workforce).
- The 13.7k January jump in employment was reported with a 5.8k decline in the labour force, which is why the unemployment rate fell to 5.7%. The decline in the labour force was in stark contrast to the ongoing growth in the working age population (+34k in the month), resulting in a 0.1ppt decline in the reported participation rate.
- In February, if participation holds steady, a 20k gain in employment will be enough to hold unemployment at 5.7%.

Aus Q1 AusChamber-Westpac Industrial Survey

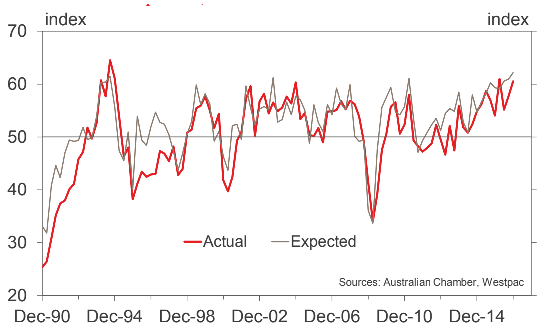
Mar 16, Last: 60.3

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector and insights into economy-wide trends. The Actual Composite tracks household demand, highlighting the key linkages between the consumer, home building and manufacturing. The Q1 survey was conducted during February and early March. In Q4, the Actual Composite rose to 60.3 after a rebound to 57.4 in September from a dip in June to 55.0. Strength is centred on a lift in new orders and output as well as increased overtime and an emerging resilience in employment. Manufacturing is benefitting from the strong upswing in new home building activity in response to low interest rates, and the significant improvement in the competitiveness of exporters and import competing firms. However, the mining investment downturn remains a major headwind.

Unemployment and participation rates



Westpac Australia Chamber Composite Indexes



UK Mar Bank of England policy decision

Mar 16, Last: 0.25%, WBC f/c: 0.25%, Mkt f/c: 0.25%

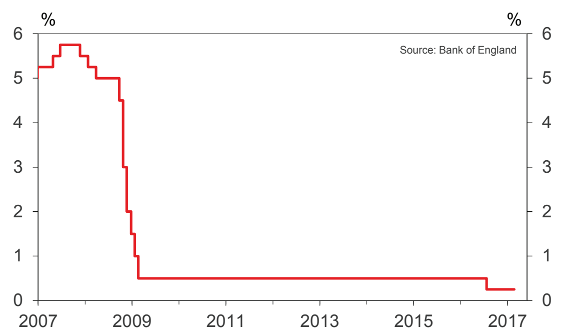
- At its February rate decision, the Bank of England left the Bank Rate on hold at 0.25% and reiterated its has a neutral policy stance, noting that "Monetary policy can respond, in either direction."
- We expect the MPC will keep the Bank Rate on hold again in March. But the key thing to watch will be the tone of the accompanying policy statement. We don't expect a significant change in bias, but we may see some more hawkish comments creeping in. The past few months have seen continued resilience in activity. At the same time, inflation has been pushing higher, particularly for imported household necessities like food and fuel. Nevertheless, the longer term downside risks for activity are likely to remain front and centre for the BOE.

US Feb CPI

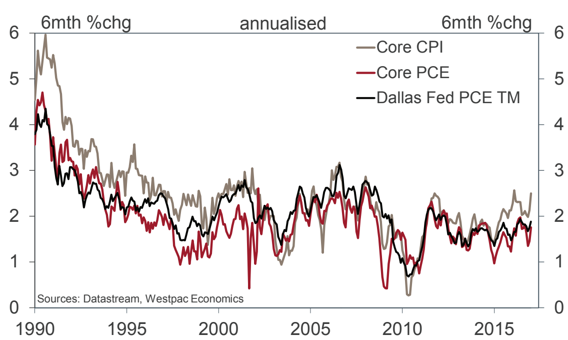
Mar 15, Last: 0.6%, WBC f/c: 0.1%

- Headline annual CPI inflation has corrected higher in recent months as the deflationary impact of weak energy prices in early-2016 fell out of the annual calculation and energy prices jumped higher month on month through Q4 2016.
- Annual headline inflation has risen from a recent low of 0.9%yr in July 2016 to 2.5%yr at January. Six-month annualised inflation has been stronger still, coming in at 3.6%. Core inflation has remained broadly stable through H2 2016 into 2017, holding a little above the 2.0%yr inflation target.
- Come February, a pullback in energy prices is set to offset continued at-target growth in core inflation, meaning headline prices will only rise around 0.1% in the month. A core prices gain of 0.2% is expected. Annual inflation for the headline and core measures will remain above 2.0%yr.

Bank of England Bank Rate



Retail sales momentum solid but not yet strong



The week ahead

US Feb retail sales

Mar 15, Last: 0.4%, WBC f/c: 0.0%

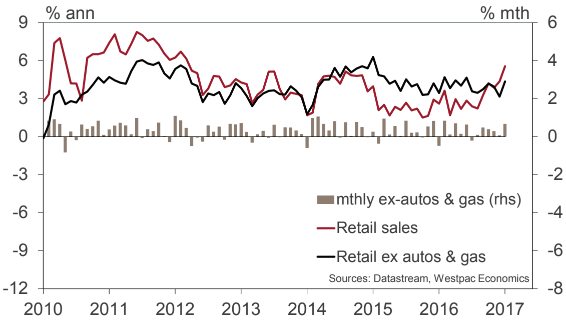
- Retail sales were a little disappointing in Q4 2016 and that tone has carried into 2017, with a 0.4% headline gain reported for retail sales in January. Poor auto sales were a material drag on growth in the month, with sales ex autos & gas rising a much more robust 0.7%.
- Confidence; employment growth; and, to a lesser extent, wage gains are all supportive of household spending. Still it seems that there remains a reticence on the part of consumers to spend on discretionary items.
- Come February, a similar result to January is anticipated. Headline sales are expected to be flat, with autos again subtracting from growth. However, core sales are also expected to be soft, likely only seeing a circa 0.2% rise. With services spending also soft in January, Q1 is shaping up as an, at best, mediocre quarter for GDP.

US Mar FOMC meeting

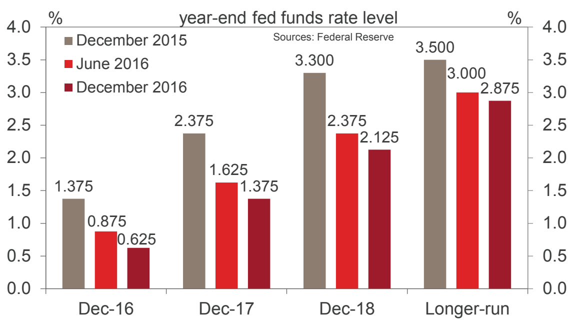
Mar 14–15, Last: 0.625%, WBC f/c: 0.875%

- There has been an abrupt shift in market pricing for the March FOMC meeting following unequivocal guidance from Chair Yellen and NY Fed President Dudley. Evident in Chair Yellen's speech was a belief that the downside risks of 2015 (global uncertainties and weak inflation) and early 2016 (wavering US jobs growth) were in the rear-vision mirror. Risk hereafter were construed as being to the upside, the chief risk arguably being that the FOMC could fall behind the curve if confidence and fiscal policy beget stronger growth. We, along with the market, expect a 25bp rate hike to be delivered in March. A follow-up move is then anticipated to occur in September. The Committee is likely to remain more hawkish, with the median Committee forecast to remain three hikes in 2017 versus our two. Market participants will parse updated forecasts with great care. However, material revisions seem unnecessary ahead of detail on fiscal reform.

Core inflation near target



FOMC's shifting interest rate expectations



Data calendar

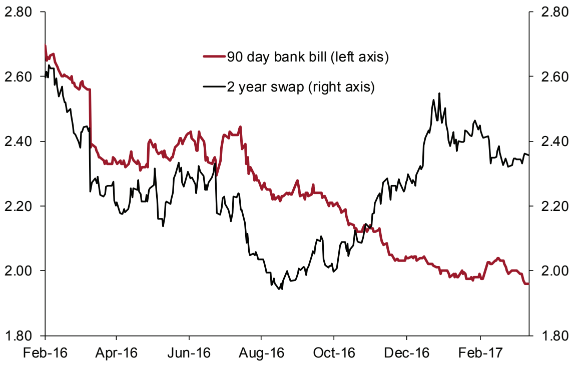
		Last	Market median	Westpac forecast	Risk/Comment
Mon 13					
NZ	Feb food price index	2.8%	–	-1.2%	Expected to retrace some of the outsized seasonal gain in January.
Eur	ECB president Draghi	–	–	–	Delivering opening remarks at ECB / MIT conference in Frankfurt.
US	Feb labour market conditions index	1.3	–	–	The Fed's composite measure of labour market conditions.
Tue 14					
Aus	Feb NAB business survey	16	–	–	Conditions up 6pts to +16. Too good to be true, expect a pull-back.
	Speech by Asst Gov Bullock	–	–	–	Bloomberg Breakfast, Sydney.
Chn	Feb retail sales YTD %yr	10.4%	10.6%	–	Employment gains strengthening, but spending growth holding pat.
	Feb fixed asset investment ytd %yr	8.1%	8.2%	–	Private sector activity remains absent.
	Feb industrial production	6.0%	6.2%	–	PMIs positive on current activity and new orders.
Eur	Jan industrial production	-1.6%	1.7%	–	PMIs indicate production growth should strengthen.
	Mar ZEW survey of expectations	17.1	–	–	Investors very optimistic.
Ger	Feb CPI (%yr, final)	2.2%	2.2%	–	Energy prices driving annual inflation higher.
US	Feb NFIB small business optimism	105.9	106.0	–	Very strong of late.
	Feb PPI	0.6%	0.1%	–	Commodity prices subdued in Feb.
Can	Feb Teranet / National Bank HPI	0.5%	–	–	Strength centred on Toronto, Hamilton and Vancouver.
Wed 15					
NZ	Q4 current account, % of GDP	–2.9%	–2.7%	–2.7%	Firmer exports (esp. tourism); strong NZD holding down import prices.
Aus	Mar Westpac–MI Consumer Sentiment	99.6	–	–	Recovered some of the ground lost over Dec–Jan.
	Feb new vehicle sales	0.6%	–	–2.0%	Industry figures point to a soft start to 2017.
Eur	Dutch election	–	–	–	Fears over anti-EU PW vote diminishing in lead up to election.
UK	Jan ILO unemployment rate	4.8%	4.8%	–	Firm business conditions point to continued low unemployment levels.
US	Mar Empire Fed manufacturing survey	18.7	15.0	–	Likely to retrace some of Feb's surge, to highest level since 2014.
	Feb CPI	0.6%	0.0%	0.1%	Energy prices a negative in Feb; core inflation presses on.
	Feb retail sales	0.4%	–0.1%	–	Gasoline prices to offset gain in core sales in Feb. Autos also softer.
	Mar NAHB housing market index	65	65	–	Higher interest rates have not dented home builders' confidence.
	FOMC policy decision, midpoint	0.625%	0.875%	0.875%	Clear signal that the time for a third hike is now.
Thu 16					
NZ	Q4 GDP	1.1%	0.7%	0.5%	Drags from primary production and manufacturing. Construction firm.
Aus	Mar MI inflation expectations	4.1%	–	–	Expectations picked up with fuel prices & just below long-run average.
	Feb employment	13.5k	–	20k	Business surveys strengthened further as 2017 began…
	Feb unemployment rate	5.7%	–	5.7%	… and point to a pick-up in employment growth in coming months.
	Q1 AusChamber–Westpac industry survey	60.3	–	–	Manufacturers benefitting from upswing in home building & lower AUD.
Eur	Feb CPI (%yr, final)	1.8%	2.0%	–	Core inflation remains below 1.0%yr.
UK	Bank of England Rate decision	0.25%	0.25%	0.25%	Activity resilient, lower pound boosting inflation.
US	Feb housing starts	–2.6%	0.7%	–	Housing investment broadly flat through 2016.
	Feb building permits	5.3%	–3.1%	–	Will developers push on despite higher interest rates?
	Initial jobless claims	243k	–	–	Claims remain at very low levels.
	Mar Philly Fed business outlook survey	43.3	28.0	–	Surged to a three decade high in Feb.
	Jan JOLTS job openings	5501	–	–	Hires; fires; quits; and vacancies.
Fri 17					
NZ	Feb BusinessNZ PMI	51.6	–	–	Points to some loss of momentum in recent months.
	Mar ANZ consumer confidence	127.4	–	–	Household activity has been firm in recent months.
Eur	Jan trade balance, €bn	24.5	–	–	Trade disparity remains across continent.
US	Feb industrial production	–0.3%	0.2%	–	Materially impacted by unseasonal weather in recent months.
	Mar Uni. Of Michigan consumer sentiment	96.3	97.0	–	Confidence riding high.
	Feb leading index	0.6%	0.4%	–	Points to growth a little above average.
Sat 18					
Chn	Feb property prices	–	–	–	Momentum unwinding in tier-1, but growth pulse holding elsewhere.

New Zealand forecasts

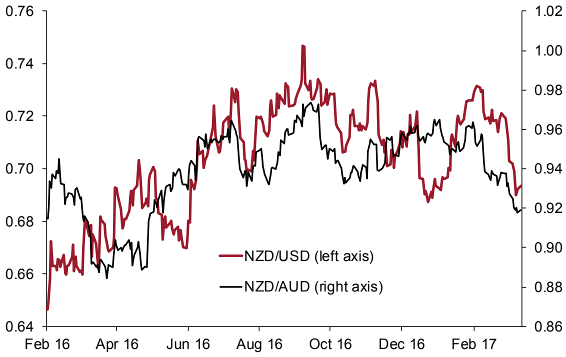
Economic Forecasts	March years				Calendar years			
% change	2015	2016	2017f	2018f	2014	2015	2016f	2017f
GDP (Production) ann avg	3.4	2.4	3.3	3.4	3.4	2.5	3.2	3.3
Employment	3.2	2.0	5.3	2.1	3.6	1.4	5.8	2.3
Unemployment Rate % s.a.	5.4	5.2	4.7	4.4	5.5	4.9	5.2	4.4
CPI	0.3	0.4	1.7	1.5	0.8	0.1	1.3	1.5
Current Account Balance % of GDP	-3.5	-3.1	-2.8	-3.0	-3.2	-3.4	-2.7	-2.9

Financial Forecasts	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	2.00	2.00	2.00	2.00	2.00
2 Year Swap	2.40	2.50	2.50	2.50	2.50	2.60
5 Year Swap	3.00	3.15	3.20	3.30	3.35	3.45
10 Year Bond	3.30	3.45	3.50	3.60	3.65	3.75
NZD/USD	0.70	0.69	0.68	0.67	0.66	0.65
NZD/AUD	0.92	0.91	0.91	0.91	0.92	0.93
NZD/JPY	81.2	81.4	80.2	80.4	80.5	80.6
NZD/EUR	0.67	0.67	0.67	0.67	0.66	0.66
NZD/GBP	0.57	0.57	0.56	0.55	0.55	0.54
TWI	77.0	76.4	75.9	75.5	75.1	75.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 13 March 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.84%	1.84%	1.84%
60 Days	1.90%	1.92%	1.93%
90 Days	1.96%	1.98%	2.02%
2 Year Swap	2.36%	2.32%	2.34%
5 Year Swap	3.08%	2.94%	2.95%

NZ foreign currency mid-rates as at Monday 13 March 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6934	0.7202	0.7198
NZD/EUR	0.6492	0.6816	0.6773
NZD/GBP	0.5699	0.5773	0.5768
NZD/JPY	79.51	80.74	81.74
NZD/AUD	0.9192	0.9379	0.9372
TWI	76.13	78.47	78.59

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016f	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.6	2.8
CPI inflation % annual	2.7	1.7	1.7	1.5	1.9	1.9
Unemployment %	5.8	6.2	5.8	5.5	5.5	5.4
Current Account % GDP	-3.4	-3.0	-4.8	-2.9	-1.2	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.6	2.2	2.4
Consumer Prices %yr	1.5	1.6	0.1	1.2	1.7	1.7
Unemployment Rate %	7.4	6.2	5.3	4.9	4.6	4.5
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.7	-2.8
Japan						
Real GDP %yr	1.4	0.0	0.5	0.6	0.6	0.7
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.6	1.5	1.3
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.9	1.5
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.6	6.0
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.8	3.8
World						
Real GDP %yr	3.3	3.4	3.1	3.2	3.5	3.5
Forecasts finalised 13 March 2017						

Interest Rate Forecasts	Latest	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.79	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.97	2.95	2.95	3.00	3.05	3.15	3.25	3.40
International								
Fed Funds	0.875	0.875	0.875	1.125	1.125	1.375	1.375	1.625
US 10 Year Bond	2.61	2.55	2.65	2.75	2.85	3.00	3.10	3.30
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40

Exchange Rate Forecasts	Latest	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
AUD/USD	0.7516	0.76	0.76	0.75	0.74	0.72	0.70	0.68
USD/JPY	115.34	116	118	118	120	122	124	126
EUR/USD	1.0595	1.05	1.03	1.01	1.00	1.00	0.99	0.98
AUD/NZD	1.0882	1.07	1.09	1.10	1.10	1.11	1.06	1.05

Contact the Westpac economics team

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