Weekly Commentary

14 November 2016

Changing conditions

The RBNZ has cut rates to a record low. The US has a new president. And New Zealand has once again been rocked by series of large earthquakes.

A record low

At its November policy decision, the RBNZ cut the Official Cash Rate (OCR) to a record low of 1.75%. This came against a backdrop of very low headline inflation, and associated downside pressure on inflation expectations. The decision was strongly signalled, and failure to deliver would have risked sharp moves higher in both the New Zealand dollar and wholesale interest rates – effectively resulting in an unwanted tightening of monetary conditions.

This is likely to be the last cut in the current cycle. However, with inflation projected to return to the 2% target only very gradually, we expect the OCR to remain at its current very low level for an extended period.

New Zealand's inflation environment is changing. In recent years, a string of temporary factors, such as falls in international oil prices and policy changes, left the RBNZ with a persistent undershoot of the inflation target. The impact of those factors is now slowly passing out of annual inflation figures. As a result, we will see inflation mechanically rising over the coming year. Consequently, the challenge the RBNZ is facing has evolved into a very slow return to the 2% target midpoint, with lingering softness in imported inflation a key challenge.

The RBNZ needs interest rates to remain low to generate a pick-up in domestic inflation in the face of continued softness in global inflation. Rate reductions to date have supported a marked strengthening in domestic economic conditions, with household spending chugging along and conditions in the business sector looking more upbeat. For its inflation forecasts to be realised, the RBNZ needs this strength to be sustained.

However, with the downside risks for economic activity dissipating, and much of the softness in inflation due to factors beyond its control, the RBNZ can afford to take a gradual approach to its price stability goal. Consistent with this, the November policy statement noted that "current projections and assumptions indicate that policy settings, including today's easing, will see growth strong enough to have inflation settle near the middle of the target range". That marks a shift to a much more neutral stance by the RBNZ, after the last few months when it had strongly signalled that "further policy easing will be required."

This does not mean that the door is completely closed with regards to further cuts. The RBNZ's forecasts suggest that it still see some small possibility of a further easing, with global conditions a key risk. However, that's certainly not the base case.

Although we expect the OCR to remain on hold for some time, that does not mean we will see the same stability in the interest rates faced by borrowers and savers. Term interest rates are facing upward pressure from several sources. This includes rising global interest rates, increases in bank funding costs, and changes in market expectations for the OCR. On this last point, interest rate markets are already factoring in more than a 50% chance of a 25bp hike by the end of 2017. That seems far too early to us given the lingering softness in inflation. If such factors persist, the RBNZ will be facing an implicit tightening of monetary conditions over the next couple of years.

Changing conditions continued

President elect Trump

The unexpected result of the US election has added an extra layer of uncertainty around the economic outlook. New Zealand is exposed to changes in the US political environment through three key channels.

First is through the financial environment. After initial nervousness, markets have calmed again, helped by the President elect's conciliatory victory speech helped stablise markets. It included a focus on infrastructure spending, which could provide a sizeable boost to growth, and could be more effective at boosting US activity than tax cuts.

We remain mindful that evolving geopolitical situations, like the changing political environment in the US and negotiations around Brexit, could be catalysts for bouts of increased volatility in financial markets. And such volatility could be disruptive for economic conditions. These situations will be front of mind over the upcoming holiday period, when markets can get thin and financial conditions can change abruptly.

The second channel that could affect New Zealand is the trade environment. Mr Trump's protectionist stance means that the Trans-Pacific Partnership Agreement is now very unlikely to be approved in its current form. More generally, his stated intention to tighten trade restrictions, particularly in relation to China, could reinforce what is already a weak environment for global trade.

We do not expect New Zealand to be a major focus for US deliberations regarding any new trade restrictions. Nevertheless, we could be affected indirectly if conditions in China or elsewhere slow materially in response to changes in trade policy.

Finally, uncertainty following the US election could affect the stance of monetary policy there, with flow-on effects for New Zealand. Prior to the election, the Federal Reserve had been inching closer to hiking the funds rate. However, increased uncertainty around the outlook could see renewed caution from the Fed. We still expect three more rate hikes from the Fed by the end of 2017, but right now we are less inclined to see a rate hike coming at the December meeting. However, this is an evolving situation, and we will continue to review the outlook over the coming weeks.

Shaky isles

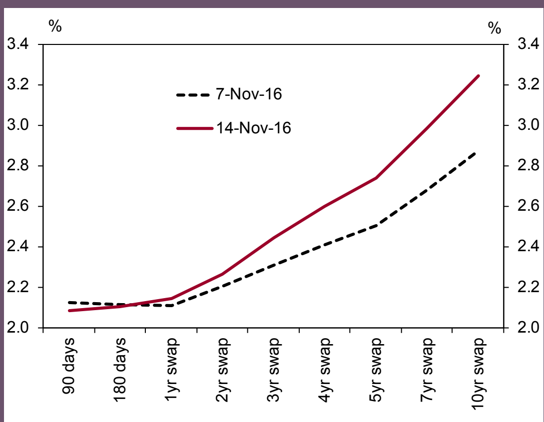
New Zealanders have woken up to (or were woken up by) a series of severe earthquakes. The first of these struck just after midnight, centred in the North Canterbury plains, at a 7.5 magnitude and a relatively shallow 15km deep. At this stage it's difficult to judge the full scale of the impact, and the risk of damaging aftershocks will remain high for several months. In addition to the considerable impact these events had on people's lives, there has been damage to assets and infrastructure, and there will be some disruptions to economic activity. But on a national scale, the closest analogy may be the sequences of earthquakes near Seddon in 2013. These caused severe damage within the region and, like last night's quake, also resulted in damage and disruptions in Wellington. As with the Seddon earthquakes, last night's quake was centred in a relatively lightly populated area, and along with high levels of private and government insurance, this suggests that the economic and financial impacts will be manageable.

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 should lock it in now.

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 Q3 real retail sales

Nov 15, Last: +2.3%, Westpac f/c: +1.1%, Mkt f/c: 0.9%

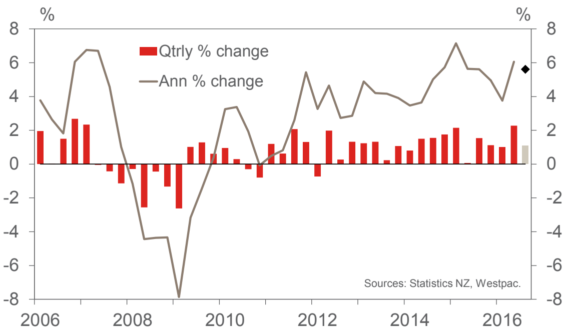
- Retail spending in New Zealand has been going from strength-to-strength. After a solid 1% lift early in the year, spending surged through the June quarter, with a 2.3% gain in sales volumes. That's the strongest increase since 2006, with gains wide spread across retail categories.
- Strength in spending is expected to be sustained in the September quarter, with card spending data pointing to a 1.1% quarterly gain. Inflation, particularly for imported goods, has remained low, which is allowing households' incomes to stretch further. On top of this, firmness in population growth and tourist inflows, as well as the level low level of interest rates, have all been supporting spending.

Aus Oct Westpac–MI Leading Index

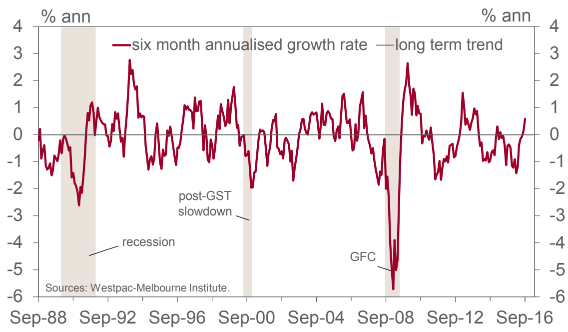
Nov 16, Last: 0.58%

- The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index rose from +0.15% in August to +0.58% in September. Resurgent commodity prices and improved global conditions have been a key positive over the last six months.
- The October update will include another positive read on commodity prices (up 7.9% in AUD terms) but other components have been weaker, most notably equity markets (ASX200 down -2.2%) and dwelling approvals (-8.7%). Consumer sentiment, labour markets and other financial market components have also been on the soft side.

Real retail sales



Westpac-MI Leading Index



Aus Q3 wage price index

Nov 16, Last: +0.5%, WBC: f/c +0.5%
Mkt f/c: 0.5%, Range: 0.5% to 0.7%

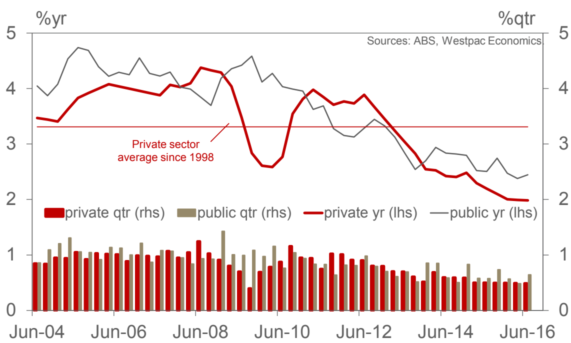
- The wage price index (WPI) lifted 0.5% in Q2, in line with expectations. This was the third consecutive print of 0.5%, keeping the annual pace flat at 2.1%yr holding the moderation seen since the recent peak of 2.6%yr in 2014Q3.
- Private sector wage inflation is key to this moderation. The private WPI has risen 0.5% every quarter since Q1 2015 – that's six quarters in a row. The annual pace held at the record low of 1.9%yr from Q1. Private sector wage inflation's recent peak was 4.0%yr in Q1 2011 and has been on a moderating trend ever since.
- There appears little to change this in the near term as private sector wage pressures remain subdued with relatively high rates of job uncertainty and rising underemployment (those in work who would like to work more).

Aus Oct employment

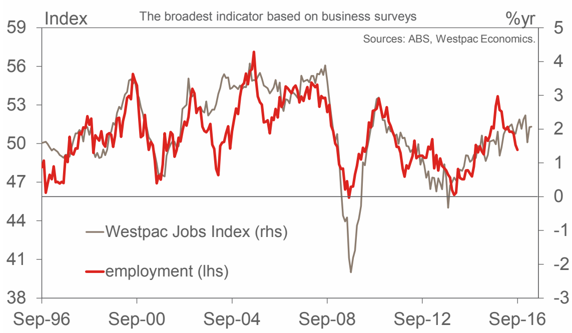
Nov 17, Last: –9.5k, WBC f/c: 25k
Mkt f/c: 20k, Range: –3k to 40k

- In September, employment fell 9.5k below the market median estimate of +15k. Despite the decline in employment the annual pace eased only slightly to 1.4%yr from 1.5%yr in August. In the year to September, total employment has grown 163.1k compared to 181.4k in the year to August. The annual pace of growth is currently well under what our Westpac Jobs Index is suggesting (somewhere closer to 2%yr).
- Hours worked continue to underperform employment and the focus remains on part-time/female employment rather than full-time/male employment. Along with the rise in underemployment this points to a soft labour market with some near terms risks. However, employment growth is well under our preferred leading indicators suggesting a near term bounce is quite likely.

Private vs. public sector wages



Westpac jobs index



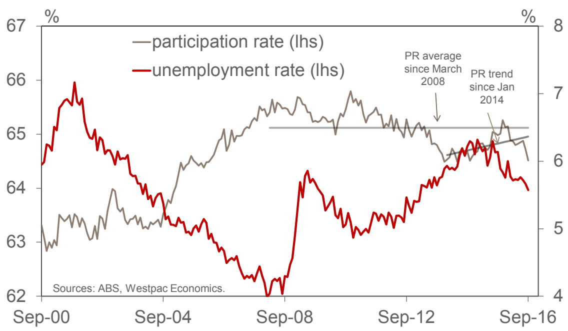
The week ahead

Aus Oct unemployment rate

Nov 17 Last: 5.6%, WBC f/c: 5.6%
Mkt f/c: 5.7%, Range: 5.5% to 5.8%

- Sep surprised with a further fall in the participation rate, from 64.7% to 64.5%, driving a 22.3k decline in the labour force. This followed on from the 16.8k drop in the labour force in Aug and, as a result, the labour force is now growing at just 1%yr compared to the robust 1.5%yr growth in the working age population. This rapid slowdown is why the unemployment rate has fallen despite a soft spot in employment growth.
- Unemployment fell to 5.6% in Sep, down from 5.7% in Aug and a recent peak of 5.8% in Jun. If the participation rate lifts to 64.6% – the mid-point between the Sep and Aug prints – then this will see a 35k lift in the labour force meaning our forecast for a robust 25k gain in employment is enough to hold the unemployment rate flat at 5.6% after rounding.

Unemployment and participation rates



Data calendar

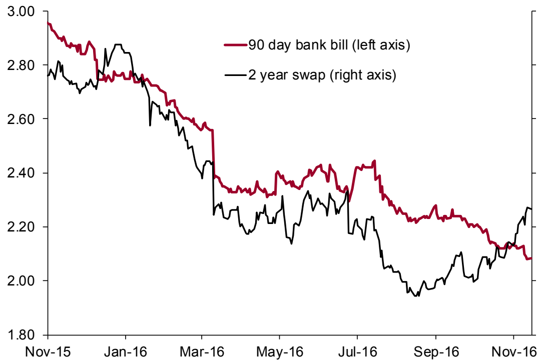
		Last	Market median	Westpac forecast	Risk/Comment
Mon 14					
NZ	Oct Business NZ PSI	54.1	–	–	Service sector conditions have eased, but remain at firm levels.
Chn	Oct industrial production	6.1%	6.2%	–	PMIs are improving; production finding a base.
	Oct retail sales %yr	10.7%	10.7%	–	Employment indicators improving.
	Oct fixed asset investment ytd %yr	8.2%	8.2%	–	Private sector remaining on the sidelines.
Eur	Sep industrial production	1.6%	–1.0%	–	Pullback expected in Sep.
US	Fedspeak	–	–	–	Kaplan speaks in Wichita, Texas.
Tue 15					
NZ	Q3 retail sales	2.3%	0.8%	1.1%	Spending remains strong, especially in the hospitality sector.
Aus	RBA minutes	–	–	–	Superceded somewhat by Nov SoMP but of interest nonetheless.
	RBA Governor Philip Lowe speaking	–	–	–	Topic TBA, CEDA dinner, Melbourne, 7:15pm.
Eur	Sep trade balance €bn	23.3	–	–	Weaker Euro would materially aid trade position.
	Nov ZEW survey of expectations	12.3	–	–	A very interestring month for investors!
	Q3 GDP (provisional)	0.3%	0.3%	0.3%	Annual growth stable at 1.6%yr.
UK	Oct CPI	0.2%	0.3%	–	Annual inflation on the rise, 1.5%yr currently.
	Sep house price index, % yr	8.4%	–	–	House prices have been resilient post–Brexit, supported by low supply.
US	Nov Empire Fed manufacturing index	–6.8	–2.5	–	Manufacturing activity remains subdued.
	Oct retail sales	0.6%	0.6%	0.7%	Core sales to rise 0.6%.
	Fedspeak	–	–	–	Lacker speaks on panel in Chestertown.
	Fedspeak	–	–	–	Williams speaks panel on regional activity and trade with China.
	Fedspeak	–	–	–	Rosengren gives keynotes in Portland.
	Fedspeak	–	–	–	Vice–chair Fischer speaks on post–crisis liquidity at Brookings Institute.
Can	Oct Teranet/National Bank house prices	0.8%	–	–	Gains centred on Vancouver and Toronto, but softness elsewhere.
Wed 16					
NZ	GlobalDairyTrade auction result	11.4%	–	–	Futures suggest dairy prices to remain broadly flat.
Aus	Oct Westpac–MI Leading Index	0.58%	–	–	Commodities take off but other components have had a soft month.
	Q3 wage cost index	0.5%	0.5%	0.5%	Labour market is softer than it looks so little to push wages faster.
	Oct new vehicle sales	2.5%	–	–2.0%	Industry figures suggests a dip in Oct, after a reasonable gain in Q3.
UK	Sep ILO unemployment rate	4.9%	4.9%	–	Post–Brexit nervousness will dampen hiring over the coming months.
US	Oct PPI	0.3%	0.3%	–	Has picked up, but USD strength will limit increases in input costs.
	Oct industrial production	0.1%	0.2%	–	Remains soft; USD impact?
	Nov NAHB housing market index	63	63	–	Builders remain optimistic.
	Fedspeak	–	–	–	Bullard speaks on monetary policy and QE in London.
	Fedspeak	–	–	–	Kashkari speaks on too–big–to–fail in New York.
Thu 17					
NZ	Nov ANZ consumer confidence	122.9	–	–	Consumers have been in good form lately.
Aus	Oct employment, '000 chg	–9.8k	20k	25k	We are passing through a soft patch in employ & falling participation
	Oct unemployment rate	5.6%	5.7%	5.6%	is driving down unemployment. Lead indicators remain positive.
Eur	Oct CPI %yr	0.4%	0.3%	–	Annual inflation slowly edging higher.
UK	Oct retail sales	0.0%	0.4%	–	Spending has held up. Lower pound boosting prices, tourist spending.
US	Oct housing starts	–9.0%	10.3%	–	Momentum for the housing pipeline looks...
	Oct housing permits	6.3%	–2.5%	–	... to be stalling. Higher interest rates coming.
	Oct CPI	0.3%	0.4%	0.4%	Core inflation expected to remain above 2%yr.
	Initial jobless claims	254k	260k	260k	Claims remain around multi–decade lows.
	Nov Philly fed business outlook survey	9.7	8.0	–	Remains at moderate levels.
	Fed Chair Yellen	–	–	–	Speaking before joint economic committee on economic outlook.
	Fedspeak	–	–	–	Harker talking in Philadelphia on the purpose of the Federal Reserve.
Fri 18					
Eur	Sep current account balance, €b	29.7	–	–	Financial income has improved in recent months.
	ECB President Draghi	–	–	–	Speaking in Frankfurt as part of Euro finance week.
Chn	Oct property prices	–	–	–	Breadth of gains has broadened, but speculation still key.
US	Oct leading index	0.2%	0.1%	–	Growth remains at trend.
	Nov Kansas City manufacturing activity	6	–	–	Has picked up, though export demand remains a headwind.
	Fedspeak	–	–	–	Bullard on panel on "Monetary policy: Which road ahead?"
	Fedspeak	–	–	–	George speaks at conference on oil and the economy in Dallas.
Can	Oct CPI %yr	1.3%	1.5%	–	Core inflation a little stronger at 1.8%yr.

New Zealand forecasts

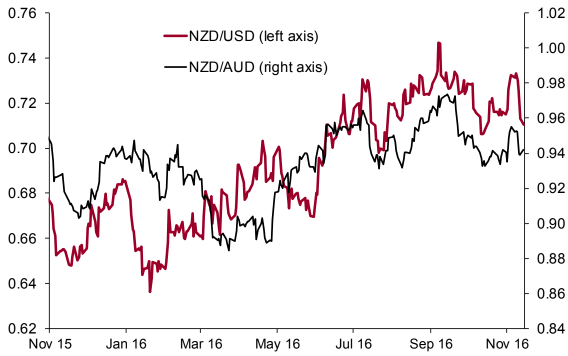
Economic Forecasts	March years				Calendar years			
% change	2015	2016	2017f	2018f	2014	2015	2016f	2017f
GDP (Production) ann avg	3.6	2.5	3.5	2.9	3.8	2.5	3.4	3.1
Employment	3.2	2.0	3.9	1.6	3.6	1.4	4.7	2.0
Unemployment Rate % s.a.	5.4	5.2	5.0	4.5	5.5	5.0	5.1	4.6
CPI	0.3	0.4	1.2	1.6	0.8	0.1	1.0	1.5
Current 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	2.10	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.30	2.40	2.50	2.50	2.50	2.50
5 Year Swap	2.70	2.80	2.90	3.00	3.00	3.00
10 Year Bond	3.00	3.10	3.20	3.25	3.30	3.25
NZD/USD	0.73	0.73	0.71	0.70	0.68	0.66
NZD/AUD	0.95	0.96	0.96	0.96	0.94	0.94
NZD/JPY	77.4	78.4	78.1	77.0	76.2	75.2
NZD/EUR	0.67	0.68	0.68	0.67	0.67	0.65
NZD/GBP	0.59	0.59	0.58	0.57	0.56	0.55
TWI	78.9	79.2	78.6	78.1	76.7	75.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 14 November 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	2.00%	2.00%
30 Days	1.97%	2.11%	2.18%
60 Days	2.01%	2.12%	2.16%
90 Days	2.09%	2.13%	2.15%
2 Year Swap	2.27%	2.14%	2.07%
5 Year Swap	2.74%	2.42%	2.26%

NZ foreign currency mid-rates as at Monday 14 November 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7106	0.7155	0.7096
NZD/EUR	0.6562	0.6510	0.6468
NZD/GBP	0.5644	0.5874	0.5843
NZD/JPY	75.94	74.73	74.04
NZD/AUD	0.9420	0.9431	0.9302
TWI	77.42	77.27	76.47

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016f	2017f	2018f
Australia						
Real GDP % yr	2.0	2.7	2.4	2.9	3.0	2.8
CPI inflation % annual	2.7	1.7	1.7	1.6	1.8	2.5
Unemployment %	5.8	6.2	5.8	5.5	5.5	5.4
Current Account % GDP	-3.4	-3.0	-4.7	-2.9	-2.6	-2.5
United States						
Real GDP %yr	1.5	2.4	2.6	1.5	2.1	2.1
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	-2.6	-2.7	-3.0	-3.1
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	1.2	1.3
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.1	1.6	1.4
China						
Real GDP %yr	7.7	7.3	6.9	6.7	6.5	6.0
East Asia ex China						
Real GDP %yr	4.2	4.1	3.7	3.7	3.9	3.8
World						
Real GDP %yr	3.3	3.4	3.1	3.3	3.5	3.4
Forecasts finalised 11 November 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	1.76	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.50	2.75	2.75	2.80	2.80	2.90	2.95	3.00
International								
Fed Funds	0.375	0.375	0.625	0.625	0.875	1.125	1.125	1.375
US 10 Year Bond	2.12	2.25	2.30	2.35	2.40	2.50	2.55	2.60
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	0.7609	0.77	0.76	0.74	0.73	0.72	0.72	0.70
USD/JPY	106.84	106	108	110	110	112	114	116
EUR/USD	1.0893	1.09	1.07	1.05	1.04	1.02	1.01	1.00
AUD/NZD	1.0554	1.07	1.07	1.07	1.09	1.11	1.09	1.09

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