

Weekly Commentary

17 July 2017



Challenges ahead

Over the past week, we have seen updates on several key aspects of the economic outlook. Putting these together, we're continuing to see an environment where inflationary pressures remain very well contained.

The RBNZ continues to face a number of challenges, with inflation set to soften in the near term...

First up, inflation is looking like it will come in on the softer side of the RBNZ's expectations. We are forecasting a subdued 0.1% rise in the CPI for the June quarter, which would see annual inflation recede from 2.2% to 1.8%. New Zealand's inflation figures are often thrown around by temporary factors and this year has been no different. There was an unusually large 1% rise in prices over the March quarter, which was led by gains in food and fuel prices. Food and fuel will continue to play an important role in the June quarter figures, though this time their net impact on the inflation rate will be negative.

Our forecast is lower than the 0.3% quarterly increase that the Reserve Bank forecast in its *May Monetary Policy Statement*. However, a downside surprise on inflation is unlikely to be too much of a concern for the Reserve Bank, which had already concluded that the pickup during the first quarter was on the back of transitory shifts in food and fuel prices and that inflation would be well below 2% again by next year.

Taking out food and fuel prices gives us a clearer picture of where inflation is heading. Under this metric, inflation bottomed out some time in 2015. Since then, it has risen gradually, though it remains below the 2% midpoint of the Reserve Bank's target band. This is consistent with our view

that while the economy is growing at a solid pace, it's not at risk of overheating.

... housing market conditions weakening...

Next up, we are seeing increasing signs of softness coming through in the housing market. The past year has seen house price inflation slow considerably, coupled with a large decline in house sales. These developments have come on the back of a tightening in lending conditions (LVRs) and creep higher in mortgage rates. Initially the impact of these changes had been concentrated heavily in Auckland. However, the latest REINZ housing market report indicates that regions outside of Auckland are also showing signs of slowing materially. Notably, sales throughout the country have fallen sharply through mid-2017, and by much more than the usual winter lull. In addition, Auckland prices have continued to fall and are now down 4% since January, while in other regions much of the resilience in house prices earlier in the year across has faded.

The slowdown in the housing market has important implications for the New Zealand economy, given that housing market conditions tend to be a key driver of household spending. Indeed, looking back to the earlier part of this year, durable goods spending has been relatively flat. With mortgage rates expected to continue to push higher, and house prices to continue easing, this signals an important headwind for economic activity over the year ahead.

Challenges ahead continued

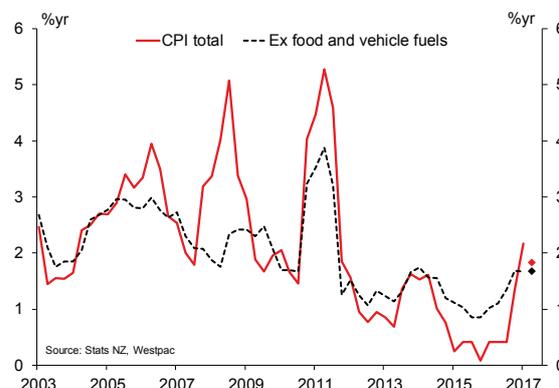
... and the NZD grinding upwards

Lastly, the New Zealand dollar has continued to push higher against the greenback, and on a trade-weighted basis, is around 3% higher than what the RBNZ was expecting. As well as adding to the challenges for exporters, lingering strength in the NZD/USD will continue to dampen imported inflation. Indeed, the strong rise in the New Zealand dollar over 2016 has yet to be fully reflected in the prices of imported goods such as clothing, cars, electronics and home furnishings.

OCR to remain on hold for some time

Putting this all together, it is looking very unlikely that inflation will threaten the upper-limit of the RBNZ's target band (1-3%) anytime soon. This reinforces our expectation that the RBNZ will keep the Official Cash Rate on hold through 2017 and 2018. However, this presents a challenge to financial markets, which in our view are too eager to assume that the RBNZ will soon join the club of central banks that are contemplating interest rate hikes. Markets are pricing in an OCR hike by June next year.

Annual inflation forecast

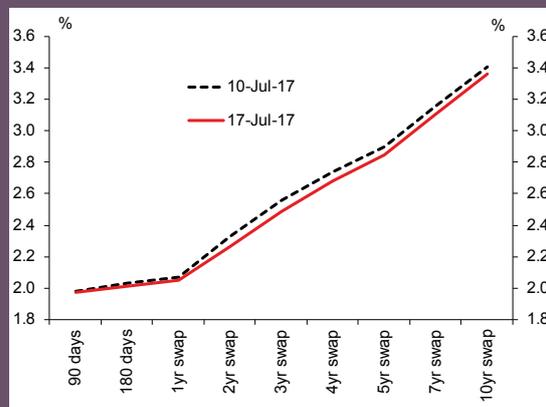


Fixed vs Floating for mortgages

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



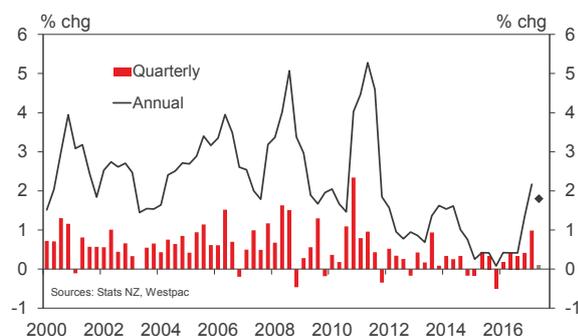
The week ahead

NZ Q2 CPI

Jul 18, Last: 1.0%, Westpac f/c: 0.1%, Mkt f/c: 0.2%

- We expect a 0.1% rise in the Consumer Price Index for the June quarter. This would bring the annual inflation rate down from 2.2% to 1.8%.
- A well-publicised spike in vegetable prices has been offset by a fall in fuel prices. We expect other seasonal influences to be a slight negative on balance.
- Our forecast is below the Reserve Bank's estimate of a 0.3% quarterly rise. However, the Reserve Bank was already expecting the recent pickup in inflation to recede over the coming year. We expect the OCR to remain unchanged until 2019, in contrast to market expectations of a rate hike by mid-2018.

NZ CPI inflation



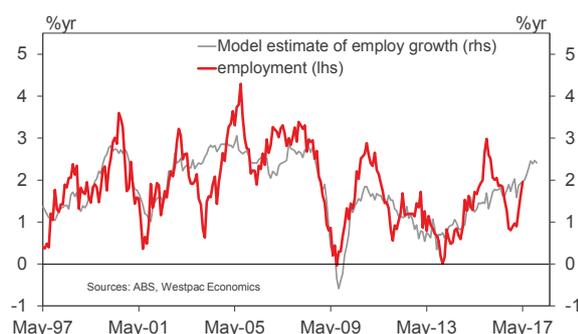
Aus June Labour Force employment '000

Jul 20, Last: 42.0k, WBC f/c: 20k

Mkt f/c: 15k, Range: -12k to 30k

- In May total employment rose 42.0k compared to a market's forecast for 10k.
- The Australian labour market went through a soft patch in 2016, particularly from August to November, but as we moved through 2017 there has been a distinct uplift in employment. In the last three months the annual pace lifted from 0.9%/yr in Feb to 2.0%/yr in May. Compare this to the 106k gain, or 0.9%/yr, in the year to Feb. In May the 42k gain in employment resulted in a 141.1k gain over the last three months or an average of 47k per month.
- Westpac's Jobs Index currently suggests employment growth should be around 2.0%/yr before accelerating to 2½%/yr by November. Our forecast for a 20k gain in June holds the annual rate at 2.0%/yr.

Westpac jobs index estimates of employment

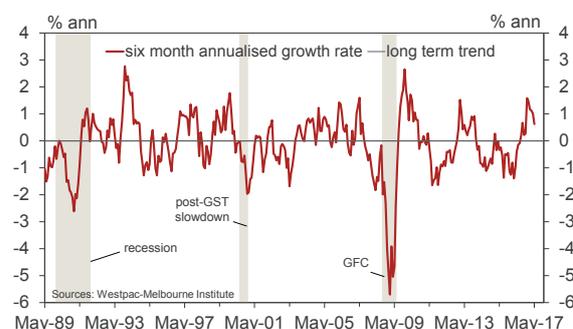


Aus Jun Westpac-MI Leading Index

Jul 19, Last: 0.62%

- The six month annualised growth rate in the Leading Index, a guide to the pace of economic activity three to nine months into the future, eased from 1.01% in April to 0.62% in May. The index is pointing to a clear slowing in momentum but remains comfortably above trend. The easing mainly reflects a less supportive backdrop for commodity prices and in global financial markets.
- The June read looks likely to be another weak one with more soft updates on a range of components including: the Westpac-MI Consumer Expectations Index (-1.4% vs -3.2% last month); and commodity prices (-5.3% vs -4.8%); dwelling approvals (-5.6% vs +4.8%). The yield spread has also narrowed (-12.5bps vs a 1.8bps widening last month). More importantly the the six month rate is now cycling past the big lift in commodity prices in late 2016.

Westpac-MI Leading Index



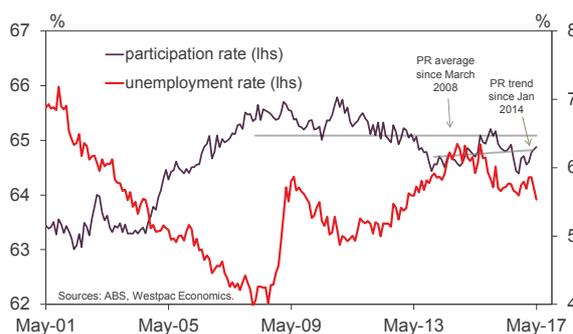
Aus May Labour Force - unemployment %

Jul 20, Last: 5.5% WBC f/c: 5.6%

Mkt f/c: 5.6%, Range: 5.5% to 5.7%

- The solid May gain in total employment was associated with a 0.1ppt lift in participation, to 64.9, driving a 23.4k gain in the labour force. This rise in the labour force limited the fall in the unemployment rate to 5.5% from 5.6% - at two decimal places the unemployment rate was 5.53%. We had been looking for the unemployment rate to fall over the next few months but we had not expected it to get to 5.5% so soon. The rise in participation in the month was all with females. Male participation was flat at 70.5 while female participation lifted to 59.4 from 59.3. And more surprising was that just about all of the gain in participation can be attributed to the rise in female participation in NSW, from 57.3 to 58.1. Holding participation flat in May lifts the labour force by 25k seeing the unemployment rate rounding up to 5.6%.

Unemployment and participation rates



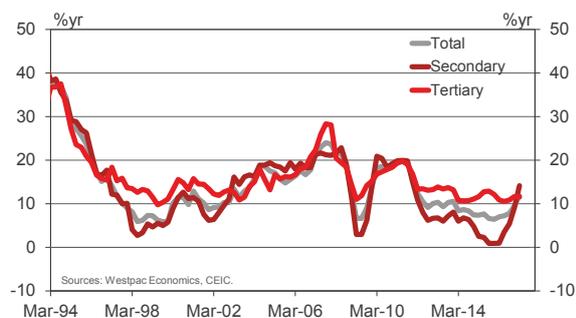
The week ahead

China Q2 GDP

Jul 17, Last: 6.9%, WBC 6.8%

- The March quarter followed December's beat with a second consecutive upside surprise, annual real GDP growth accelerating from 6.8%yr to 6.9%yr against expectations for an unchanged result. Compared to authorities' 2017 annual growth target of "around 6.5%yr", Q1 was certainly a strong start which provides a solid foundation to meet (or exceed) the 2017 growth target of 6.5%.
- Available PMI data for the June quarter points to continued robust growth over the past three months. Though the deterioration in employment conditions does warrant some caution over momentum in the services sector.
- We look for annual growth to edge down to 6.8% in Q2 on its way to a 6.6% result for 2017 overall. Nominal growth will continue to be supported by commodity prices.

China nominal GDP: total & by broad sector

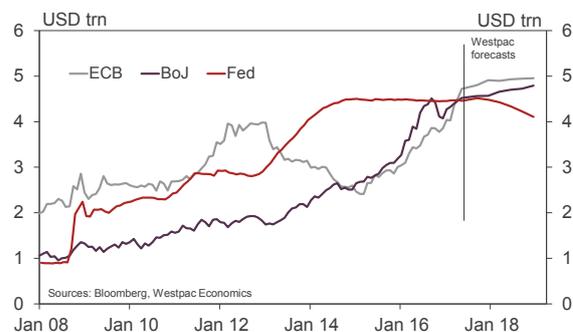


ECB July meeting

Jul 20, Last: -0.4%, WBC -0.4%

- The market has continued to speculate over a near-term change in the stance of policy by the ECB in recent months. Optimism in the region is unquestionably strong and this has supported robust gains in the Euro.
- The reality is that no announcement is likely until at least September, when the ECB's next set of forecasts will be released. The actual stance of policy wont change until the beginning of next year. During 2018, the pace of asset purchases will be curtailed, but only slowly.
- In terms of the key themes, the focus for post-meeting communications will be on: underutilisation of labour and associated weak wages growth; consequent expectations for core inflation; and the balance of activity growth between consumption and investment.

US first (and only) to reverse balance sheet



Data calendar

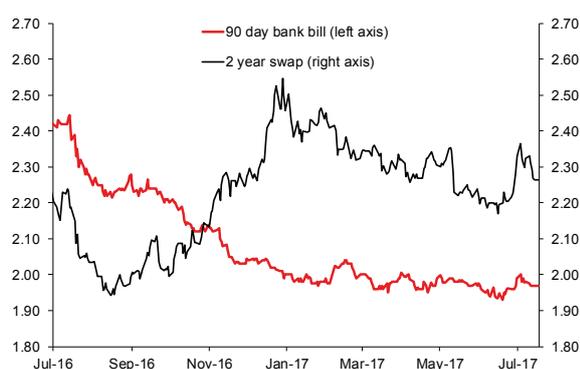
		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Jun Performance of Services Index	58.8	-	-	Service sector conditions remain firm, new orders strong.
	RBNZ Deputy Gov'nr Bascand speech	-	-	-	"NZ's net foreign liabilities: What lies beneath, and ahead?"
Chn	Jun retail sales %yr	10.7%	10.6%	-	Firm growth continues.
	Jun fixed asset investment ytd %yr	8.6%	8.5%	-	Investment in private sector remains underwhelming.
	Jun industrial production	6.7%	6.7%	-	Solid but not strong.
	Q2 GDP %yr	6.9%	6.8%	-	Annual growth to tick down in Q2.
UK	Jul Rightmove house prices	-0.4%	-	-	Despite low rates, uncertainty is weighing on housing demand.
US	Jul Fed Empire state index	19.8	15.0	-	One of the more positive manufacturing surveys.
Tue 18					
NZ	Q2 CPI	1.0%	0.2%	0.1%	Lower fuel prices and waning impact from higher food prices.
Aus	RBA minutes	-	-	-	Gov's decision statement in July a little more dovish?
	Jun new vehicle sales	2.9%	-	3.0%	Industry figures point to solid 4%qtr gain for Q2 as a whole.
Chn	Jun property prices	-	-	-	Balance between growth in tier 1 and rest remains the focus.
Eur	Jun CPI %yr (final)	1.3%	-	1.3%	Inflation pulse remains underwhelming.
	Jul ZEW survey of expectations	37.7	-	-	Optimism very strong.
UK	Jun CPI	0.3%	0.2%	-	Lower pound has boosted core and headline inflation.
	May house price index, %yr	5.6%	-	-	Lower supply is limiting the downside for prices.
US	Jun import price index	-0.3%	-0.2%	-	Weaker USD to support import prices.
	Jul NAHB housing market index	67	68	-	Mortgage rates and household incomes supportive.
Wed 19					
NZ	GlobalDairyTrade auction	-0.4%	-	-	Dairy futures remains flat, due to end of season volumes.
Aus	Jun Westpac-MI Leading Index	0.62%	-	-	Growth pulse slowing as external boosts wane.
	RBA Head of Economics speaks	-	-	-	Alex Heath, at Women in Economics panel, Sydney, 3:30pm.
US	Jun housing starts	-5.5%	-	-	Underlying trend has flattened...
	Jun building permits	-4.9%	-	-	... for starts and permits.
Thu 20					
Aus	Q2 NAB business survey	-	-	-	Survey for month of June reported condition up 4pts to +15.
	Jun employment	42.0k	15.0k	20.0k	Employment bounced back lifting the annual pace to be...
	Jun unemployment rate	5.5%	5.6%	5.6%	... on par with leading indicators. Pace should hold to Q4.
Eur	ECB policy decision	-0.4%	-0.4%	-0.4%	No change till September - to take effect in 2018.
	Jul consumer confidence	-1.3%	-	-	Very robust.
UK	Jun retail sales	-1.2%	-0.3%	-	Rising prices have eroded household spending power.
US	Initial jobless claims	247k	-	-	Very low.
	Jul Philly Fed index	27.6	21.5	-	Another very positive survey on manufacturing.
	Jun leading index	0.3%	0.4%	-	Activity growth at trend.
Fri 21					
NZ	Jun net migration	5,900	-	6,060	Continued firmness in new arrivals, NZ departures low.
Aus	RBA Deputy Governor Debelle	-	-	-	Global influences on domestic monetary policy, Adel', lunch.
	RBA Ast' Gov' Fin Systems speaks	-	-	-	Michele Bullock, Economic Conference, Melbourne, 1:30pm.
UK	Jun public sector net borrowing, £b	6.0	-	-	Slower growth likely to hamper progress on public borrowing.
Can	Jun CPI	0.1%	-	-	Current softness temporary, expect to rise as activity strengthens.

New Zealand forecasts

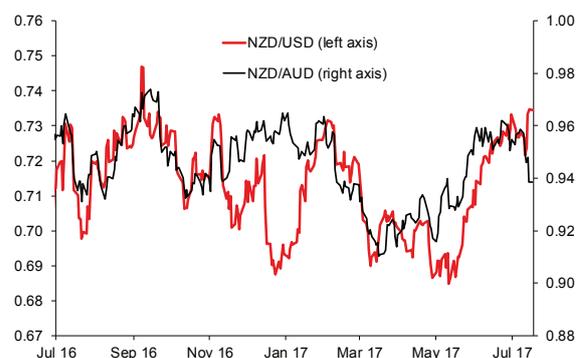
Economic Forecasts	2017				Calendar years			
	% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f
GDP (Production) ann avg	0.5	1.0	0.9	0.7	2.5	3.1	2.8	3.2
Employment	1.2	0.3	0.5	0.5	1.4	5.8	2.5	1.9
Unemployment Rate % s.a.	4.9	4.9	4.6	4.4	4.9	5.2	4.4	4.5
CPI	1.0	0.2	0.4	0.2	0.1	1.3	1.8	1.9
Current Account Balance % of GDP	-3.1	-3.1	-3.1	-3.2	-3.4	-2.8	-3.2	-3.3

Financial Forecasts	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-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	2.15
2 Year Swap	2.30	2.35	2.40	2.45	2.50	2.60
5 Year Swap	2.90	3.00	3.10	3.20	3.30	3.40
10 Year Bond	3.15	3.30	3.50	3.70	3.80	3.85
NZD/USD	0.71	0.70	0.69	0.67	0.66	0.64
NZD/AUD	0.96	0.96	0.96	0.97	0.97	0.98
NZD/JPY	79.5	79.8	78.7	77.1	76.6	74.9
NZD/EUR	0.65	0.65	0.66	0.65	0.65	0.63
NZD/GBP	0.56	0.56	0.56	0.54	0.54	0.53
TWI	77.8	77.5	77.1	75.9	75.4	74.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 17 July 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.82%	1.86%	1.86%
60 Days	1.89%	1.92%	1.89%
90 Days	1.97%	1.99%	1.95%
2 Year Swap	2.27%	2.34%	2.20%
5 Year Swap	2.85%	2.88%	2.68%

NZ foreign currency mid-rates as at Monday 17 July 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7345	0.7326	0.7253
NZD/EUR	0.6401	0.6409	0.6470
NZD/GBP	0.5605	0.5628	0.5681
NZD/JPY	82.61	82.22	80.45
NZD/AUD	0.9386	0.9536	0.9536
TWI	78.21	78.59	78.12

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.3	3.0
CPI inflation % annual	2.7	1.7	1.7	1.5	2.1	2.3
Unemployment %	5.8	6.2	5.8	5.7	5.7	6.2
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-1.7	-3.3
United States						
Real GDP %yr	1.5	2.4	2.6	1.6	2.1	2.4
Consumer Prices %yr	1.5	1.6	0.1	1.3	2.0	1.8
Unemployment Rate %	7.4	6.2	5.3	4.9	4.4	4.3
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	1.1	1.0
Euroland						
Real GDP %yr	-0.3	0.9	1.6	1.7	1.8	1.4
United Kingdom						
Real GDP %yr	2.2	2.9	2.2	2.0	1.8	1.6
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	3.3	3.5	3.5

Forecasts finalised 14 July 2017

Interest Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.70	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.72	2.90	2.95	3.05	3.20	3.35	3.30	3.30
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.34	2.55	2.65	2.90	3.10	3.30	3.30	3.30
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30

Exchange Rate Forecasts	Latest	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
AUD/USD	0.7741	0.74	0.73	0.72	0.69	0.68	0.65	0.65
USD/JPY	113.43	113	114	115	115	116	116	118
EUR/USD	1.1408	1.13	1.13	1.11	1.10	1.08	1.07	1.06
AUD/NZD	1.0578	1.04	1.04	1.04	1.03	1.03	1.02	1.02

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- (i) Chinese Wall/Cell arrangements;
- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
- (iv) a "need to know" policy;
- (v) documented and well defined procedures for dealing with conflicts of interest;
- (vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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