Weekly Commentary

24 July 2017

Old school

Last week's inflation report confirmed that price pressures in New Zealand were subdued in the June quarter, and in fact even softer than expected. While technological change has played some part, the recent weakness in inflation seems to be largely for old-fashioned reasons.

Consumer prices overall were flat in the June quarter, following a surprisingly large 1% increase in the March quarter. That saw the annual inflation rate slow from 2.2% to 1.7%. Both of the last two quarters were affected by what we expect to be temporary factors, so these numbers probably overstate the degree to which inflation has swung around lately. But a broad range of measures of underlying inflation also point to a slowdown in the annual rate.

New Zealand is far from alone in that regard. Many of our trading partners – most of whom report their inflation figures monthly rather than quarterly – have already seen a pullback in both headline and underlying inflation measures in recent months, after a strong pickup in the early part of this year. The common thread is oil prices, which rose sharply between early 2016 and early 2017 but have dropped back a bit since then.

As for New Zealand specifically, we can break the trends in inflation down to two broad themes. First, most of the slowdown in the inflation rate over the June quarter was in the tradables component. That includes the drop in fuel prices, but there were also some big price drops for import-heavy items such as home furnishings and electronics.

The electronics components of the CPI – such as TVs, computers and smartphones – should be treated with caution, as the prices are heavily quality-adjusted to take account of improving technology. So while there was a particularly large drop in these prices in the June quarter, they've been falling rapidly for many years now. And their deflationary influence is no greater now than it was in the 2000s, when overall inflation was persistently testing the top end of the Reserve Bank's target range.

The more significant factor that weighed on tradables inflation was the strong rise in the New Zealand dollar over 2016 – up around 12% in trade-weighted terms. Exchange rate movements flow through to the retail prices of imported goods with a typical lag of two to three quarters, reflecting importers' stock turnover rates and/or exchange rate hedges. The lag isn't precise – there was less exchange rate passthrough than we expected in the March quarter, but more than expected in the June quarter. But if we take the two quarters together, the strength of the relationship between the NZD and tradables inflation seems to be much the same as it ever was.

The second theme is that non-tradables inflation, while up from its lows, is still running substantially below where it was in the years before the Global Financial Crisis. This group includes government charges and other non-market prices, which on balance have actually been less of an inflationary force in recent times.

But for the most part, non-tradables inflation reflects the strength of domestic demand and the extent of domestic capacity constraints. And here, the reason for low inflation is simple: the local economy just isn't growing fast enough to cause it to overheat. Strong population growth means that New Zealand's GDP is growing faster than many of our peers, but in per-capita growth terms we're distinctly in the middle

Old school continued

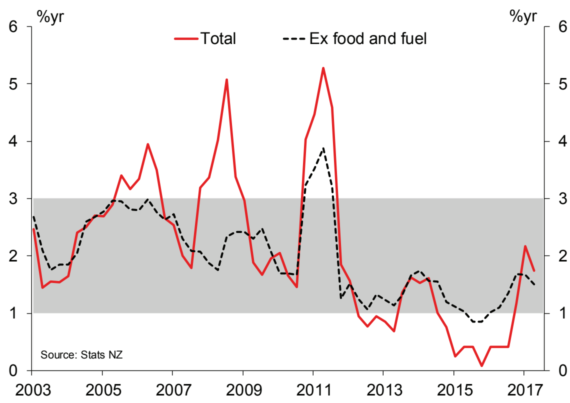
of the pack. The unemployment rate has been declining, and at around 5% it's arguably no longer in disinflationary territory, but it's not in what most economists would consider to be in inflationary territory either.

The notable exception to the domestic inflation story is in housing. Prices for newly built homes (excluding the land value) rose 6.4% in the year to June; in Auckland they rose by 8.1%. But we note that this component of the CPI has been rising strongly for several years, with no sign of these price pressures spilling over into other areas. Rising prices and the slow supply response seem to be very much a product of the structure of the homebuilding industry, which is understandably coming in for increased scrutiny.

For the Reserve Bank, the policy prescription remains the same. The economy needs to be allowed to continue to grow and gradually use up its spare capacity, in order for inflation to settle around the 2% target midpoint on a sustained basis. And that means keeping interest rates at low levels for an extended period.

The June quarter CPI is the last major piece of data before the RBNZ starts to prepare its August *Monetary Policy Statement*. (The June quarter labour market figures are released in early August, but not in time to make it into their forecasting process.) Recent developments have generally been of the soft side: inflation was lower than forecast, the New Zealand dollar has strengthened, and the housing market is cooling down much faster than the RBNZ expected.

CPI inflation



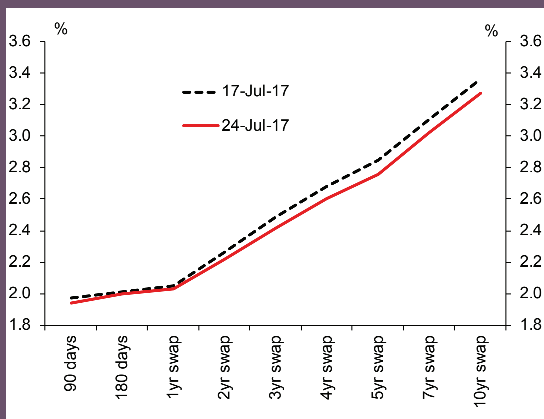
If the RBNZ was "firmly neutral" in its last review, it is hardly going to be mulling the timing of interest rate hikes this time around. We think that the market is off-base in pricing in an OCR hike for next year, even if the timing has been pushed out from June to August since the CPI figures. In contrast, we don't expect an OCR hike before 2019, and that sort of horizon is too far out to be specific about the timing.

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



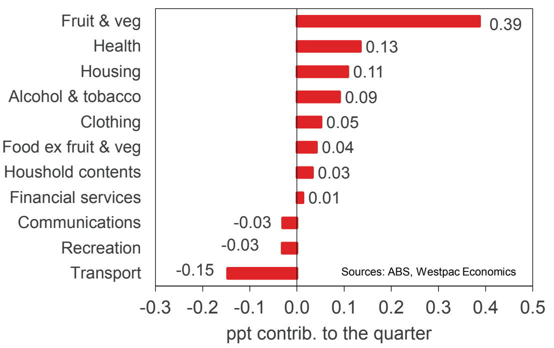
The week ahead

Aus Q2 Consumer Price Index

Jul 26 Last: 0.5%, WBC f/c: 0.6%
Mkt f/c: 0.4%, Range: 0.2% to 0.8%

- The Q1 CPI printed 0.5% for an annual rate of 2.1%yr compared to 1.5%yr in Q4, 1.3%yr in Q3 and 1.0%yr in Q2. The June quarter 2016 was the lowest rate of annual inflation since June 1999.
- The core measures, which are seasonally adjusted and exclude extreme moves, rose 0.4% on average compared to the market's expectation of 0.5% rise. The annual pace of the average of the core measures is now 1.8%yr from 1.5%yr in Q4 and Q3.
- In the June quarter, a large Debbie boost to fruit plus a recovery in dwellings are offset by falling auto fuel. Westpac's forecast for the headline CPI is 0.6%qtr lifting the annual pace to 2.4%yr from 2.1%yr. Core inflation is forecast to print 0.5%qtr (0.54% at two decimal places) holding the annual rate flat at 1.8%yr.

Contributions 2017Q2 CPI forecast

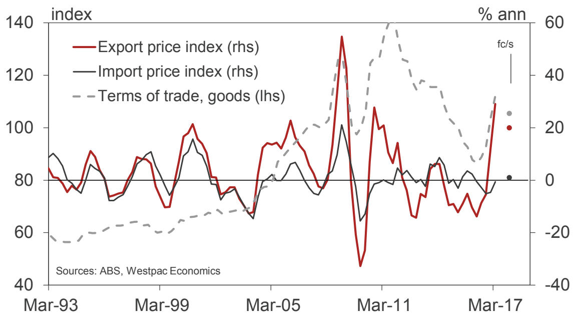


Aus Q2 import price index

Jul 27, Last: 1.2%, WBC f/c: 0.7%
Mkt f/c: 0.7%, Range: -1.0% to 2.0%

- Import goods prices were little changed over the past year, with a Q1 result of +1.2%qtr, -0.6%yr.
- For the June quarter, the price of imported goods is expected to edge higher, increasing by 0.7%, reflecting the impact of the weaker currency. That would have import prices 1% above the level of a year ago.
- The Australian dollar weakened during the June quarter, declining by 2.2% on a TWI basis, reversing the gain in the previous three months. Over the past year, the dollar is 3% higher on a TWI basis.
- Global energy prices fell in the June quarter, declining by around 5%. Lower fuel prices partially offset the impact on import prices of the weaker dollar.

Import & export goods prices

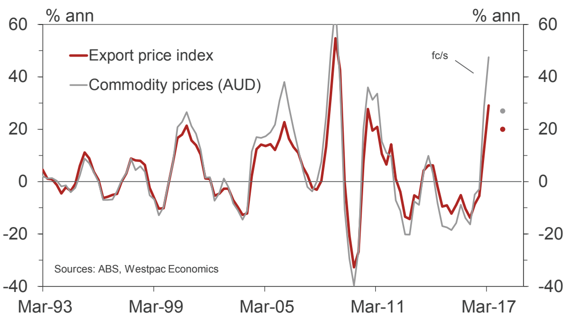


Aus Q2 export price index

Jul 27, Last: 9.4%, WBC f/c: -5.5%
Mkt f/c: -5.5%, Range: -12.0% to -2.9%

- Export prices increased sharply over the past year, rebounding as commodity prices bounced off the lows prevailing early in 2016.
- In Q1, the export price index increased by 9.4%qtr, 29.1%yr.
- However, the tide turned in the June quarter. Commodity prices eased back in the period, falling by about 8% in AUD terms, driving a fall in export prices.
- For Q2, the export price index is expected to decline by 5.5%. Annual growth moderates to 20%.
- The terms of trade for goods, on these estimates, fell by 6.2% in the quarter, trimming annual growth from 30% to 18.5%.

Commodity prices & export price index

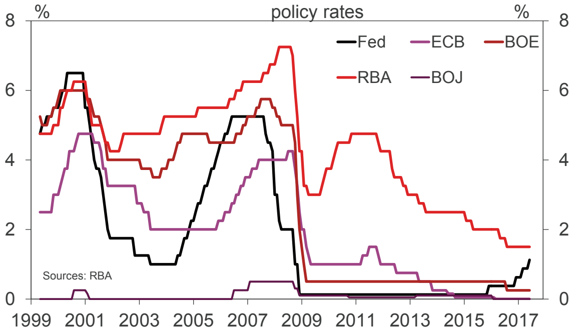


US FOMC July meeting

Jul 26, Last: 1.125%, WBC 1.125%

- In their June meeting communications, the FOMC remained resolutely positive on the outlook for the economy. This was principally owing to the strength of the labour market and a belief that, inevitably, this would translate into stronger wages growth and consumption. Their view of business investment was also constructive. A degree of unease however emerged in the minutes, with fiscal policy shifting from a solely positive risk to an either or proposition; the potential negative impact on investment of fiscal impasse was also noted. Since then, some members of the FOMC have also questioned the potential impact of balance sheet normalisation on the Fed Funds Rate path. Absent Q&A and forecasts, the July meeting offers limited scope to provide detailed guidance. But you can expect the statement to contain a positive view to keep the FOMC's options open, particularly given the market's sombre view.

Developed world policy interest rates



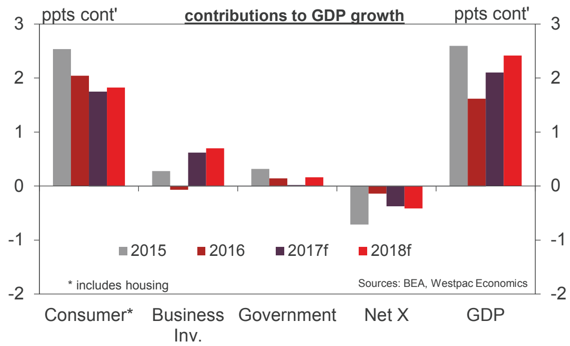
The week ahead

US Q2 GDP

Jul 28, Last: 1.4%, WBC 2.5% (annualised)

- Q1's 1.4% annualised outcome was a disappointment for a number of reasons, but most notably because of the weakness evident in consumption. To an extent this was due to unseasonal weather which limited demand for services – two-thirds of total consumption.
- However, durables and non-durables demand also experienced a material deterioration in Q1. Come Q2, the demand pulse for these categories is again likely to underwhelm. Partial data also suggests services will struggle to accelerate materially. Given confidence and jobs growth, spending should be much stronger.
- Business investment rebounded in Q1, but Q2 will see slower growth; the public sector's contribution will also be negligible. All told, a 2.5% gain is most likely. Risks are skewed to the downside and centred on the consumer.

US GDP growth depends on consumer

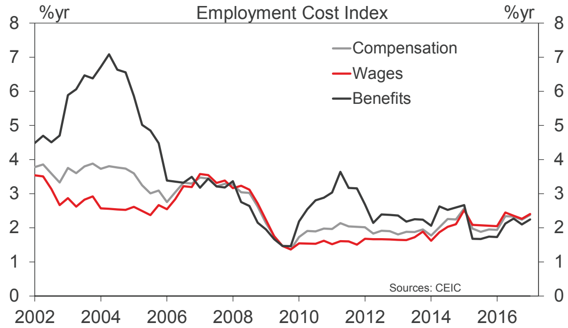


US Q2 Employment Cost Index

Jul 28, Last: 0.8%, WBC 0.6%

- Q1 finally saw a stronger wage outcome, total compensation rising 0.8% in the three months to March. This was driven by a 0.8% gain for wages, although benefits also rose 0.7%. Compensation is up 2.4%yr; wages 2.5%yr.
- The strength shown in the labour market should see wages growth accelerate. However, the pass through has been underwhelming to date, hence further progress is likely to be slow going.
- It is important to note that an eye also needs to be kept on benefits growth, with private-sector employers clearly using this component of consumption to offset demands for stronger wages from workers.
- Given the above, we look for a 0.6% rise for total compensation, though the wage gain could be stronger. That will keep the annual rate for compensation unchanged.

Benefit growth lags wages



Data calendar

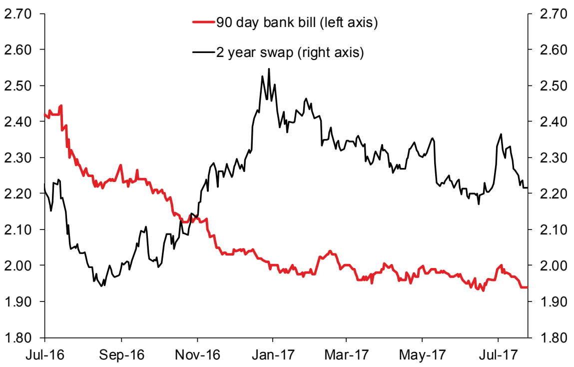
		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
Eur	Jul Markit manufacturing PMI – flash	57.4	57.2	–	Very strong…
	Jul Markit services PMI – flash	55.4	55.5	–	… and likely to remain that way.
US	Jul Markit manufacturing PMI – flash	52.0	52.1	–	Is pointing to a much more modest growth pace…
	Jul Markit services PMI – flash	54.2	–	–	… than the ISM variants.
	Jun existing home sales	1.1%	–1.2%	–	Still in an uptrend.
Can	May wholesale trade sales	1.0%	–	–	Firming in conditions across a range of industries.
Tue 25					
US	May FHFA house prices	0.7%	0.5%	–	Price growth remains robust…
	May S&P/CS home price index	0.28%	0.20%	–	… across most major cities.
	Jul consumer confidence index	118.9	116.0	–	Consumer's optimism based on labour market.
	Jul Richmond Fed index	–	–	–	Regional surveys mixed and volatile.
Wed 26					
NZ	Jun trade balance, $m	103	300	200	Import bill should fall back after a jump in oil imports in May.
Aus	Q2 CPI	0.5%	0.4%	0.6%	Large fruit boost offset by falling auto fuel & wider discounting.
	Q2 CPI trimmed mean	0.5%	0.5%	0.5%	With extremes trimmed, core falls to around 0.5% pace.
	RBA Governor Philip Lowe	–	–	–	"The Labour Market and Monetary Policy", Sydney 1:05pm.
UK	Q2 GDP (advanced)	0.2%	0.3%	0.3%	Softness in household and business sectors.
US	Jun new home sales	2.9%	0.8%	–	Demand reportedly limited by supply.
	FOMC policy decision, midpoint	1.125%	1.125%	1.125%	Will hold to positive view on economy & gradual normalisation.
Thu 27					
Aus	Q2 import price index	1.2%	0.7%	0.7%	Prices up on weaker AUD, partly offset by lower fuel prices.
	Q2 export price index	9.4%	–5.5%	–5.5%	The tide turns, commodity prices fall after recent strong run.
Chn	Jun industrial profits %yr	16.7%	–	–	Commodities continue to support.
Eur	Jun M3 money supply %yr	5.0%	5.0%	–	Credit data also due.
US	Jun wholesale inventories prelim.	0.4%	–	–	Continue to fluctuate.
	Jun durable goods orders prelim.	–0.8%	3.0%	–	Headline bounce expected, but underlying trend still soft.
	Jun Chicago Fed activity index	–0.26	–	–	Points to growth near trend.
	Initial jobless claims	233k	–	–	Very low.
	Jul Kansas City Fed index	11	–	–	Regional surveys mixed and volatile.
Fri 28					
Aus	Q2 PPI	0.5%	–	0.5%	Falling auto fuels offsetting rising food & construction costs.
Eur	Jul economic confidence	111.1	110.8	–	Sentiment is strong across the Continent…
	Jul business climate indicator	1.15	1.18	–	… amongst businesses…
	Jul consumer confidence	–1.7	–	–	… and households.
UK	Jul GfK consumer confidence	–10	–11	–	Had softened; squeeze on spending power & political uncertainty.
	Jul Nationwide house prices	1.1%	–0.2%	–	Low inventories providing a floor under prices despite headwinds.
US	Q2 employment cost index	0.8%	0.6%	0.6%	Q1 bounce not likely to be repeated in Q2.
	Q2 GDP %annualised – advance	1.4%	2.5%	2.5%	A solid but not strong rebound predicted for Q2.
	Jul Uni. of Michigan sentiment	93.1	93.0	–	Remains strong.
	Fedspeak	–	–	–	Kashkari participates in Q&A at a town hall in Minnesota.

New Zealand forecasts

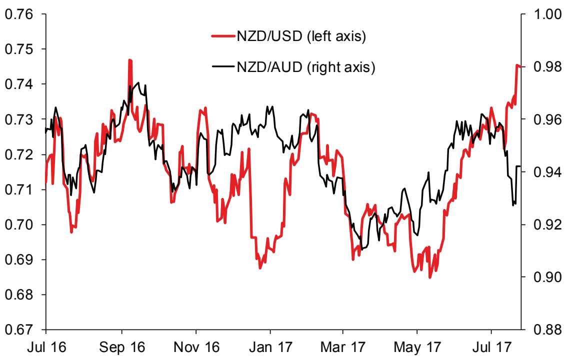
Economic Forecasts	2017				Calendar years			
% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f	2018f
GDP (Production) ann avg	0.5	1.0	0.9	0.7	2.5	3.1	2.8	3.2
Employment	1.2	0.3	0.5	0.5	1.4	5.8	2.5	1.9
Unemployment Rate % s.a.	4.9	4.9	4.6	4.4	4.9	5.2	4.4	4.5
CPI	1.0	0.0	0.4	0.2	0.1	1.3	1.6	1.9
Current Account 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 24 July 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.82%	1.86%	1.85%
60 Days	1.87%	1.91%	1.90%
90 Days	1.94%	1.98%	1.96%
2 Year Swap	2.22%	2.33%	2.21%
5 Year Swap	2.76%	2.90%	2.68%

NZ foreign currency mid-rates as at Monday 24 July 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7450	0.7275	0.7283
NZD/EUR	0.6385	0.6384	0.6503
NZD/GBP	0.5728	0.5648	0.5725
NZD/JPY	82.75	82.86	80.98
NZD/AUD	0.9421	0.9592	0.9643
TWI	78.85	78.44	78.70

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	1.69	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.70	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	2.26	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	0.7889	0.74	0.73	0.72	0.69	0.68	0.65	0.65
USD/JPY	112.04	113	114	115	115	116	116	118
EUR/USD	1.1628	1.13	1.13	1.11	1.10	1.08	1.07	1.06
AUD/NZD	1.0628	1.04	1.04	1.04	1.03	1.03	1.02	1.02

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