

Weekly Commentary

27 March 2017



Hold the line

The Reserve Bank left the Official Cash Rate unchanged at 1.75% last week, as was widely expected. Overall, there was little in the accompanying statement to suggest any shift in the RBNZ's thinking relative to its February Monetary Policy Statement or the Governor's speech earlier this month.

The bottom line is that the RBNZ expects the cash rate to remain low for a considerable period (the forecasts published in February suggested no change until late 2018). The outlook for the New Zealand economy remained positive, but the risks around the global environment were seen to the downside.

On the latter, geopolitical risks are certainly a concern, but not the only one. RBNZ Governor Wheeler has already spelled out his concerns about Trump's policy agenda and the potential impact on New Zealand, and nothing has changed in recent weeks to allay those concerns. But the RBNZ also highlighted the economic aspects: there is still significant excess capacity in the global economy, and core inflation (excluding oil price movements) remains low and stable. The implication is that imported inflation is still seen as largely absent.

In contrast to the international picture, the RBNZ is still positive on the local economy, which is being supported by strong population growth, building activity and low interest rates. The RBNZ noted the weaker than expected December quarter GDP outturn, but attributed it to temporary factors.

The RBNZ also held its line on the housing market, noting again that it wasn't convinced that the recent slowdown in house prices will be sustained. This is one area where we differ. We've long emphasised the role of interest rates in determining house prices, and we think that the rise in mortgage rates over recent months will have a lasting impact on the rate of house price growth. That will have

consequences for inflation, in terms of the strength of growth in domestic demand, and in the building industry's ability to keep ramping up prices.

One of the few additions to last week's statement was that the RBNZ was "encouraged" by the fact that the New Zealand dollar has lost some ground in recent weeks. However, there's no real sense that this will make a meaningful difference on the inflation front. A 4% fall in the exchange rate, even if sustained, just isn't that significant in the scheme of things. What's more, this comes after a 10% rise in the exchange rate in the preceding year, which has yet to be fully passed through into retail prices.

The RBNZ noted that headline inflation will be "variable" over the coming year due to one-off effects from food and imported goods prices. That's clearly a reference to the fact that the next inflation result is shaping stronger than the 1.5% rate that the RBNZ forecast in the February MPS (we expect it to reach 1.8%).

However, the RBNZ seems to share our view that the inflation rate will struggle to move any higher over the rest of this year. Some of the factors behind the near-term rise in inflation are:

- World oil prices are up about 80% on a year ago, when they were at their lowest ebb. Unless prices continue to rise at that pace – unlikely, with US frackers once again stepping in to ramp up production – we are now passing the peak inflationary impact of oil prices.

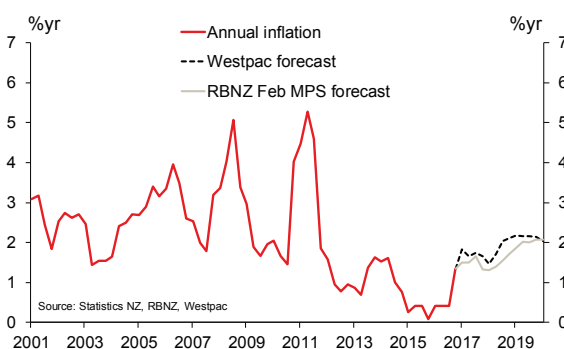
Hold the line continued

- Locally, prices for dairy products have risen in line with the lift in the farmgate milk price for this season (which affects the cost of ingredients). Unless next season's milk price is substantially higher than the current season, these price increases won't be repeated.
- Prices for some fresh produce have been unusually high in recent months, as poor weather has delayed harvesting. These prices will drop back to normal levels as the harvest is completed.

Meanwhile, evidence of a broad-based rise in inflation pressures remains hard to come by. New Zealand's economy is growing at a reasonable pace compared to its peers, but this growth has been flattered by a surge in in population growth. Net migration reached another record high in the year to February, with more migrants arriving on work visas and more Kiwis choosing to live and work in New Zealand instead of Australia. This inflow (largely prime working-age) people is adding to both demand and supply in roughly equal measure.

Take out population growth, and the economy is growing at a much more modest pace of around 1% per year. That's just not a sign of an economy that's at risk of overheating. Similarly, an unemployment rate of around 5% and a lack

CPI inflation



of upward pressure on wage growth suggest that the job market as a whole isn't especially tight. And that means that getting inflation back to the 2% target, and maintaining it there, is likely to be a gradual process.

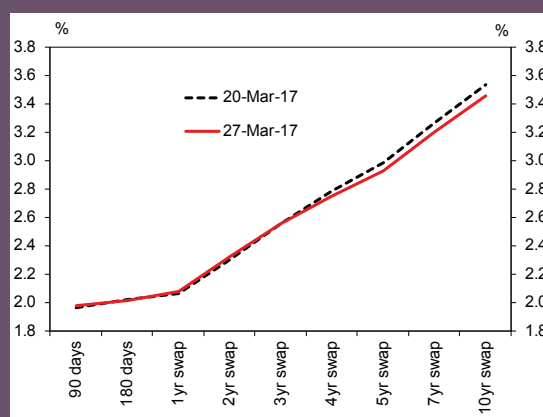
Consequently, we agree with the RBNZ that the OCR will remain on hold for a considerable time. We've pencilled in two OCR increases in the first half of 2019, but the way we'd describe this more broadly is that the first rate hike is too far away to be precise about the timing.

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

NZ Mar business confidence

Mar 31, Last: 16.6

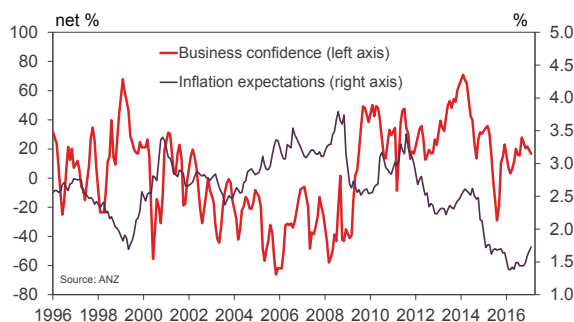
- February’s survey showed that firms remained upbeat about their own economic prospects, indicative of a solid pace of growth continuing in early 2017. Construction firms remained the most upbeat, although firms in services and manufacturing sectors were also relatively positive about their business prospects.
- One-year ahead inflation expectations have been trending higher since October last year, rising to 1.73% in February – the highest since early 2015. While it’s clear that inflation is well past its trough, we expect subdued imported inflation to hold inflation in the lower half of the RBNZ’s target for some time. Continued strong gains in survey pricing measures in coming months would cast some doubt on that assessment.

NZ Feb building consents

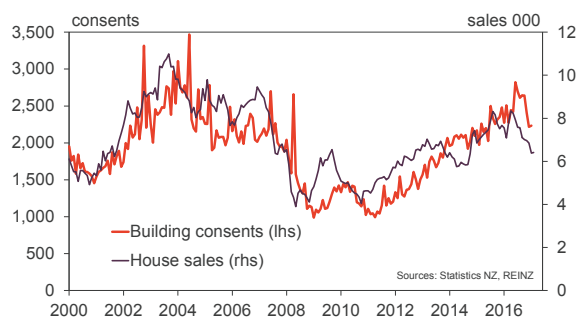
Mar 31, Last: 0.8%, Westpac f/c: 5%

- The number of new residential dwelling consents issued rose by 0.8% in January. That was a very modest increase following some large declines in November (-8.9%) and December (-7.9%) and leaves us looking at a soft start to the year in terms of construction activity. In fact, comparing the three months to January with the preceding three months, consent numbers are down 13%. Much of this softness has been centred on Auckland.
- With legislative hurdles around the Unitary Plan being worked out, and earthquake related disruptions fading, we expect to see consent issuance picking up over the coming months. Nevertheless, issuance in Auckland is expected to remain below the required levels.

NZ business confidence and inflation expectations



NZ housing activity



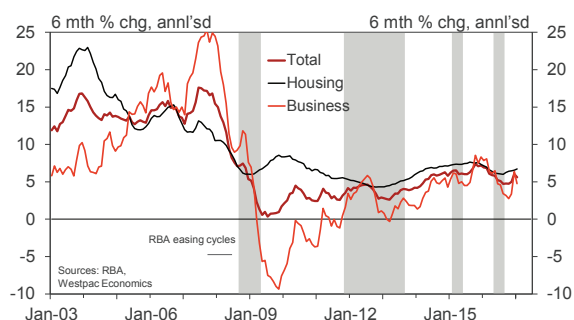
Aus Feb private sector credit

Mar 31, Last: 0.2%, WBC f/c: 0.4%

Mkt f/c: 0.5%, Range: 0.4% to 0.7%

- Credit to the private sector has been volatile of late, centred on business. An on par +0.5% in November was followed by a relatively strong +0.7% in December and then +0.2% in January. For February, we expect a moderate gain of 0.4%.
- Housing credit growth is robust, supported by RBA rate cuts in 2016. Expect a February result in line with that for January, of 0.55%, 6.8% annualised.
- In 2016, business credit grew by 5.6%, in what was a stop-start performance. A stalling mid-year, around the July Federal election, was followed by a catch-up late in the year. In December business credit jumped 1.1%. However, January saw a rare fall, -0.3%, on the recent slip in commercial finance. For February, we anticipate only a small gain.

Credit: momentum shift



Data calendar

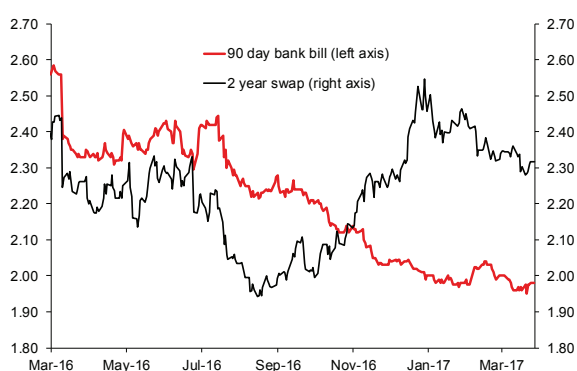
		Last	Market median	Westpac forecast	Risk/Comment
Mon 27					
Eur	Feb M3 money supply %yr	4.9%	4.9%	-	Comes with private sector loan growth. Credit was solid in Jan.
Ger	Mar IFO business climate survey	111.0	110.8	-	Firms are optimistic - view of current business situation at 2011 high.
US	Mar Dallas Fed index	24.5	21.0	-	Manufacturing sector in a cyclical upswing.
	Fedspeak	-	-	-	Evans speaks on economy and policy in Madrid.
Tue 28					
Aus	RBA speak	-	-	-	Debelle speaks at the FX Week Australia conference in Sydney.
UK	Mar Nationwide house prices	0.6%	0.5%	-	Tentative date - 28 to 04.
US	Feb wholesale inventories	-0.2%	0.2%	-	Pulled back in Jan but inventories should add to Q1 GDP growth.
	Jan S&P/CS home price index	0.9%	0.7%	-	Trending up, reached a 30 mth high in Dec despite higher rates.
	Mar consumer confidence index	114.8	113.4	-	Confidence at 15 year high, centred on business and labour conditions.
	Mar Richmond Fed index	17	14	-	Manufacturing positive, firms expect this to continue.
	Fedspeak	-	-	-	Kaplan discussing economic conditions and policy in Texas.
	Fedspeak	-	-	-	George gives keynote at forum on banking and the economy in Kansas.
	Fed chair Yellen speaks	-	-	-	Yellen speaks on workforce development in low-income communities.
	Fedspeak	-	-	-	Kaplan holds Q&A with Dallas committee of foreign relations.
Wed 29					
UK	Feb net mortgage lending €bn	3.4	-	-	Lending has been steady to date, supported by low interest rates...
	Fed mortgage approvals	69.9k	-	-	... but nervousness may weigh on households' demand for credit.
	Brexit article 50 trigger date	-	-	-	Negotiations of UK's exit from the EU begin.
US	Feb pending home sales	-2.8%	2.5%	-	Weakness in Midwest and West. Differs from other housing data.
	Fedspeak	-	-	-	Powell speaks on the history and structure of the Fed.
	Fedspeak	-	-	-	Evans speaks on economy and policy at conference in Frankfurt.
	Fedspeak	-	-	-	Rosengren speaks on the economic outlook in Boston.
	Fedspeak	-	-	-	Williams speaking on 'From recovery to sustainable growth' in NY.
Thu 30					
Chn	Q4 current account balance - final	37.6	-	-	Preliminary reading indicated a drop from Q3.
Eur	Mar economic confidence	108.0	108.1	-	2017 has been flat to date following 2016 lift.
	Mar business climate indicator	0.82	0.82	-	Edged up slightly in Feb after strong rise in Jan. At post 2010 high.
	Mar consumer confidence - final	-5.0	-	-	Mar flash points to further improvement
Ger	Mar CPI	0.6%	0.4%	-	Sits above broader Eurozone measure, CPI ex energy last at 1.7%yr.
US	Q4 GDP annualised (third estimate)	1.9%	2.0%	-	Second estimate was slightly below market expectations.
	Initial jobless claims	258k	-	-	Around historic lows.
	Fedspeak	-	-	-	Mester speaks on payment system improvement in Chicago.
	Fedspeak	-	-	-	Kaplan speaks at capital markets summit in Washington.
	Fedspeak	-	-	-	Williams speaks at learning community event in New York.
Fri 31					
NZ	Q1 Westpac MM labour market conf.	112.7	-	-	Confidence lifted in Q4 supported by increases in job openings.
	Feb building permits	0.8%	-	5.0%	Building levels to lift after earlier softness and quake disruptions.
	Mar ANZ business confidence	16.6	-	-	Confidence dipped lower last month and inflation expectations rose.
Aus	Feb private sector credit	0.2%	0.5%	0.4%	Expect a modest gain, after volatile run (0.5%, 0.7%, 0.2%).
Chn	Mar manufacturing PMI	51.6	51.6	-	Elevated as manufacturing cycle picks up.
Eur	Mar CPI %yr	2.0%	1.8%	-	Headline lifting on energy, but core remains weak at 0.9%.
UK	Mar GfK consumer sentiment	-6	-7	-	Rising prices and political uncertainty likely to dampen confidence.
	Q4 current account balance €bn	-25.5	-16.0	-	Lower pound pushing up import prices, offsetting improved exports.
	Q4 GDP (final)	0.7%	0.7%	-	Firm household spending and improved manufacturing conditions.
US	Feb personal income	0.4%	0.4%	-	Picked up in Jan after annual growth slowed in 2016 from 2015.
	Feb personal spending	0.2%	0.2%	-	Slower Jan followed an above average rise in Dec.
	Feb PCE deflator	0.4%	0.1%	-	Tracking beneath CPI but still rose to Fed target of 2.0%yr...
	Feb core PCE deflator	0.3%	0.2%	-	... though core measure remained at 1.7%yr.
	Mar Chicago PMI	57.4	56.8	-	Volatile lately, Feb jump points to business optimism.
	Mar Uni. of Michigan sentiment - final	97.6	97.8	-	Mar flash near 10yr high but 5-10yr inflation expectations fell to 2.2%.
	Fedspeak	-	-	-	Kashkari answers questions at a banking conference.

New Zealand forecasts

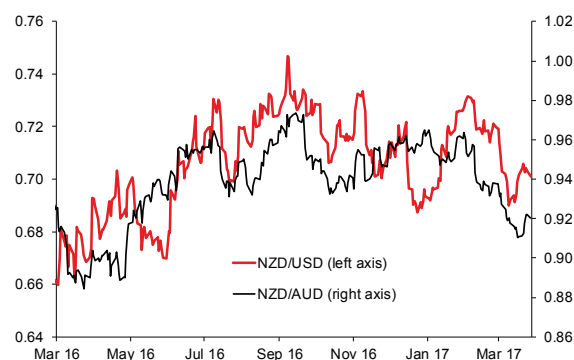
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2015	2016	2017f
GDP (Production) ann avg	3.4	2.4	3.1	3.4	2.5	3.1	3.2	3.4
Employment	3.2	2.0	5.3	2.1	1.4	5.8	2.3	1.5
Unemployment Rate % s.a.	5.4	5.2	4.7	4.4	4.9	5.2	4.4	4.2
CPI	0.3	0.4	1.8	1.5	0.1	1.3	1.6	2.1
Current Account Balance % of GDP	-3.5	-3.1	-2.7	-2.7	-3.4	-2.7	-2.6	-3.3

Financial Forecasts	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-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	2.50	2.50	2.50	2.50	2.60	2.70
5 Year Swap	3.15	3.20	3.30	3.35	3.45	3.60
10 Year Bond	3.45	3.50	3.60	3.65	3.75	4.00
NZD/USD	0.69	0.68	0.67	0.66	0.64	0.63
NZD/AUD	0.91	0.91	0.91	0.91	0.92	0.93
NZD/JPY	81.4	80.2	80.4	80.3	79.7	79.4
NZD/EUR	0.66	0.66	0.66	0.66	0.65	0.64
NZD/GBP	0.57	0.57	0.56	0.56	0.54	0.53
TWI	76.3	75.8	75.5	75.0	74.2	73.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 27 March 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.84%	1.84%
60 Days	1.90%	1.90%	1.92%
90 Days	1.98%	1.96%	1.98%
2 Year Swap	2.32%	2.36%	2.32%
5 Year Swap	2.93%	3.08%	2.94%

NZ foreign currency mid-rates as at Monday 27 March 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7009	0.6934	0.7202
NZD/EUR	0.6469	0.6492	0.6816
NZD/GBP	0.5617	0.5699	0.5773
NZD/JPY	77.64	79.51	80.74
NZD/AUD	0.9204	0.9192	0.9379
TWI	76.33	76.13	78.47

International forecasts

Economic Forecasts (Calendar Years)	2013	2014	2015	2016	2017f	2018f
Australia						
Real GDP % yr	2.1	2.8	2.4	2.5	2.6	2.8
CPI inflation % annual	2.7	1.7	1.7	1.5	2.0	1.9
Unemployment %	5.8	6.2	5.8	5.7	5.9	6.0
Current Account % GDP	-3.4	-3.0	-4.7	-2.7	-0.6	-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	1.3	2.1	1.8
Unemployment Rate %	7.4	6.2	5.3	4.9	4.4	4.4
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	1.7	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 20 March 2017

Interest Rate Forecasts	Latest	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-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	2.76	2.95	3.00	3.05	3.15	3.25	3.40	3.40
International								
Fed Funds	0.875	0.875	1.125	1.125	1.375	1.375	1.625	1.625
US 10 Year Bond	2.43	2.65	2.75	2.85	3.00	3.10	3.30	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	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18
AUD/USD	0.7616	0.76	0.75	0.74	0.72	0.70	0.68	0.66
USD/JPY	111.26	118	118	120	122	124	126	128
EUR/USD	1.0767	1.05	1.03	1.01	1.00	0.99	0.98	0.96
AUD/NZD	1.0857	1.10	1.10	1.10	1.09	1.09	1.08	1.06

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