

Weekly Commentary

8 August 2016



How low can you go?

Low inflation has already seen the RBNZ cut the Official Cash Rate to a record low. Now, although inflation is likely past its nadir, it's only set to climb at a gradual pace – likely too gradual for the RBNZ's liking. The RBNZ has essentially told financial markets that the OCR will be cut at the time of the August *Monetary Policy Statement*. We expect that they'll cut rates again towards the end of the year.

The RBNZ will next review the OCR on 11 August. Much of the mystery around this decision has already been removed following an unscheduled economic update just over two weeks ago. That terse statement highlighted the RBNZ's clear discomfort with the lingering strength in the NZ dollar, which is currently around 6% higher than they had been expecting. That's a fairly sizeable surprise, and leaves the central bank fighting an uphill battle to achieve its inflation goals.

Inflation has now been below the bottom of the RBNZ's target band for two years. In part, this has been due to temporary factors that have dampened prices, including earlier weakness in international oil prices. Inflation is set to rise back into the RBNZ's target band over the coming year as those temporary downside influences pass. However, beyond this, the expected pick-up in inflation is looking like it will be fairly gradual.

The key reason for the lingering softness in inflation is ongoing weakness in tradable prices. The prices of imported goods remain subdued, while price competition in the retail sector remains intense. Combining these conditions with a NZ dollar that's continuing to defy gravity, and we're likely to see declines in tradable prices for some time yet.

The domestic inflation picture is a bit better, but only a bit. Housing related costs, such as construction costs and rents, have been climbing and are expected to remain firm

for some time. Increases in government charges, such as the tobacco excise tax, will also boost inflation. However, a generalised increase in domestic inflation (excluding government changes) remains elusive despite firm GDP growth in recent years.

Part of the reason for this very low domestic inflation picture is the low level of inflation expectations. Over the past year, many measures of inflation expectations have dropped below the 2% mid-point of the RBNZ's target band, including the RBNZ's own closely-watched 2-year ahead measure. These expectations are a key influence on how businesses adjust wages and prices. Consequently, their declines have reinforced New Zealand's soft inflation environment. This was seen very clearly in last week's wage inflation data, which has remained at very low levels in recent years. It's likely that we won't see expectations rising until inflation does, putting the onus on the RBNZ to get things rolling.

With an already subdued inflation environment, and strength in the exchange rate adding to the downward pressure on prices, the RBNZ is facing an uncomfortably slow return to target. In response, the RBNZ's interim economic update stated that "further policy easing will be required to ensure that future average inflation settles near the middle of the target range." That's a very clear signal that the OCR will be cut to a new record low of 2% at the upcoming review.

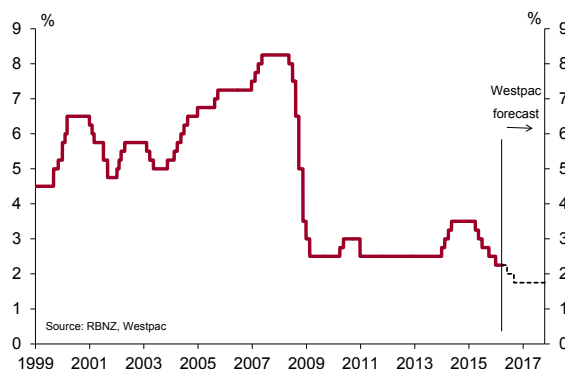
How low can you go? continued

The key question, however, isn't whether the RBNZ is going to cut this week, but whether this will be enough to assuage their concerns about the persistent softness in inflation. We don't think it will be. The factors dampening inflation are just too pervasive. As a result, this week's OCR cut is likely to be accompanied by a statement along the lines of "further easing may be required". And we expect that the RBNZ will follow through with a further 25bps cut in November.

Even then, generating a sustained pick-up in inflation is likely to be a challenging task. To do that, the RBNZ will need to boost demand in the economy. But that may be easier said than done. One of the notable features of the current economic cycle is that per capita spending in the economy has been very subdued. That's despite low interest rates and strong house price growth – factors that have typically been associated with strengthening household spending.

On top of those concerns, further reductions in interest rates will throw even more fuel on the already smoking housing market, adding to the likelihood that we see further tightening in macro-prudential policies over the coming year.

Official Cash Rate forecast



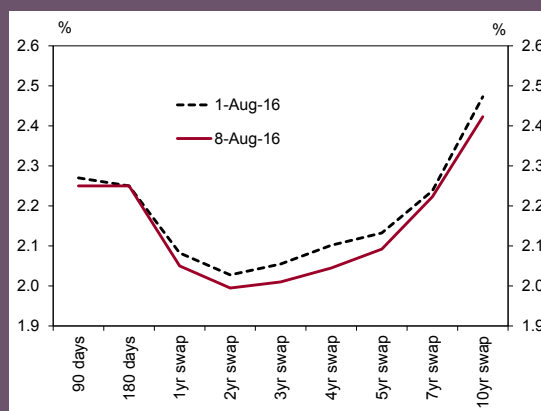
Fixed vs Floating for mortgages

Fixed rates have fallen a long way recently, and are becoming a more attractive option for borrowers.

For borrowers with a deposit of 20% or more, the best value probably lies in the two-year rate or shorter terms. Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the next four or five years. That said, fixing for a longer term does offer the borrower greater stability.

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 July retail card spending

Aug 9, last: +1.2%, WBC: f/c -0.3%, Mkt f/c: -0.1%

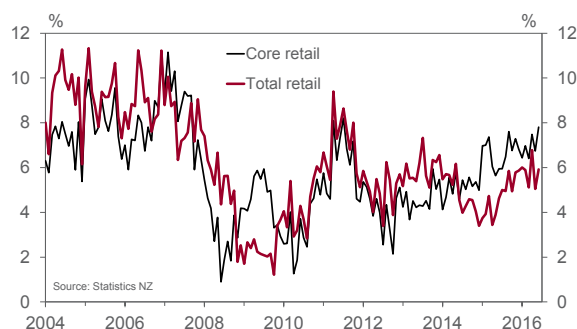
- Spending on retail cards surged in June, with a 1.2% gain over the month. Gains in spending were widespread in June. There were particularly large increases in spending on durables (likely related to the continuing strength of the housing market) and apparel, possibly assisted by the recent turn in the weather. The strong tourism season also appears to be boosting spending, with a solid increase in spending on hospitality.
- Following the strong June gain, spending is expected to moderate in July. This includes a likely pull-back in durables spending following its earlier strength. Nominal retail spending will also be dampened by the fall in petrol prices over the month.

NZ RBNZ Monetary Policy Statement

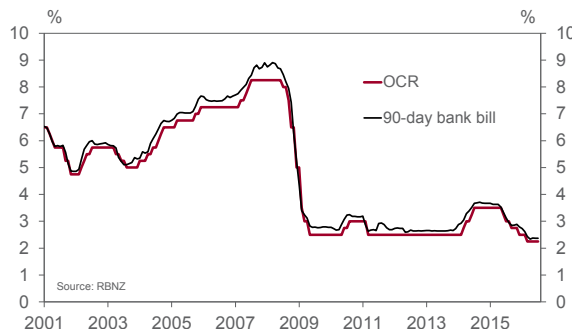
Aug 11, Last: 2.25%, Westpac: 2.00%, Market: 2.00%

- We expect the Reserve Bank to cut the OCR by 25 basis points to 2%, and to signal that a further cut this year is likely.
- There is little doubt about the Reserve Bank's intentions for the August OCR review, after it took the unusual step of correcting market pricing by releasing an unscheduled, strongly-worded statement last month.
- The sharp rise in the New Zealand dollar since June is the RBNZ's biggest concern. Lower tradables inflation suggests that looser monetary policy is needed to keep overall inflation on track to return to the target.

Card transactions, annual % change



NZ OCR and 90-day rate



NZ Q2 real retail sales

Aug 12, Last: +0.8%, Westpac f/c: +1.5%, Mkt f/c: 1.0%

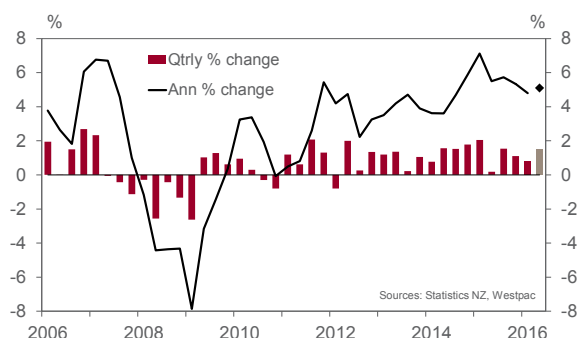
- Retail spending growth eased off a bit in early 2016, with real sales up 0.8% in the March quarter. Some moderation in retail sales growth in early 2016 wasn't too surprising. Late 2015 saw strong growth in spending on durable items such as hardware and furnishings, and it's normal to subsequently see a bit of a pull back.
- The June quarter report is expected to show solid growth in retail spending, with volumes up 1.5%. Inflation, particularly for imported goods, has remained low, and this is allowing households' incomes to stretch further. On top of this, firmness in population growth and tourist inflows have been supporting spending.

NZ Jul REINZ house prices and sales

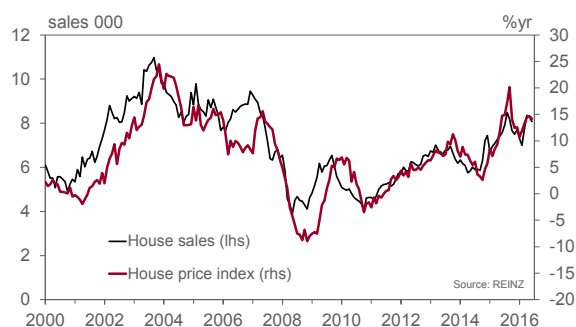
Aug 12 (tbc), Sales last: -2.7%, Prices last: 14.2%/yr

- House prices have raced ahead in recent months, with the gains becoming increasingly widespread across regions.
- Some of the strength was likely the result of a 'rush to the door' in anticipation of further lending restrictions. That is likely to have continued into July.
- New loan-to-value restrictions were indeed announced in late July, and banks began to enforce them immediately, so we are likely to see a cooling in the market from August.

Real retail sales



REINZ house prices and sales



The week ahead

Aus Aug Westpac-MI Consumer Sentiment

Aug 10 Last: 99.1

- The **Westpac-Melbourne Institute Consumer Sentiment Index** fell by 3% to 99.1 in July. Given the 'Brexit' shock in late June and the Federal election related uncertainty during the survey week, the fall in sentiment was surprisingly modest.
- The August survey is in the field over the week ended August 6. It will capture reactions to the RBA's 25bp rate cut. Unlike the Bank's May move though this cut was widely expected. The sentiment boost may also be affected by the smaller 10-14bp reduction in standard variable mortgage rates by the major banks (vs across the board 25bp reductions in May). Most banks increased rather than cut term deposit rates. Other factors may have a positive influence including a continued post-Brexit rebound in financial markets (ASX up 4.5% vs the July survey) and a notable drop in petrol prices (average pump prices now down 14¢/l since June).

Consumer Sentiment Index

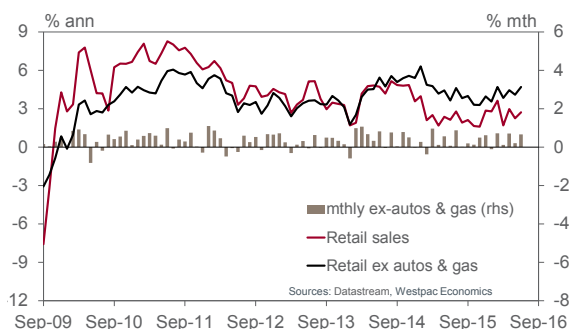


US July retail sales

Aug 12, Last: 0.6%, WBC 0.3%

- The US consumer has received considerable support from strong jobs growth and emerging momentum in wages. Sentiment has remained robust over the past year as a result.
- Q2 2016 started on a strong note, with headline retail sales rising 1.2%. However, since then, retail sales have only managed solid (not strong) growth circa 0.4% per month, leaving annual growth at 2.7%yr – last year's oil price declines and a weak Q1 still being felt.
- Over the past six months, core sales have been more robust, with growth of 0.4% per month leaving annual growth at 4.7%yr.
- Come July, growth in headline sales is likely to slow to 0.3%. Autos will be supportive, but gasoline prices a negative. The trend through Q3 will be critical to the outlook.

US retail sales, moderate momentum



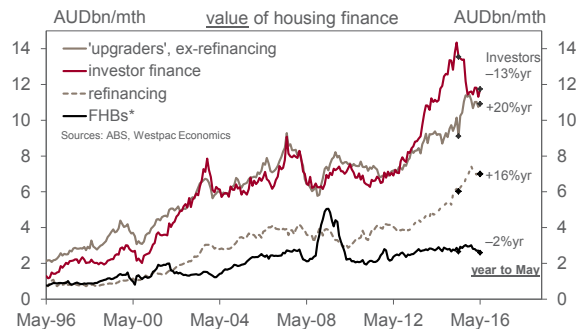
Aus Jun housing finance (no.)

Aug 10, Last: -1.0%, WBC f/c: 3.0%

Mkt f/c: 2.3%, Range: -1.0% to 3.5%

- Housing finance approvals dipped in May but were slightly better than expected with the value of investor finance approvals showing a partial bounce-back from a sharp 5% drop in April. The picture over the last 12 months is broadly flat for both the number of owner occupier approvals and the total value of loan approvals including to investors.
- The June update is expected to show a 3% rise in owner occupier approvals, industry data suggesting the May rate cut generated a decent lift. Auction clearance rates have also firmed although the tone suggests investor activity may have shown a more muted rate cut response.

Value of finance approvals by segment



Data calendar

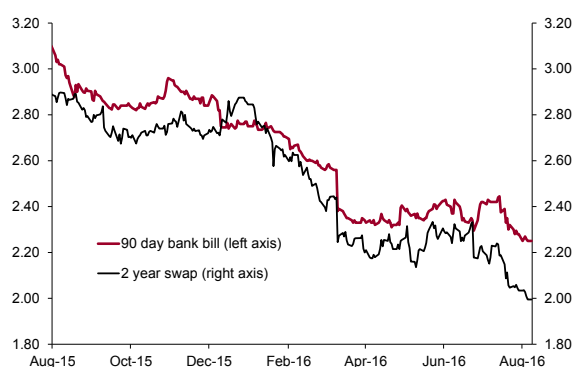
		Last	Market median	Westpac forecast	Risk/Comment
Mon 8					
Aus	Jul ANZ job ads	0.5%	–	–	The annual pace has eased back to 8%/yr from 12%/yr near end 2015.
Chn	Jul trade balance USDbn	48.1	48.0	–	Little change in balance expected in July.
	Jul foreign direct investment %yr	9.7%	–	–	Global concerns limiting investment pulse.
Eur	Aug Sentix investor confidence	1.7	3.6	–	Investors should have received boost from markets.
Ger	Jun industrial production	–1.3%	0.9%	–	Conditions soft on global demand.
US	Jul labour market conditions index	–1.9	–	–	Fed composite measure of labour market.
Tue 9					
NZ	Jul retail card spending	1.2%	0.1%	–0.3%	Some easing expected after earlier gains and falls in petrol prices.
Aus	Jul NAB business survey	12	–	–	In June, conditions index +2pts to 12, well > LR avg.
Chn	Jul CPI %yr	1.9%	1.8%	–	Inflation to remain well below target for foreseeable future.
	Jul PPI %yr	–2.6%	–2.0%	–	Impact of commodity price weakness lingers.
Ger	Jun trade balance €bn	21.0	–	–	Stability expected in June.
UK	Jun industrial production	–0.5%	–0.1%	–	Gauges of business sector activity have been softening.
	Jun trade balance, £bn	2.3	–	–	Soft external demand has been weighing on exports.
US	Jul NFIB small business optimism	94.5	94.5	–	Opportunities apparent, but competing against big firms difficult.
	Jun wholesale inventories	0.1%	0.0%	–	A major drag on growth in Q2.
Wed 10					
Aus	Aug Westpac–MI Consumer Sentiment	99.1	–	–	Rebound from 'Brexit', election uncertainty plus a rate cut boost.
	Jun housing finance	–1.0%	2.3%	3.0%	RBA's May rate cut to give a lift. Investor activity more muted?
	RBA Governor Stevens	–	–	–	Final speech as Governor, "An Accounting", Sydney, 1pm.
Chn	Jul aggregate financing, CNYbn	1630.0	1010.0	–	Tentative date 10–15 August.
	Jul new loans, CNYbn	1380.0	885.0	–	Tentative date 10–15 August.
	Jul M2 money supply %yr	11.8%	11.0%	–	Tentative date 10–15 August.
US	Jun JOLTS job openings	5500	–	–	Hires; fires; quits; and vacancies. A month behind payrolls.
Thu 11					
NZ	RBNZ Monetary Policy Statement	2.25%	2.00%	2.00%	RBNZ's recent update strongly signalled a cut.
	July food prices	0.4%	–	1.0%	Seasonal rise in produce prices; annual inflation still near zero.
Aus	Aug MI inflation expectations	3.7%	–	–	Have picked up from 3.2% low in May but still historically modest.
UK	Jul RICS house price balance	16%	–	–	House prices inflation slowing after policy changes, Brexit.
US	Initial jobless claims	269k	–	–	Despite the recent increases, claims remain low.
Can	Jun new house price index	0.7%	–	–	Growth likely to soften after sharp increase last month.
Fri 12					
NZ	Q2 retail sales volumes	0.8%	1.0%	1.5%	Spending on durables a key driver.
	Jul Business NZ manufacturing PMI	57.7	–	–	Business sector conditions have remained firm.
	Jul REINZ house sales	–2.7%	–	–	Due by the end of this week. Sales have slowed on limited supply.
	Jul REINZ house prices %yr	14.2%	–	–	Prices still rising strongly across many regions.
Chn	Jul industrial production %yr	6.2%	6.2%	–	PMI's stabilising, but yet to show evidence of uptrend.
	Jul retail sales %yr	10.6%	10.5%	–	Consumers optimistic over jobs despite weak current activity.
	Jul fixed asset investment ytd %yr	9.0%	8.9%	–	Investment dependent on public sector.
Eur	Jun industrial production	–1.2%	0.6%	–	Conditions soft on global demand.
	Q2 GDP (provisional)	0.3%	0.3%	0.3%	Momentum fades following strong Q1, as was the case in 2015.
Ger	Jul CPI (final)	0.3%	0.3%	–	Inflation pressures remains absent.
	Q2 GDP (provisional)	0.7%	0.3%	–	German growth a real disappointment given strength of labour market.
UK	Jun construction output	–2.1%	–	–	Nervous in the business sector is weighing on investment decisions.
US	Jul retail sales	0.6%	0.4%	0.3%	Growth solid, but not strong.
	Jul PPI	0.4%	0.2%	–	Wholesales price have been rising, especially in the services sector.
	Jun business inventories	0.2%	0.1%	–	A major drag on growth in Q2.
	Aug University of Michigan sentiment	90	91.5	–	Confidence amongst consumers remains robust.

New Zealand forecasts

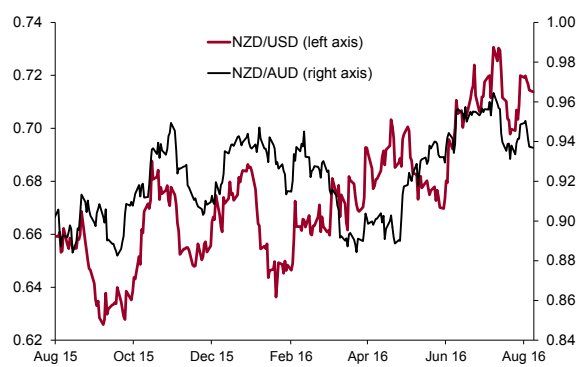
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016	2017f	2014	2015	2016f	2017f
GDP (Production) ann avg	2.7	3.6	2.4	2.9	3.7	2.5	2.9	2.7
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.3	0.8	0.1	1.1	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.0	-3.7	-3.1	-3.2	-3.3	-3.9

Financial Forecasts	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Cash	2.00	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.00	1.90	2.00	2.00	2.00	2.00
5 Year Swap	2.10	2.10	2.20	2.30	2.40	2.50
10 Year Bond	2.10	2.20	2.30	2.50	2.60	2.70
NZD/USD	0.70	0.68	0.67	0.65	0.63	0.62
NZD/AUD	0.93	0.93	0.92	0.92	0.91	0.91
NZD/JPY	73.5	70.0	68.3	65.7	64.3	64.5
NZD/EUR	0.64	0.63	0.63	0.62	0.59	0.58
NZD/GBP	0.54	0.53	0.53	0.51	0.49	0.48
TWI	75.4	73.9	73.3	71.7	69.9	68.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 8 August 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.15%	2.30%	2.37%
60 Days	2.20%	2.30%	2.40%
90 Days	2.25%	2.32%	2.42%
2 Year Swap	2.00%	2.05%	2.23%
5 Year Swap	2.09%	2.15%	2.25%

NZ foreign currency mid-rates as at Monday 8 August 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7138	0.6993	0.7296
NZD/EUR	0.6369	0.6369	0.6602
NZD/GBP	0.5457	0.5321	0.5634
NZD/JPY	72.82	74.26	73.42
NZD/AUD	0.9369	0.9368	0.9642
TWI	76.03	75.26	78.05

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.7	2.5	3.0	3.0
CPI inflation % annual	2.2	2.7	1.7	1.7	2.0	1.5
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.5
Current Account % GDP	-4.4	-3.4	-3.0	-4.8	-4.7	-4.7
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.6	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.1	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.8	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.6	0.5
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.5	1.2
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.1	0.5
China						
Real GDP %yr	7.7	7.7	7.3	6.9	6.4	6.2
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.7	3.7	3.9
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.2	3.4
Forecasts finalised 3 August 2016						

Interest Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Australia						
Cash	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
10 Year Bond	1.89	1.95	2.15	2.20	2.30	2.45
International						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.59	1.50	1.70	1.80	2.00	2.10
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
AUD/USD	0.7618	0.75	0.73	0.73	0.71	0.69
USD/JPY	101.96	102	103	102	101	102
EUR/USD	1.1085	1.10	1.08	1.07	1.05	1.06
AUD/NZD	1.0672	1.07	1.07	1.09	1.09	1.10

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