Weekly Commentary

19 February 2018

A difference of opinion

Financial markets are always eager to pick turning points in the economic cycle. That's perhaps unsurprising given the potential payoff in being the first to get it right. But it also means that, from time to time, financial markets can be a bit too keen to get out of the starting blocks when it comes to picking the timing of central bank tightening or easing cycles. We think now is one of those times.

The OCR has been unchanged at 1.75% since November 2016. And we expect it won't be moved until late 2019. In contrast, markets have priced in a rate hike from the RBNZ by early next year.

One reason we are more dovish than the market, or indeed the RBNZ's February Monetary Policy Statement, is that we think that growth will slow this year. GDP growth reached 4% in 2016, but has since slowed to around 3%yr and we think it could slow further in the year ahead. Weaker than expected GDP growth means the economy may struggle to generate the non-tradables inflation required for the RBNZ meet its inflation target.

There are several reasons we expect the pace of GDP growth to remain slow. The recent slump in business confidence is set to weigh on investment, growth in the construction sector will be restrained as the Canterbury rebuild continues to wind down and capacity constraints elsewhere in the country start to bite, and a gradual slowing in net migration will dampen population growth.

Importantly, we're predicting an extended period of subdued house price inflation in response to government policy changes due to be introduced in the coming years. These include restrictions on foreign buyers, an extension on the 'bright line' test for capital gains, and the ring-fencing of losses on investment properties. There's also the possibility of a broad-based capital gains tax coming back on the agenda in the run-up to the 2020 election.

A weaker housing market will have a big effect on household spending. New Zealanders hold a large proportion of their wealth in either investment or owner-occupied housing, and weakness in the housing market tends to translate into softer consumer spending. In some quarters, doubts about this relationship emerged in 2015 and 2016. However, faith in this relationship was restored by last year's revisions to historical GDP data. The revisions included upgraded estimates of household spending that were much more consistent with the strength in house price growth we'd seen over 2015 and 2016.

Yet while our forecasts incorporate a weaker housing market later this year and beyond, the past few months have actually seen some renewed vigour in house prices and sales as pre-election nervousness has faded, LVR restrictions have eased and mortgage rates have pushed down. January REINZ data released last week continued this theme, showing that nationwide house prices rose 0.3% in the month and were up 3.4% on a year ago. House sales fell 2.1% on the month, though data collection issues mean this should be taken with a grain of salt; our best guess is that house sales were actually about flat in January.

Renewed strength in the housing market also supported strong growth in retail spending in January. Retail card spending lifted 1.4% (up 3.4% on the year). There was a strong lift in durables spending, consistent with a second wind in the housing market and with purchases of 'back

A difference of opinion continued

to school' supplies, which increasingly include electronic devices. Spending on hospitality was also up, suggesting that New Zealanders were getting out and taking advantage of the favourable weather at the start of the year.

Of course GDP growth is not the only thing which influences inflation and the likely path of the OCR. Moves in the exchange rate and inflation expectations are two other critical factors.

The concern of late has been that after a sustained period of unexpectedly weak inflation (most recently surprisingly weak Q4 inflation), inflation expectations could drift lower. However, there was little sign of this in last week's data. Two-year ahead inflation expectations, which are often considered the 'headline' result, jumped from 2.02% last quarter to 2.11% this quarter, while the one-year ahead measure and the longer-term measures of inflation expectations were all broadly steady.

This may reflect businesses' concerns about costs escalating due to new Government regulations – a theme that has cropped up in other surveys. Alternatively, Government moves to give the Reserve Bank a dual mandate to target both the labour market and inflation may have influenced respondents, although we would have thought that these types of concerns would affect long-term inflation expectations, not short-term.

On the exchange rate, we also have a different view to the market. We think the recent bout of US dollar weakness is partially an overreaction that will iron itself out in time. As the US Federal Reserve continues to raise rates, and the RBNZ stays on hold, we expect the US dollar to appreciate again.

Indeed, we recently updated our view on the likely path of Fed policy, with interest rates set to rise more aggressively than we previously thought on the back of strong momentum in the US economy, and major fiscal stimulus now in train. The US government has recently signed off on a $1.5tn tax cut package and a $300bn boost to defence spending. This is a controversially large spending boost at a time when the economy is already running close to full capacity, igniting inflation concerns. We now forecast the Fed to raise rates three times in 2018 and twice more in 2019 (March and June), boosting the US dollar. A lower NZ dollar will provide some offsetting tradables inflation pressure, making up for the weaker economy as far as inflation forecasts are concerned.

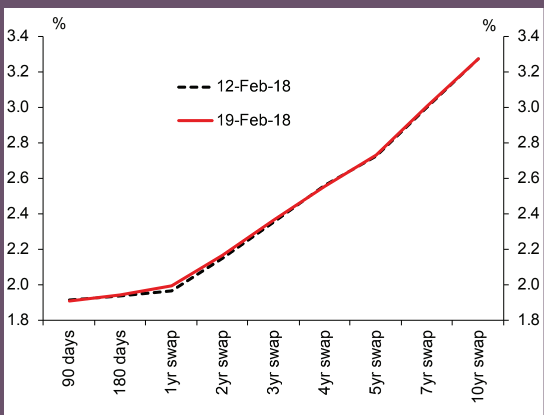
Balancing all this up, we think it is most likely that the RBNZ will remain on hold until late 2019. Of course forecasting is an uncertain business, and we have warned that although an OCR cut this year is not likely, it remains a possibility. Indeed, given our views on GDP growth, we regard a cut in the OCR this year as more likely than a hike.

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 fixed terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

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



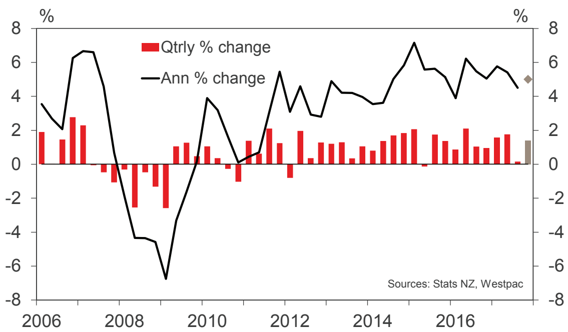
The week ahead

NZ Q4 real retail sales

Feb 23, Last: +0.2%, Westpac f/c: +1.4%, Mkt f/c: +1.3%

- Retail spending posted a modest 0.2% gain in the September quarter. Some of the softness we saw was due to declines in the volatile vehicle and fuel categories. However, core spending growth also slowed following earlier temporary boosts associated with high profile sporting events.
- We expect the December quarter retail spending figures will show that New Zealand households ended 2017 with a bang. We're forecasting a 1.4% gain in spending over the quarter. Monthly spending figures have shown solid increases in core spending categories in recent months

Real retail sales

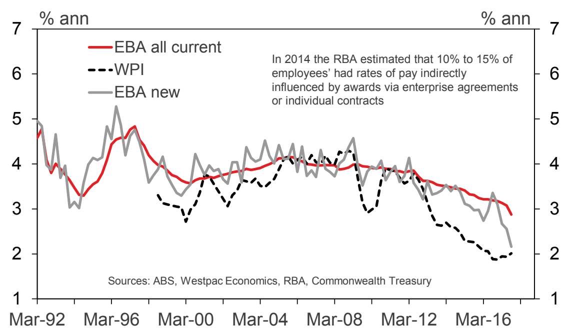


Aus Q4 Wage Price Index

Feb 21, Last: 0.5%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.4% to 0.7%

- Total hourly wages ex bonuses rose by 0.5% in Q3, below Westpac's and the market's expectation of 0.7%. The result is in line with the persistently low range of 0.4-0.6% despite an above normal increase in the minimum wage of 3.3% effective in Q3. Annual wages growth is still near historic lows, up marginally to 2.0%yr from 1.9%yr. The 2017-18 Fair Work Commission's annual wage review decision saw a 3.3% increase in the national minimum wage and minimum wages across all awards, effective July 1. This compares to the previous year's 2.4% rise, when there was also a lower proportion of workers on award wages. We estimate that the minimum wage rise had a net effect of 0.2ppts to Q3's wage growth. Enterprising bargaining continues to provide lower wage rises than the average of all existing agreements. This will continue to be a drag on the Wage Price Index.

As WPI stabilises, EBA wages moderate

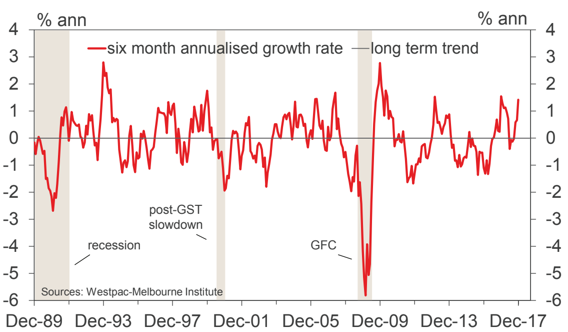


Aus Jan Westpac–MI Leading Index

Feb 21, Last: +1.41%

- The six month annualised growth rate in the Leading Index rose to 1.41% in December, a strong above trend reading indicating decent momentum heading into year end.
- The Jan update looks likely to show some cooling with components pulling back, most notably dwelling approvals which reversed sharply in Dec (down 20% vs +12.6% in Dec). Other components recording softer months include: the ASX200, down 0.4%; the Westpac-MI Consumer Expectations Index, down 2.9%; and hours worked (–1.4%). Some positive offset will come from commodity prices, up 4.6% in AUD terms; and a further improvement in the Westpac-MI Unemployment Expectations Index.

Westpac-MI Leading Index

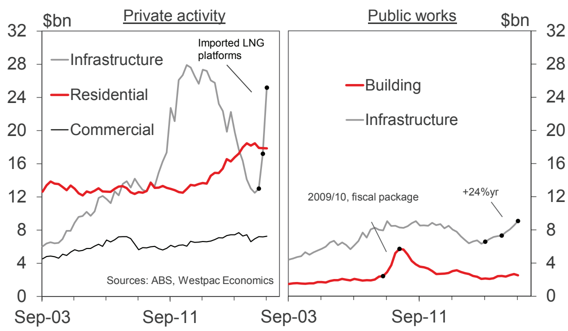


Aus Q4 construction work

Feb 21, Last: 15.7%, WBC f/c: –, Mkt f/c: -10%, Range: -19% to 5%

- Currently, the Construction Work survey is an unreliable partial indicator due to the treatment of imported LNG platforms, (a few of which have arrived in recent quarters). The survey includes their full value when imported, rather than actual work in the period, as in the national accounts. 'Construction Work' reportedly rose 9.8% in Q2 and then by a further 15.7% in Q3, a $13.1bn increase in aggregate, largely due to a $12.2bn jump in private infrastructure. By contrast, the National Accounts report only a $0.6bn increase in private infrastructure activity over the period. Near-term, this spike in the Construction Work survey will be unwound. Turning to private building and public works, activity in these areas grew by 1.2%qtr, 6.3%yr in Q3. For Q4, we anticipate a rise of around 1.4%, with strength broadly based across residential (led by renovations rebounding from a sharp dip in Q3); commercial building; and public works, particularly infrastructure projects.

'Construction work' inflated by LNG platforms



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 19					
NZ	Jan BusinessNZ PSI	56	–	–	Service sector conditions softened, but remain healthy.
Eur	Dec current account balance, €bn	37.8	–	–	Surplus led by Germany.
UK	Feb Rightmove house prices	0.7%	–	–	Price growth remains weak, esp. in London.
US	Presidents Day	–	–	–	Public holiday.
Tue 20					
Aus	RBA Assist' Governor Financial System	–	–	–	Michele Bullock, Responsible Lending & Borrowing, 9:15am.
	RBA Minutes of February meeting	–	–	–	Colour on uncertainties around central growth forecasts.
Eur	Feb ZEW survey of expectations	31.8	–	–	Feb saw a spike in vol, but investors still confident.
	Feb consumer confidence	4	–	–	The labour market remains key for household sentiment.
Wed 21					
NZ	GlobalDairyTrade auction	5.9%	–	–	Weather related supply concerns boosted prices recently.
Aus	Jan Westpac–MI Leading Index	1.41%	–	–	Riding high at end 2017 but set to pull back in early 2018.
	Q4 wage cost index	0.5%	0.5%	0.5%	New enterprise bargaining agreements restraining wages.
	Q4 construction work	15.7%	–10.5%	–	Survey distorted by imports of LNG platforms.
Eur	Feb Markit manufacturing PMI	59.6	59.2	–	Strength set to be sustained...
	Feb Markit services PMI	58.0	57.5	–	... demand is broad based and robust.
UK	Dec ILO unemployment rate	4.3%	4.3%	–	Unemployment still very low, labour demand holding up.
	Jan public sector borrowing £bn	1.0	–11.1	–	Growing tax revenues helping to reduce borrowing needs.
	BOE Governor Carney	–	–	–	Testimony before Parliament's Treasury Committee.
US	Feb Markit manufacturing PMI	55.5	55.5	–	Both of the Markit measures...
	Feb Markit services PMI	53.3	–	–	... point to more subdued conditions than ISMs.
	Jan existing home sales	–3.6%	0.9%	–	Lack of sale volumes a key driver of monthly volatility.
	FOMC minutes	–	–	–	From the Jan 31 meeting.
	Fedspeak	–	–	–	Harker on the economic outlook.
	Fedspeak	–	–	–	Quarles speaking on the global economy.
Thu 22					
Eur	ECB minutes	–	–	–	Jan 24–25 policy meeting.
UK	Q4 GDP (2nd)	0.5%	0.5%	0.5%	Firmness in the services sector is supporting growth.
US	Initial jobless claims	230k	–	–	At historic lows.
	Jan leading index	0.6%	0.7%	–	Pointing to above–trend growth.
	Feb Kansas City Fed index	16	–	–	Remains near post–Trump peak; very strong.
	Fedspeak	–	–	–	Dudley at NY Fed briefing on Puerto Rico.
	Fedspeak	–	–	–	Bostic Speaks at Banking Conference in Atlanta.
Fri 23					
NZ	Q4 retail sales	0.2%	1.3%	1.4%	Past few months seen solid gains in core categories.
Eur	Jan CPI %yr final	1.4%	1.3%	1.3%	Flash pointed to minor loss of momentum in Jan.
	ECB Couere speaks	–	–	–	In NY, on panel about the objectives of monetary policy.
US	Fedspeak	–	–	–	Williams on the US economic outlook.
	Fed	–	–	–	To publish semi–annual monetary policy report to Congress.
	Fedspeak				(Fed Chair Powell testimony to Congress on Feb 28).
Sat 24					
Chn	Jan property prices	0.0%	–	–	Tier 1 under strict controls; rest continue to see gains.

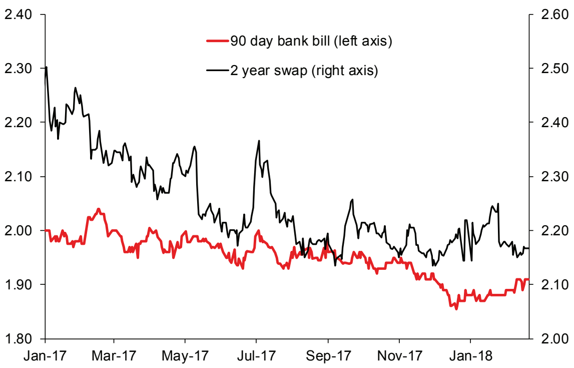
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017		2018		Calendar years			
% change	Sep(a)	Dec	Mar	Jun	2016	2017f	2018f	2019f
GDP (Production)	0.6	0.8	0.6	0.6	4.0	2.9	2.8	3.0
Employment	2.2	0.5	0.4	0.4	5.8	3.7	1.6	1.2
Unemployment Rate % s.a.	4.6	4.5	4.4	4.4	5.3	4.5	4.5	4.7
CPI	0.5	0.1	0.6	0.4	1.3	1.6	1.8	1.5
Current Account Balance % of GDP	-2.6	-2.6	-2.1	-2.3	-2.5	-2.6	-2.8	-3.1

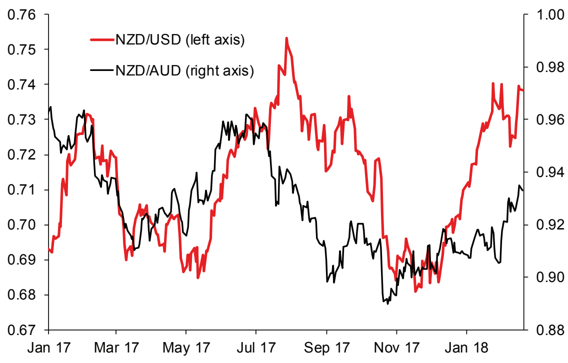
[1] Annual average % change

Financial Forecasts	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.10	2.10	2.20	2.30	2.40	2.55
5 Year Swap	2.70	2.75	2.85	3.00	3.10	3.20
10 Year Bond	3.00	3.10	3.20	3.35	3.40	3.45
NZD/USD	0.71	0.69	0.67	0.65	0.63	0.64
NZD/AUD	0.91	0.91	0.91	0.90	0.90	0.90
NZD/JPY	79.5	79.4	78.4	76.1	73.7	74.9
NZD/EUR	0.59	0.59	0.58	0.57	0.55	0.55
NZD/GBP	0.52	0.52	0.52	0.51	0.50	0.51
TWI	73.5	72.6	71.3	69.8	68.3	69.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 19 February 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.80%	1.80%	1.78%
60 Days	1.86%	1.84%	1.83%
90 Days	1.91%	1.89%	1.88%
2 Year Swap	2.17%	2.17%	2.25%
5 Year Swap	2.73%	2.74%	2.78%

NZ foreign currency mid-rates as at 19 February 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7385	0.7296	0.7284
NZD/EUR	0.5951	0.5866	0.5938
NZD/GBP	0.5269	0.5172	0.5244
NZD/JPY	78.57	80.38	80.61
NZD/AUD	0.9329	0.9218	0.9111
TWI	75.78	74.93	74.98

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.3	2.5	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	2.1	1.9
Unemployment %	6.2	5.8	5.7	5.5	5.4	5.3
Current Account % GDP	-3.0	-4.7	-2.9	-2.1	-2.3	-3.2
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	3.0	2.5
Consumer Prices %yr	1.6	0.1	1.3	2.1	2.1	2.0
Unemployment Rate %	6.2	5.3	4.9	4.4	4.0	3.8
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.3	1.1	1.0	1.5	1.3	1.0
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.4	2.1	1.7
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.7	1.6	1.6
China						
Real GDP %yr	7.3	6.9	6.7	6.9	6.3	6.1
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.5	4.3	4.3
World						
Real GDP %yr	3.6	3.4	3.2	3.9	3.8	3.7
Forecasts finalised 14 February 2018						

Interest Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.77	1.77	1.78	1.78	1.78	1.78	1.78	1.78
10 Year Bond	2.91	2.90	2.90	3.00	3.20	3.20	3.20	3.20
International								
Fed Funds	1.375	1.625	1.875	2.125	2.125	2.375	2.625	2.625
US 10 Year Bond	2.90	2.80	2.90	3.10	3.35	3.50	3.40	3.40
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.40	−0.20	0.00	0.00

Exchange Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
AUD/USD	0.7944	0.78	0.76	0.74	0.72	0.70	0.71	0.72
USD/JPY	106.13	112	115	117	117	117	117	118
EUR/USD	1.2515	1.20	1.17	1.15	1.15	1.15	1.17	1.18
AUD/NZD	1.0732	1.10	1.10	1.10	1.11	1.11	1.11	1.11

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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