

Weekly Commentary

26 June 2017



No surprises

The RBNZ keep the Official Cash Rate on hold last week, and we expect it will remain on hold for some time yet. Markets are pricing in a hike by mid-2018. However, we think that's far too early.

OCR to stay on hold for some time

Last week's Official Cash Rate review from the Reserve Bank didn't deliver any surprises. As expected, the RBNZ kept the OCR on hold at the current record low of 1.75%. In addition, the bottom line of the press release was unchanged from the May Monetary Policy Statement, noting that *"Monetary policy will remain accommodative for a considerable period."*

Developments since the RBNZ's previous policy statement in May have been broadly neutral from a policy perspective. While we've had lower than expected house price inflation and GDP growth in early 2017, these surprises have been balanced against stronger outlooks for both export earnings and fiscal policy. As a result, the RBNZ's assessment of overall economic conditions appears to have remained largely unchanged.

To generate the sustained rise in underlying inflation pressures that the RBNZ is targeting will require a protracted period of strong activity. And that will require ongoing support from low interest rates for some time yet. We expect that the OCR will remain on hold through to early 2019. While that's not quite as long as the RBNZ assumed in their May forecasts (which showed rates on hold until the latter half of 2019), we don't think this is a big difference. The key point is that we're in for an extended period where the OCR remains very low.

However, financial markets more generally expect to see rates rising sooner. In fact, current market pricing is

consistent with at least two rate hikes before the end of 2018, with the first coming around June next year. We think this is far too early.

It's true that inflation has picked up. The March quarter read of 2.2% was not only the above the mid-point of the RBNZ's target band, it was the highest level in five years. However, much of the rise in inflation over the past year has been due to temporary factors. That includes weather related increases in produce prices, as well as earlier gains in fuel prices. These factors will reverse over the coming year, and the resulting downturn in inflation will be exacerbated by the recent downturn in oil prices. This means that mid-2018 will see headline inflation dropping back into the lower part of the RBNZ's target band. The RBNZ does look through temporary swings in inflation associated with volatility in the prices of items like food and fuel – both on the upside and the downside. Nevertheless, it's tough to make a case for raising rates at a time when inflation is likely to be falling and below the mid-point of the target band.

What's more important for the OCR is the longer term trend in prices. Looking at measures of underlying inflation in the economy, we see that they have been rising over the past year, but they remain below the 2% target mid-point. Over the coming years, underlying inflation will pick up as the economy continues to expand. But as long as the pickup in underlying inflation remains gradual, and inflation expectations remain well anchored, the RBNZ is unlikely find itself under pressure to raise rates by this time next year.

Reinforcing the case for continued stability in the OCR

No surprises continued

are changes in borrowing rates. Even though the OCR has remained low and on hold for most of the past year, borrowing rates have been creeping higher, and we expect that they will continue gradually rising over the coming year. Global term interest rates have risen since last year in response to expectations of tightening by the Fed. At the same time, New Zealand banks are facing higher funding costs as borrowing outpaces deposit growth. Both of these factors reinforce the need for the OCR to remain low in order to support activity.

Migration back at a record high

After a slight moderation in recent months, net migration picked up again in May. The annual net inflow over the past year was just shy of 72,000 people – a fresh record high. This has seen population growth rising to its fastest pace since the 1970s.

In part, the high level of net migration is due to strong inflows of those on residency and work visas, with large numbers arrivals from China, India and the UK. However, this only accounts for around half of the pick-up in net migration since 2011. Over this same period, we've also seen very low numbers of New Zealanders moving offshore and higher than usual numbers moving back from abroad. In the

case of both new arrivals and the low departures of New Zealanders, our stable and positive economic conditions are a big draw card compared to many other regions.

Migration is will eventually ease off as the global economy improves. But the eventual downturn is likely to be gradual, and flows are likely to remain strong in the near-term. A key reason for this is conditions in the Australian economy, the main destination for New Zealanders moving abroad. We expect that GDP growth in New Zealand will continue to outpace that in Australia for some time yet. In addition, policy changes in Australia affecting the costs of study for international students and costs associated with hiring foreign workers make New Zealand seem all the more attractive.

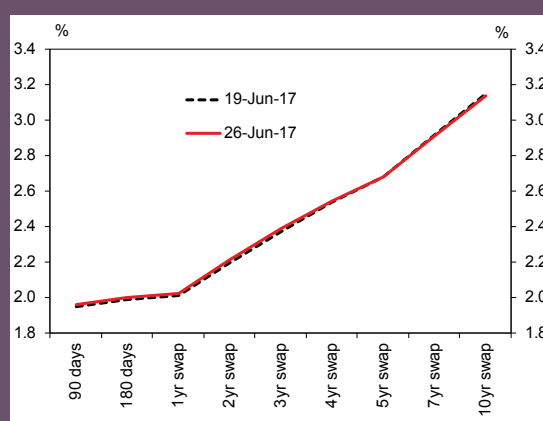
Migration and population growth are having a range of impacts on the economy. As well as boosting demand in areas like retail spending, we're also seeing increased pressure in terms of housing demand and strains on infrastructure. Migration also affects our productive capacity, helping us to meet essential skill shortages in areas like construction. Balancing these influences is a challenging task, and the issue is receiving a large amount of attention ahead of September's election. If we do not see migration naturally easing off, this would increase the chance that see some sort of policy change over the coming year.

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 June business confidence

Jun 29, Last: 14.9

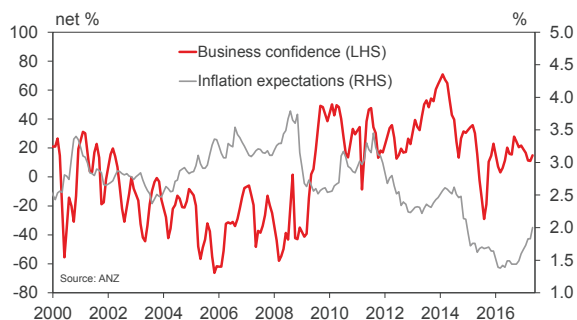
- Business confidence picked up slightly in May, with firms reporting increases in investment and hiring intentions. Businesses have signalled that they expect solid levels of demand, consistent with GDP growth of around 3%yr.
- Businesses' view of the underlying inflation pulse in the economy is looking firmer. Inflation expectations have picked up, and that is passing through to an increase in the number of businesses looking to raise prices this year. Nationwide pricing intentions are at their highest level in three years, with the gains strongest in the construction sector.

NZ May building consents

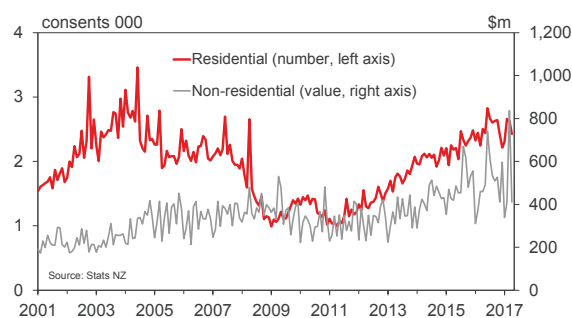
Jun 30, Last: -7.6%, WBC f/c: 4.0%

- Residential consent numbers fell 7.6% over April, following a 1.2% decline in May. Some of this softness looks like it is due to the timing of Easter, with public holidays meaning less time for the processing of consents. Looking through the volatility associated with public holidays, it appears that consent issuance has levelled off rather than declined. We expect consent issuance will pickup again in May, with large amounts of building work planned in coming years. However, there are questions around how fast construction will rise. Capacity pressures in the building industry have already emerged, and both building costs and borrowing rates have been creeping higher. At the same time, house price growth has levelled off and reconstruction activity in Canterbury has eased back. While the outlook for building is positive, these factors may constrain the pickup in activity.

NZ business confidence and inflation expectations



NZ building consents



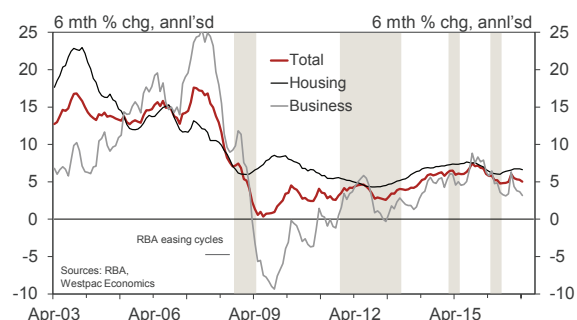
Aus May private credit

Jun 30, Last: 0.4%, WBC f/c: 0.4%

Mkt f/c: 0.4%, Range: 0.4% to 0.6%

- Private credit grew by 4.9% in the year to April, moderating from 6.6% a year earlier. Housing has slowed over this period, to 6.5% from 7.0%, as lending conditions have tightened. Business has eased, to 3.1% from 7.3%, in part due to weakness around the time of the 2016 Federal election, as well as a soft start to 2017. For May, credit growth is expected to be 0.4%, matching the outcome for April. Housing credit grew by 0.50% in April, moderating a touch from March's 0.54%, with the prospect of a further slowing. The housing sector is beginning to cool, with the value of housing finance trending a little lower from February. Business credit grew by 0.4% in April, with a similar result anticipated for May. The April outcome was an improvement on softness in recent months, with commercial finance - which remains volatile - up off its lows.

Credit: momentum shift



Data calendar

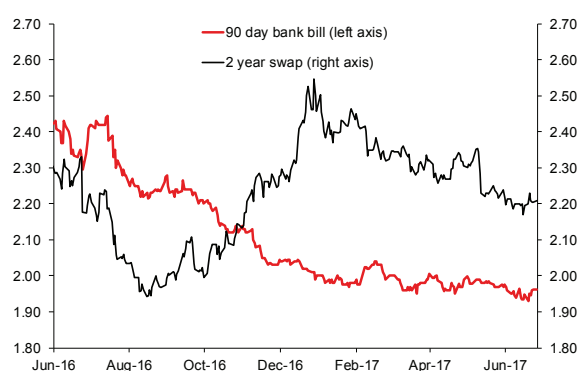
		Last	Market median	Westpac forecast	Risk/Comment
Mon 26					
Eur	ECB Draghi speaks	-	-	-	Opening remarks at ECB Sintra conference – 26th to 28th.
US	May durable goods orders (prelim)	-0.8%	-0.7%	-0.3%	Underlying trend to remain soggy.
	May Chicago Fed activity index	0.49	-	-	Trend growth continues.
	Jun Dallas Fed index	17.2	-	-	One of the strong regional indexes.
	Fedspeak	-	-	-	Williams in Sydney on fostering sustainable growth in the US.
	Fedspeak	-	-	-	Ex Chair Bernanke at Sintra – "When growth is not enough".
Tue 27					
NZ	May trade balance \$m	578	375	500	Seasonal highs for export volumes.
Chn	May industrial profits %yr	14.0%	-	-	Still benefitting from higher commodity prices in 16/17.
	Premier Li Keqiang speaks	-	-	-	World Economic Forum event in Dalian.
Eur	ECB Draghi speaks	-	-	-	Introductory speech on day 2 ECB conference – youth dialogue.
US	Apr S&P/CS home price index	0.87%	0.60%	-	Robust growth in prices continuing.
	Jun consumer confidence index	117.9	115.0	-	Remains strongly positive.
	Jun Richmond Fed index	1	-	-	Has fallen back.
	Fed Chair Yellen speaks	-	-	-	Conversation with Nicholas Stern on global economic issues.
	Fedspeak	-	-	-	Williams in Syd. – 'The Global Growth Slump: Causes and Conseq.'
	Fedspeak	-	-	-	Harker on the economy and international trade in London.
Wed 28					
Eur	May M3 money supply %yr	4.9%	4.9%	-	Credit data also due.
	ECB Sintra – central bank policy panel	-	-	-	Draghi, Carney, Kuroda, Poloz, Flug (ECB, BOE, BOJ, BOC, BOI)
UK	Jun Nationwide house prices	-0.2%	-	-	Losing momentum, drags from uncertainty and high prices.
US	May wholesale inventories	-0.5%	0.2%	-	Will continue to add volatility to GDP.
	May pending home sales	-1.3%	1.1%	-	Moderate momentum.
	Fedspeak	-	-	-	Kashkari at a townhall event in Houghton, Michigan.
	Fedspeak	-	-	-	Williams gives a repeat of "Global Growth..." speech in Canberra.
Thu 29					
NZ	Jun ANZBO business confidence	14.9	-	-	Pointing to solid activity, inflation gauges have lifted.
Aus	RBA Deputy Governor Debelle speaks	-	-	-	Global FX code of conduct launch, Singapore, 6:30pm AEST.
Chn	Q1 current account balance \$bn	19.0	-	-	Dated detail on foreign trade and financial flows.
UK	May net lending secured dwellings, £b	2.7	-	-	Low borrowing rates are helping to support demand...
	May mortgage approvals	64.6k	-	-	... but the housing market is slowing.
Eur	Jun economic confidence	109.2	109.4	-	Quite positive.
	Jun business climate indicator	0.90	1.00	-	Belief in outlook robust.
	Jun consumer confidence (final)	-1.3	-	-	Labour market a big positive.
US	Q1 GDP %ann (third estimate)	1.2%	1.2%	1.2%	Material revisions unlikely.
	Initial jobless claims	241k	-	-	Claims remains around historic lows.
	Fedspeak	-	-	-	Bullard on the US economy and monetary policy in London.
Fri 30					
NZ	Q2 Westpac-MM employment conf.	109.9	-	-	Labour market confidence eased in Q1, but still at firm levels.
	May building consents	-7.6%	-	4.0%	Earlier softness likely due to holidays. Return to trend expected.
Aus	May private sector credit	0.4%	0.4%	0.4%	Modest growth. Housing beginning to slow.
Chn	Jun manufacturing PMI	51.2	51.0	-	Employment detail has deteriorated...
	Jun non-manufacturing PMI	54.5	-	-	... a concern for aggregate growth in 17/18.
UK	Jun GfK consumer confidence	-5	-	-	Post-election uncertainty to weigh on confidence.
	Q1 current account balance, £b	-12.1	-	-	Lower pound boosting exports, but also adding to import costs.
	Q1 GDP (final)	0.2%	-	0.2%	Rising prices & uncertainty weighing on spending & investment.
Eur	Jun CPI %yr (advance)	1.4%	1.3%	-	Volatile of late, well below target.
US	May personal income	0.4%	0.3%	-	Incomes continue to grow at robust pace...
	May personal spending	0.4%	0.1%	-	... but spending held back by consumer caution...
	May PCE deflator %yr	1.7%	1.5%	-	... inflation to settle a little below target.
	Jun Chicago PMI	59.4	58.0	-	Another positive region for manufacturing.
	Jun Uni. of Michigan sentiment (final)	94.5	94.5	-	Remains resilient to doubts over Trump policy progress.

New Zealand forecasts

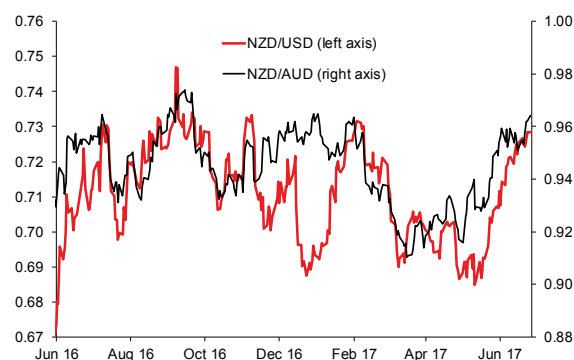
Economic Forecasts	2017				Calendar years			
	% change	Mar (a)	Jun	Sep	Dec	2015	2016	2017f
GDP (Production) ann avg	0.5	1.0	0.9	0.7	2.5	3.1	2.8	3.2
Employment	1.2	0.3	0.5	0.5	1.4	5.8	2.5	1.9
Unemployment Rate % s.a.	4.9	4.9	4.6	4.4	4.9	5.2	4.4	4.5
CPI	1.0	0.2	0.4	0.2	0.1	1.3	1.8	1.9
Current Account Balance % 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 26 June 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.85%	1.87%
60 Days	1.90%	1.89%	1.91%
90 Days	1.96%	1.94%	1.97%
2 Year Swap	2.21%	2.20%	2.22%
5 Year Swap	2.68%	2.69%	2.72%

NZ foreign currency mid-rates as at Monday 26 June 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7283	0.7209	0.7051
NZD/EUR	0.6503	0.6430	0.6312
NZD/GBP	0.5725	0.5668	0.5508
NZD/JPY	80.98	79.52	78.46
NZD/AUD	0.9643	0.9568	0.9479
TWI	78.70	77.79	76.55

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	2.0	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	2.1	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	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 16 June 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	1.72	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.38	2.75	2.85	3.05	3.20	3.35	3.30	3.15
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.16	2.55	2.65	2.90	3.10	3.30	3.30	3.15
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	0.7545	0.74	0.73	0.72	0.69	0.68	0.65	0.67
USD/JPY	111.37	112	114	114	115	116	116	118
EUR/USD	1.1149	1.10	1.08	1.05	1.03	1.02	1.01	1.00
AUD/NZD	1.0403	1.04	1.04	1.04	1.03	1.03	1.02	1.05

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