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Walking a tightrope

Markets are divided over the likely outcome of the December RBNZ Monetary Policy Statement this week. Market pricing is attaching roughly equal odds to interest rates remaining unchanged or a 25 basis point cut.

While we acknowledge it won't be a clear cut decision, on balance we think the weak inflation outlook will tip Governor Wheeler into the rate cut camp. Last week's data has mostly reinforced that view by illustrating the strong headwinds the NZ economy faces from the soggy international environment and soft commodity prices. What's more, there's growing evidence one of the key impediments to lower interest rates, the strong Auckland housing market, is rapidly fading.

New Zealand's terms of trade, which measures the price of what we export relative to what we import, fell by 3.7% in the September quarter. The lower NZ dollar both offset some of the impact of lower commodity export prices and made imports more expensive. New Zealand's terms of trade is now 8% below where it was back in early 2014 and is likely to fall further in the December quarter as the pace of decline in the NZD slows and dairy prices take another step down.

Dairy farmers were offered a glimmer of hope in last week's GlobalDairyTrade auction as prices improved a little after a recent run of falls. Overall prices rose 3.6%, including a 5.3% lift in the crucial whole milk powder price. This leaves us comfortable with our \$4.50 farm gate milk price forecast for this season (which relies on further improvement in dairy prices in the coming months). But even if we're right with this prediction, most dairy farmers will be operating at a loss this season. Needless to say farmers will be looking to cut costs wherever possible, which will be a big drag on spending – especially in provincial centres.

But for now, economic activity in New Zealand remains quite strong. Construction activity rose 0.5% in the September quarter, driven by a 2.9% jump in residential building. And the number of consents issued in October suggests this pace of growth has been at least maintained. Residential consent issuance is up 9% on a year ago as building activity in Auckland continues to gather steam – although consent issuance in Canterbury has fallen 27% over the past year, as residential construction there fades.

Walking a tightrope continued

The strong construction sector, along with rapid population growth and solid consumer spending is supporting business confidence. Confidence ticked higher in November, with firms more upbeat about both the outlook for their own businesses and the general economy. But this improvement needs to be kept in perspective. The overall level of confidence in the ANZBO survey is only just back around mid-2012 levels, still below a 5 year average. That's nothing like the heights scaled back in early 2014 when dairy prices were hitting the stratosphere.

Perhaps just as importantly, the number of firms indicating that they intend to increase prices actually eased a touch in November, particularly in the retail sector which had recorded a strong increase in the preceding couple of months. With retailing focused heavily on the sales of imported products, this casts doubt on the extent to which the weaker NZD will be passed through to consumers. Meanwhile firms' expectations of inflation over the next 12 months sits at 1.6% - well below the 2% midpoint of the RBNZ's target band.

But even with a benign inflation backdrop, the RBNZ has approached rate cuts with caution. One reason for this has been the strength of the housing market, particularly in Auckland. Last week's data on the housing market from Barfoot and Thompson (the largest Auckland real estate agency) should go some way to soothing this concern. It showed house sales took another big step down in November, declining 16%. This follows an even bigger decline in sales the previous month (subsequently corroborated by the nationwide REINZ data) and leaves the overall level of sales 33% below the level they surged to in September, just before the new tax changes came into effect. Although it may take the RBNZ some time before it publically expresses any comfort or certainty about the way its new restrictions on lending to investors and tax changes are impacting the housing market, the evidence available so far certainly suggests the Auckland housing market has slowed with a thump. This should help ameliorate the RBNZ's concerns about low interest rates stoking financial stability risks.

So how will the RBNZ weigh up these recent developments in this week? Faced with the very real risk of a sustained period of below-target inflation outcomes, a NZ dollar higher than it is comfortable with, and still depressed dairy prices, the most likely outcome on Thursday is a 25 basis point OCR cut.

House sales, seasonally adjusted



One temptation for the RBNZ may be to rely on an expected Fed rate hike a week later to put downward pressure on the NZ dollar. But such a strategy carries risks. The market reaction to last week's ECB decision (where the ECB eased but the Euro rose sharply) should serve as a case in point. The exchange rate reaction to a Fed move will depend not only on its decision on interest rates, but also its signals around the future path of interest rates from here relative to market expectations – a complex equation that has the potential to see the NZD/USD move in either direction immediately after the Fed's meeting.

If we're right about the RBNZ cutting rates, the Bank will need to be very careful with the language in its accompanying *Statement*. In particular, we expect RBNZ communications to carefully tread the fine line between keeping its options open by not removing the possibility of further rate cuts, and at the same time not explicitly signalling that further cuts are likely. In particular, the RBNZ will be aiming to avoid either a big jump in the NZ dollar (which puts further downward pressure on inflation), or a sharp fall in interest rates (which risks stoking the housing market). A tricky task, but phrases such as "Future OCR decisions will depend on the emerging flow of data" and "The OCR is expected to remain low for some time," along with the detailed projections contained in the accompanying *MPS* should help contain market reaction.

Fixed vs Floating for mortgages

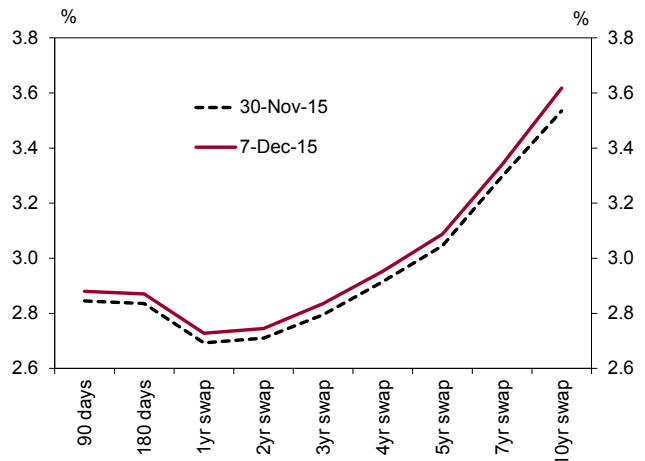
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but even those looking to fix may want to wait a while longer.

For borrowers with a deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years.

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

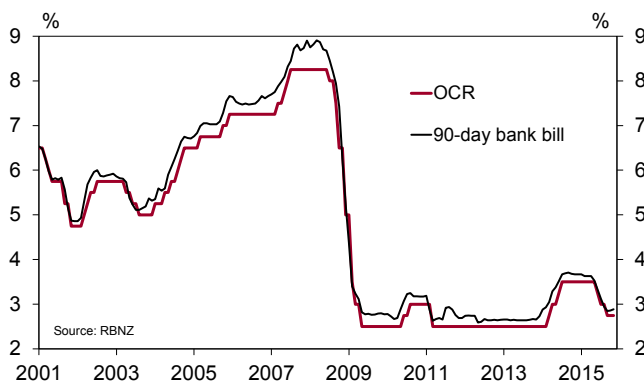


RBNZ MPS

Dec 10 Last: 2.75%, f/c: 2.5%, Market: 2.5%

- This is a highly uncertain OCR Review, and could produce large market reactions in either direction.
- Good arguments can be made either way, but we find the case for cutting the OCR most compelling. Recently, dairy prices have fallen, the exchange rate has risen, inflation has proven to be lower than the RBNZ had expected, and the Auckland housing market has slowed with a thump. These factors outweigh robust domestic data and the likelihood of a Fed hike.
- If the RBNZ does cut, it will sound neutral and non-committal about future OCR changes. If the OCR stays unchanged, the RBNZ will signal a cut in early-2016.

NZ OCR and 90-day rate

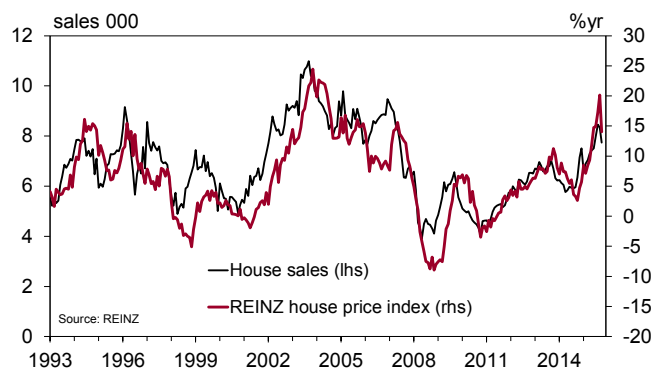


NZ Oct REINZ house prices and sales

Dec 7-11, Sales last: -7.2%, Prices last: 14.1%yr

- REINZ nationwide house sales figures for November are due this week.
- Both house sales and prices fell very sharply in October following changes to tax rules at the start of the month. In addition, new restrictions on bank high loan-to-value ratio lending came into effect on 1 November. These tightened the lending restrictions in Auckland, but eased them in the rest of the country.
- The changes appeared to hit the Auckland market particularly hard in October, with both house sales and prices down sharply in the month. A single month of data must always be treated with caution, so we will be watching this week's November data carefully to see if this trend continued.

REINZ house prices and sales



Aus Dec Westpac-MI Consumer Sentiment

Dec 9 Last: 101.7

- The Westpac-Melbourne Institute Consumer Sentiment Index rose 3.9% in Nov, nudging back into positive (i.e. >100) territory for the first time since May. The gain is all the more remarkable given the decision by banks to raise standard variable mortgage rates in the month (up an average 17bps). The detail shows rising optimism about the economy was the main driver – likely reflecting both the recent leadership change and better than expected outcomes (e.g. on jobs).
- The Dec survey is in the field over the week ended Dec 6. Developments over the last month have been mixed, with the economy posting a better than expected 0.9% gain in Q3, but commodity prices entering a renewed slide and the Sydney and Melbourne housing markets showing clear signs of slowing. The ASX is unchanged since the Nov survey, but the AUD has lifted well above 70c US.

Consumer Sentiment Index

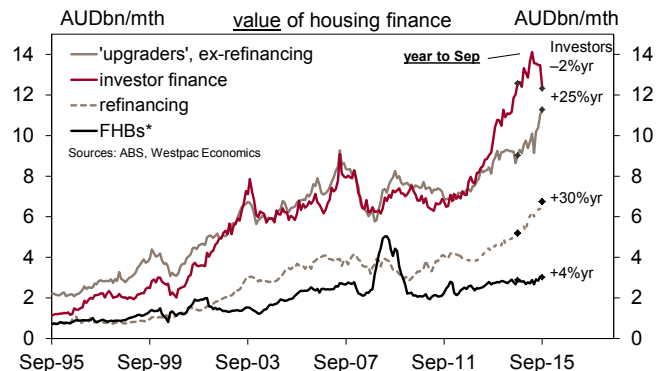


Aus Oct housing finance (no.)

Dec 9, Last: 2.0%, WBC f/c: -1.5%
Mkt f/c: -1.0%, Range: -1.5% to 0.5%

- The number of owner occupier finance approvals came in above expectations in Sep with a 2% rise, but wider measures that include investor loans and exclude refinance recorded a significant decline (-3.3% in value terms). APRA's measures aimed at containing risk and growth in investor housing credit continue to see major disruptions – weakening investor but indirectly boosting owner-occupier loans.
- Housing markets are showing clear signs of cooling off, especially in the previously 'hot' Sydney and Melbourne markets. Industry data suggests the number of owner occupier loans declined in Oct – we expect a 1.5% fall in the ABS measure. The total value of loans – covering both owner occupiers and investors – is likely to show an even bigger decline.

Value of finance approvals by segment

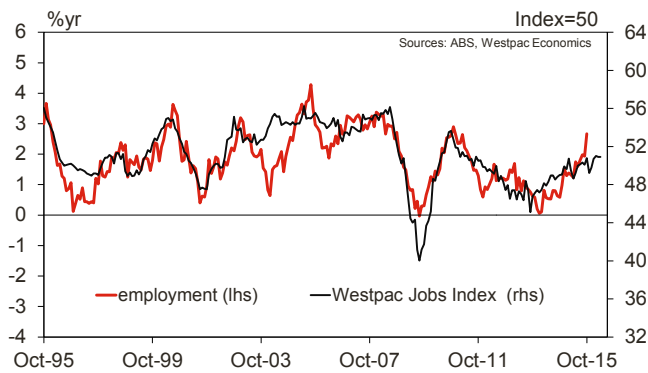


Aus Nov labour force - total employment '000

Dec 10, Last: 58.3k, WBC f/c: -20k
Mkt f/c: -10k Range: -20k to 15k

- Employment lifted 58.3k in October, more than double the top of the market estimate of +25k, and has now grown 315k (or 2.7%yr) over the past year. This is a significant acceleration from the 2.0%yr pace seen in September.
- We noted in our bulletin that we were very cautious about taking this month's number at face value. Firstly, the annual pace of employment growth of 2.7%yr looks way too strong compared to other indicators of the labour market. Secondly, the original data suggests total employment rose 92.7k, when normally it is a significant negative in October (you have to go back to 1979 to find a small positive for October).
- The leading indicators are pointing to employment growth around 2.0%yr and our forecast for -20k would take the annual pace back down to this rate.

Employment outpacing jobs index, a rare event

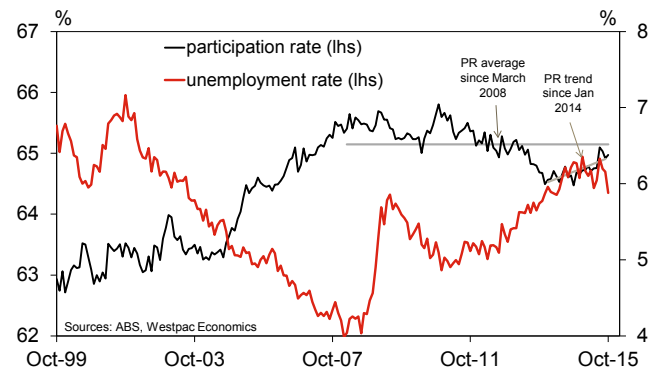


Aus Nov labour force - unemployment %

Dec 10, Last: 5.9%, WBC f/c: 6.0%
Mkt f/c: 6.0%, Range: 5.9% to 6.1%

- It appears that the recent changes to Newstart have boosted participation. In October, the participation lifted to 65.0%, well up on the October 2014 low of 64.5% and holding a rising trend. We are also yet to see any correction to the July surge in female participation in NSW, which should have happened if it is all just statistical noise.
- In October, the 0.1ppt lift in participation resulted in a 25k rise in the labour force. With a 58.3k rise in employment, this drove the unemployment rate down to 5.9% from 6.2%.
- For November, we are looking for a small 0.1ppt drop in participation. As we think statistical noise overstated the employment gains, there is likely also some noise in the participation rate. This will hold the rise in unemployment to a 0.1ppt gain to 6.0%.

Unemployment and participation rates

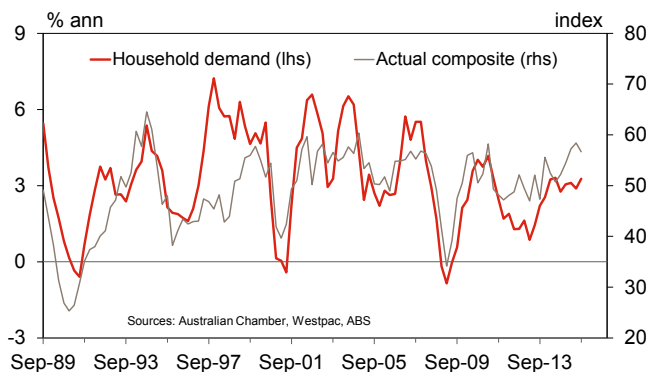


Aus Q4 Australian Chamber-Westpac survey

Dec 10, Last: 56.7

- The Australian Chamber-Westpac survey of the manufacturing sector provides a timely update on conditions in the sector, with insights into economy-wide trends. The Actual Composite tracks household demand, highlighting the key linkages between the consumer, home building and manufacturing.
- In Q3, the Actual Composite moderated to 56.7, down 1.7pts from Q2. That is a still solid reading, above the long-run average and up from 52.4 on average in 2014. Strength is centred on a lift in new orders and output, as well as an increase in overtime.
- Manufacturing is benefitting from the strong upswing in new home building activity, in response to low interest rates, and the significant improvement in competitiveness of exporters and import competing firms from the sharply lower currency. However, the cycle remains constrained. Consumer spending growth is below average and mining investment is contracting.

Westpac-AusChamber composite & household demand

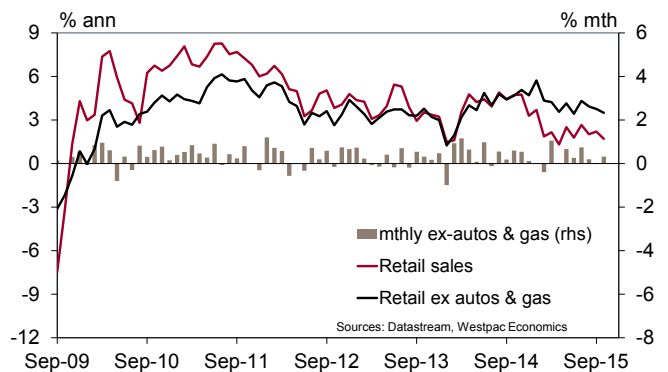


US Nov retail sales

Dec 11 Last: 0.1%, WBC f/c: 0.4%

- US retail sales have continued to disappoint of late. Consumer credit is freely available and real incomes have received a substantial boost from the sharp decline in the oil price. Yet momentum has failed to fire as the FOMC had hoped.
- Sure enough, part of the story is the impact the lower oil price has had on this nominal sales measure. Core retail sales (ex autos & gas) are up 3.5% over the past year, versus a meek 1.7% gain for headline sales. Yet the core sales result is still best considered poor given confidence and unemployment.
- Come November, we anticipate yet another modest outcome of 0.4% for core retail sales, in line with the 6-month average. The oil price should provide little to no drag, so headline sales should also rise around 0.4% in the month.

US retail sales, momentum still absent



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 7					
NZ	Nov REINZ house sales	-7.2%	-	-	Due this week. Sales have fallen due to regulatory changes.
	Nov REINZ house prices %yr	14.1%	-	-	Prices in Auckland dropped sharply last month. Likelihood of further falls.
Aus	Nov ANZ job ads %yr	12.1%	-	-	Has show a trend improvement, but we use this index with caution.
Chn	Nov foreign reserves USDbn	3526	3492	-	Edged higher in Oct; scale of hot flows seems to be easing somewhat.
Eur	Nov Sentix investor confidence	15.1	17.0	-	ECB decision came too late to influence, but will be felt in time.
Ger	Oct industrial production	-1.1%	0.7%	-	Broadly unchanged over the year; weak global growth weighing.
UK	Nov Halifax house prices	1.1%	0.2%	-	Due this week. Low mortgage rates have boosted the housing market.
US	Nov labour conditions index	1.6	-	-	FOMC's aggregate measure of the US labour market.
	Oct consumer credit	\$28.9b	\$18.0b	-	Its still all about student and auto loans.
	Fedspeak	-	-	-	Bullard speaks on monetary policy in Indiana.
Tue 8					
NZ	Q3 survey of manufacturing	0.4%	-	-	This is a key input to Q3 GDP.
Aus	Nov NAB business survey	9	-	-	Conditions index holding at +9, well above LR avg.
Chn	Nov USD exports %yr	-6.9%	-5.0%	-	Ex Greater China -5% starting point, very weak demand non-Asian EM.
	Nov USD imports %yr	-18.8%	-11.8%	-	Volume down in assembly trade; price & volume in raw materials.
	Nov trade balance USDbn	61.6	64.0	-	CNY equivalents 393/388. Imports & exports both declining at lesser rate.
Eur	Q3 GDP (provisional)	0.3%	0.3%	0.3%	Second estimate; no change from advance release expected.
UK	Oct industrial production	-0.2%	0.1%	-	The strong GBP and soft external demand are weighing on manufacturing.
US	Nov NFIB small business optimism	96.1	96.5	-	Much improved, but still below long-run average.
	Oct JOLTs job openings, 000s	5526	5580	-	Hires, fires and quits; are robust, limited and growing.
Wed 9					
Aus	Dec Westpac-MI Consumer Sentiment	101.7	-	-	Nudged back >100 in Nov, led by improved expectations for economy.
	Dec Westpac-MI unemploy. expectat.	139.4	-	-	Despite a 3.3% rise in Oct, the index is down (lower unemploy) 8.7%yr.
	Oct housing finance	-2.0%	-1.0%	-1.5%	Housing markets clearly cooling. Wider measures incl. investors weaker.
Chn	Nov CPI %yr	1.3%	1.4%	-	Non-food 0.9%, both rent & private house components rolling over.
	Nov PPI %yr	-5.9%	-6.0%	-	Multiple years of upstream deflation reflect structural challenges.
Ger	Oct trade balance	22.8b	21.8b	-	Not receiving as much support from external demand as hoped.
US	Oct wholesale inventories	0.5%	0.1%	-	Manufacturers have run them down; to flow on to intermediaries?
Thu 10					
NZ	RBNZ policy decision, MPS	2.75%	2.50%	2.50%	Inflation remains low, the housing market and NZD are key concerns.
	Nov electronic card spending	0.0%	0.4%	0.6%	Low prices and strength in the housing market have boosted spending.
Aus	Nov employment ch	58.3k	-10k	-20k	The large jump in Oct was the result of an unseasonally large rise in original terms being only partly muted by a historical seasonal factor.
	Nov unemployment rate	5.9%	6.0%	6.0%	
	Dec MI inflation expectations %yr	3.5%	-	-	New measure average is 4.5%yr; recent low was 3.2%yr in Sep 2015.
	Q4 Aus Chamber-WBC survey	56.7	-	-	Conditions > avg, manufacturing up on housing upswing & lower AUD.
Chn	Nov new loans RMBbn	513.6	800	-	Tentative date: Credit intensive sectors under cycl. & str. pressure.
	Nov total credit RMBbn	476.7	950.0	-	Tentative date: Very weak in Oct on off-balance sheet retrenchment.
	Nov M2 money supply %yr	13.5%	13.4%	-	Tentative date: FX reserves stabilised in Oct, PBOC a little more active.
UK	Nov RICS house price balance	49%	50%	-	Demand in the housing market remains firm, despite low listings.
	Oct trade balance	-£1.4b	-£1.7b	-	Soft external demand is weighing on exports.
	Bank of England rate decision	0.50%	0.50%	0.50%	Domestic activity has firmed, but external headwinds persist & inflation is low.
US	Initial jobless claims	269k	-	-	Claims have remained at low levels for an extended period.
Can	Oct new housing price index	0.1%	-	-	House price inflation has remained limited in recent months.
Fri 11					
NZ	Nov BusinessNZ PMI	53.3	-	-	Despite softening, manufacturing sector conditions remain healthy.
	Nov food prices	-1.2%	-	-0.3%	Seasonal decline in fruit and veg prices will pull overall prices down.
	Dec consumer confidence	6.8%	-	-	House confidence has lifted and is at firm levels.
Ger	Nov CPI (final)	0.1%	0.1%	-	Headline annual inflation at 0.3%yr, very benign.
UK	Oct construction output	-0.2%	0.8%	-	Demand remains firm in both the residential and business sectors.
US	Nov retail sales	0.1%	0.3%	0.4%	Oil drag to dissipate, but underlying momentum weak.
	Nov PPI	-0.4%	0.0%	-	Inflation pressures are completely absent.
	Dec Uni of Mich. consumer sentiment	92.0	91.3	-	Back around long-run average levels after brief pop higher.
Sat 12					
Chn	Nov retail sales %yr	11.0%	11.1%	-	Bounce in consumer sentiment, late Oct rate cut, Single's Day.
	Nov industrial production %yr	5.6%	5.7%	-	Mixed PMIs, but export decline less rapid, HH view of biz conditions up.
	Nov fixed investment %ytd	10.2%	10.1%	-	Staggering into year-end. Heavy ind, real estate still in downtrends.

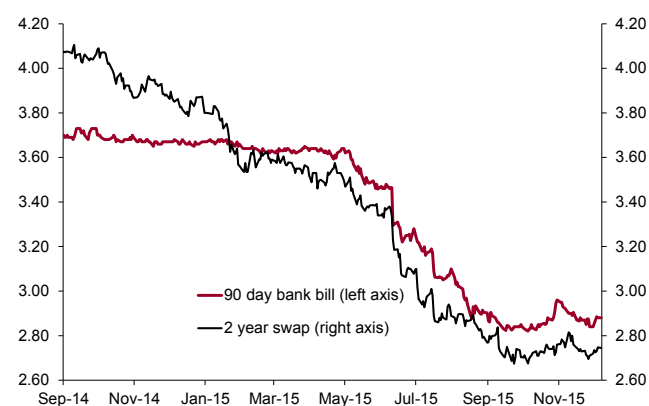


New Zealand forecasts

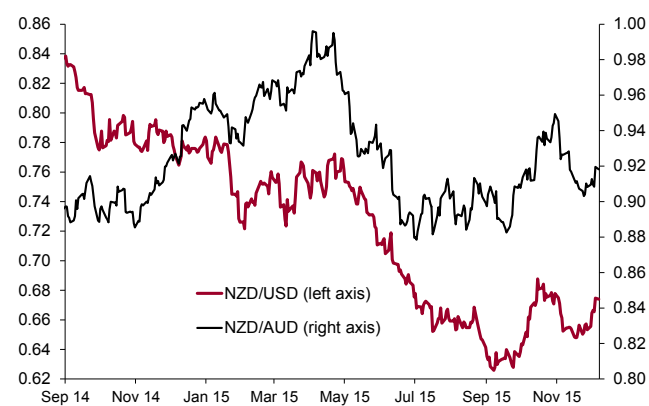
Economic Growth Forecasts	March years				Calendar years			
	2014	2015	2016f	2017f	2013	2014	2015f	2016f
% change								
GDP (Production) ann avg	2.5	3.2	2.1	2.1	2.3	3.3	2.3	2.0
Employment	3.8	3.2	1.0	2.3	2.9	3.6	1.2	2.1
Unemployment Rate % s.a.	6.0	5.8	6.4	6.3	6.1	5.7	6.3	6.4
CPI	1.5	0.3	1.1	1.5	1.6	0.8	0.3	1.7
Current Account Balance % of GDP	-2.6	-3.4	-3.7	-3.5	-3.2	-3.1	-3.5	-3.7

Financial Forecasts	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Cash	2.50	2.25	2.00	2.00	2.00	2.00
90 Day bill	2.60	2.30	2.10	2.10	2.10	2.10
2 Year Swap	2.60	2.40	2.20	2.20	2.20	2.20
5 Year Swap	3.10	3.10	3.10	3.20	3.20	3.20
10 Year Bond	3.40	3.50	3.60	3.70	3.80	3.80
NZD/USD	0.64	0.63	0.62	0.62	0.62	0.62
NZD/AUD	0.94	0.95	0.94	0.93	0.90	0.89
NZD/JPY	78.1	77.5	76.9	77.5	78.1	76.3
NZD/EUR	0.60	0.61	0.60	0.59	0.58	0.57
NZD/GBP	0.43	0.43	0.42	0.42	0.41	0.40
TWI	70.5	70.4	69.3	69.0	68.1	67.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 7 December 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.75%	2.75%	2.75%
30 Days	2.78%	2.85%	2.89%
60 Days	2.83%	2.84%	2.90%
90 Days	2.88%	2.88%	2.92%
2 Year Swap	2.75%	2.74%	2.81%
5 Year Swap	3.09%	3.09%	3.11%

NZ foreign currency mid-rates as at Monday 7 December 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6740	0.6560	0.6508
NZD/EUR	0.6200	0.6164	0.6064
NZD/GBP	0.4462	0.4319	0.4322
NZD/JPY	83.03	80.56	80.18
NZD/AUD	0.9182	0.9068	0.9262
TWI	72.90	71.26	71.16



Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.2	2.7
CPI inflation % annual	3.0	2.2	2.7	1.7	1.6	2.3
Unemployment %	5.2	5.3	5.8	6.2	6.3	6.0
Current Account % GDP	-2.8	-4.4	-3.4	-3.0	-4.0	-4.0
United States						
Real GDP %yr	1.6	2.2	1.5	2.4	2.4	2.8
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.1	1.7
Unemployment Rate %	8.9	8.1	7.4	6.2	5.3	4.9
Current Account %GDP	-2.9	-2.9	-2.3	-2.2	-2.3	-2.3
Japan						
Real GDP %yr	-0.5	1.7	1.6	-0.1	0.6	1.3
Euroland						
Real GDP %yr	1.6	-0.8	-0.3	0.9	1.5	1.1
United Kingdom						
Real GDP %yr	1.6	0.7	1.7	3.0	2.5	2.5
China						
Real GDP %yr	9.5	7.7	7.7	7.3	7.0	6.6
East Asia ex China						
Real GDP %yr	4.5	4.6	4.2	4.1	3.5	4.0
World						
Real GDP %yr	4.2	3.4	3.3	3.4	3.0	3.6
Forecasts finalised 6 Nov 2015						

Interest Rate Forecasts	Latest	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.30	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.95	2.85	2.90	3.00	3.10	3.30
International						
Fed Funds	0.125	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	2.29	2.35	2.50	2.70	2.90	3.00
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
AUD/USD	0.7319	0.70	0.68	0.66	0.66	0.67
USD/JPY	122.52	123	124	125	126	127
EUR/USD	1.0938	1.07	1.05	1.03	1.03	1.04
AUD/NZD	1.0945	1.09	1.08	1.06	1.06	1.08

Westpac economics team contact details

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

David Norman, Industry Economist
+64 9 336 5656

Any questions email:
economics@westpac.co.nz

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Disclaimer continued

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