

21 September 2015



Weekly Commentary

Kea, Arthurs Pass National Park.

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Take it slow

After considering the last week's events, we have changed our view on the timing of OCR cuts. We now expect the Reserve Bank to pause at 2.75% at its 29 October review, before delivering further rate cuts in December, January and March.

We should emphasise up front that we have not changed our view of a 2% terminal rate for the OCR in this cycle. We're sceptical that the lower New Zealand dollar will generate the sustained degree of inflation pressure that the RBNZ is forecasting. Rather, we think that the initial burst of inflation will be short-lived, and that further interest rate cuts will be needed to maintain inflation around the 2% target midpoint over the medium term.

But our call on the October OCR review needs to reflect the RBNZ's current thinking. In its September *Monetary Policy Statement*, the RBNZ indicated that (1) it expects to deliver only one more OCR cut in this cycle, and (2) it can be flexible around the timing of that cut. At the time we stuck with our view that the RBNZ would cut again in October, but noted that this was uncertain and data-dependent.

In fact, some of last week's developments strengthened the case for further OCR cuts. The latest GDP figures showed that growth in the June quarter was lower than expected at just 0.4%. That's particularly surprising given that we would have expected a rebound following weak growth in the drought-affected March quarter. This second soft growth outturn highlights that the wind really has been coming out of the economy's sails, and resulted in annual growth slowing to 2.4% in the year to June. That's well down from 3.5% at the end of last year.

On top of this, the Federal Reserve held rates at its September policy meeting. This was a particularly important event for the RBNZ, which has been counting on a higher Fed funds rate to push the NZD lower, supporting domestic export earnings and boosting inflation. However, the change in the NZD on the day was ultimately quite muted.



Take it slow continued

Balanced against the above developments are signs of resilience in economic activity, which suggest that the RBNZ can move more gradually. As we've moved into the back end of 2015 many measures of economic activity have actually held up. For instance, both the PMI and PSI ticked up in August. In addition, the housing market has remained firm, with sales and prices continuing to push higher.

Importantly, there was also another large increase in prices in the GlobalDairyTrade auction, with overall prices up 16% and whole milk powder rocketing up by another 21%. International dairy prices have now risen close to 50% since August.

The dairying sector isn't out of woods just yet. Despite the pick-up in prices, this season's payout is still likely to be below the breakeven level for many farmers. In addition, there is increasing concern about the strength of global demand, particularly in China. Finally, deepening El Niño conditions mean that there is increased risk of drought over the summer. Nevertheless, the outlook for the dairying sector is much less negative than feared a few months back.

With the dairying sector not looking as weak as feared, and recent indicators of domestic demand holding up, we think the RBNZ will hold fire at its October interest rate review. Instead, they will continue to eye a December cut. One thing to keep an eye on will be the September quarter CPI figures, which are released in mid-October. A sufficiently weak outturn could be enough to push the RBNZ over the line at its October OCR review. The strength of the global economy, especially China, will also be a key concern.

Looking beyond the next meeting, we are still comfortable with our view that the RBNZ will need to cut the OCR by more than it is currently assuming, and are forecasting a 2% low point for the cash rate. The economy is facing significant challenges in form of weakening global conditions, headwinds in the dairying sector, and the levelling off of the Canterbury rebuild. These developments have already seen both consumer and business confidence falling sharply in recent months, and a further slowdown in GDP growth is on the cards for 2016.

Weighted average dairy prices at auction



The above conditions are going to make it tough for the RBNZ to achieve its longer-term inflation goals. Softening domestic activity and reductions in government charges will keep the domestic components of inflation at low levels for some time. At the same time, the RBNZ is counting on the fall in the New Zealand dollar to generate a large and sustained pick-up in inflation through until late 2018 (some of this pick-up reflects that the RBNZ is expecting the lower exchange rate to boost demand over the coming years).

But we have our doubts. While the fall in the NZD will result in imported inflation rising sharply over the next few months, this will really only result in a temporary pick-up in inflation. Longer-term, the RBNZ's forecasts for a persistent rise in inflation in the face of softening economic activity look very optimistic. It's likely that the economy will need a significant shot in the arm in the form of lower interest rates if the RBNZ wants to generate a sustained lift in inflation.

Looking to the week ahead, today will see the release of the September quarter Westpac-McDermott Miller consumer confidence report and net migration figures for August. Later in the week, we'll receive merchandise trade figures for August.

Fixed vs Floating for mortgages

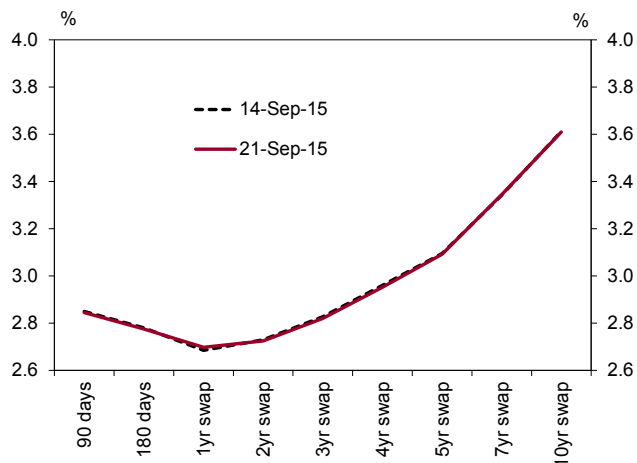
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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 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

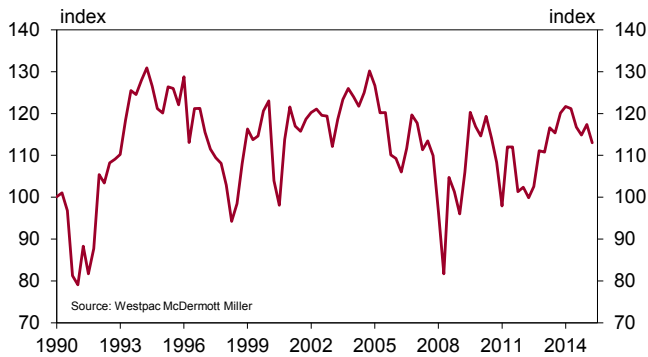


NZ Q3 Westpac-MM Consumer Confidence

September 21, Last: 113.0

- Consumer confidence reached a peak in early 2014, and has steadily softened as the dairy industry's fortunes have turned and the domestic economy has come off the boil. In the June quarter, confidence fell to 113.0, a two-year low.
- But while consumers have become noticeably less optimistic for the wider economy, to date their attitudes to spending have remained moderately upbeat.
- The September quarter survey was in the field over 1-11 September.

Westpac-McDermott Miller consumer confidence



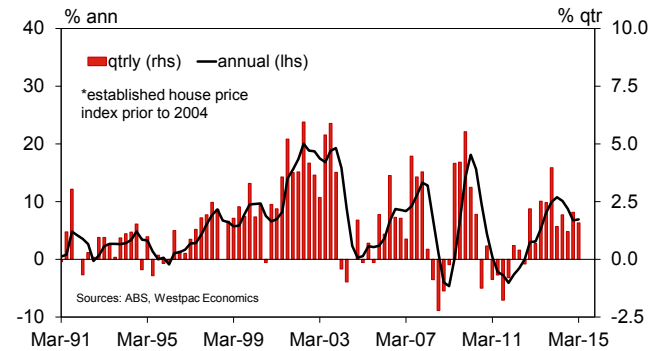
Aus Q2 residential property price index

Sep 21, Last: 1.6%, WBC f/c: 4.0%

Mkt f/c: 2.4%, Range: 1.2% to 4.0%

- Though fairly dated, this official price measure for Q2 may cause a stir. The ABS residential property price index showed a 1.6%qtr rise in Q1, taking annual price growth to 6.9%. The Q2 estimate is likely to show a much stronger read.
- The Q2 wash-up from private sector measures showed gains ranging from 2.9%qtr, 8.7%yr (Residex), to 4.1%qtr, 9.7%yr (APM) and 2.1%qtr, 10%yr (CoreLogic RP Data). The ABS measure tends to track the APM series more closely due to a similar methodology. With the official series already running behind the APM measure in Q1 that points to a strong Q2 read and potential upward revisions. Overall we expect a 4%qtr gain, lifting annual price growth to 9.1%. Capital city moves are likely to show a wide variation with extremes running from even stronger gains in Sydney to price declines in Perth.

Residential property price index, ABS measure

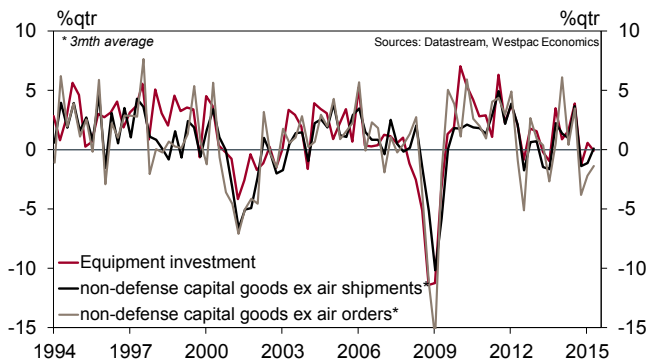


US Aug durable goods orders

Sep 24, Last: 2.2%, WBC f/c: -2.2%

- Durable goods orders rose 2.2% in July following a 4.1% gain in June, offsetting the weak outcomes reported prior to that.
- Ex transport and defence, core orders also gained a healthy 2.1% in July, helping the annual change firm from -6.4%yr to a still weak -3.3%yr.
- The underlying trend in core orders has been poor through 2015 as firms remained noncommittal on expanding capacity. The strong US dollar and underwhelming global backdrop are key, but so too are lingering doubts over the degree to which US domestic demand will firm.
- August is expected to see total orders fall back as transport sector new business ebbs; core orders should be broadly flat.

US durable goods underlying trend weak



Data calendar

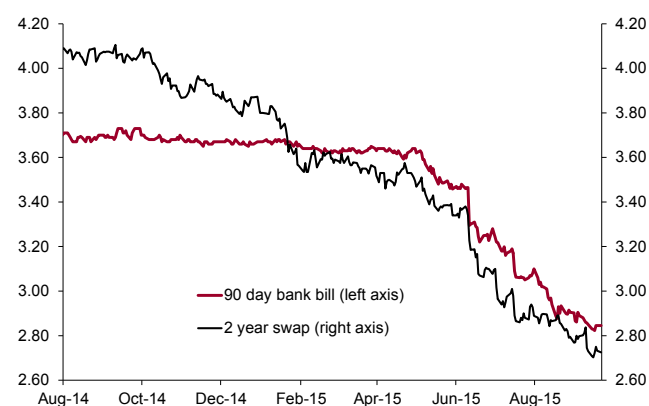
		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
NZ	Q3 Westpac MM consumer confidence	113	–	–	Confidence softened through mid-2015, but remained a bit above average.
	Aug net migration	5,740	–	5,100	Net migration inflows still showing no sign of slowing.
UK	Sep Rightmove house prices	–0.8%	–	–	Earnings growth and low mortgage rates have been supporting prices.
US	Aug existing home sales	2.0%	–1.6%	–2.0%	Very strong of late; momentum likely to ebb.
Can	Jul wholesale trade	1.3%	–	–	Trade picked up by more than expected in June.
Tue 22					
Aus	Q2 ABS residential property price index	1.6%	2.4%	4.0%	Old news but strong Q2 result for this official measure may cause a stir.
Eur	Sep consumer confidence	–6.9	–7.1	–	Confidence in outlook notably improved of late.
UK	Aug public sector borrowing	–2.1b	–	–	Improving economic conditions are boosting government revenues.
US	Jul FHFA house price index	0.2%	0.4%	–	Housing market gains continuing.
	Sep Richmond Fed manufacturing index	0	3	–	Factory sector gauges have pulled back recently.
	Fedspeak	–	–	–	Fed's Lockhart speaks on the economy in Atlanta.
Wed 23					
Eur	Sep Markit manuf. PMI (provisional)	52.3	52.2	–	Moderate momentum apparent; soft global growth a factor.
	Sep Markit services PMI (provisional)	54.4	54.2	–	Supported by ECB's intent, services sector doing well.
Ger	Sep Markit manuf. PMI (provisional)	53.3	52.8	–	As for region as a whole, world economy weighs.
	Sep Markit services PMI (provisional)	54.9	54.5	–	Gains possibly a little disappointing given labour market strength.
US	Sep Markit manuf. PMI (provisional)	53.0	53.2	–	USD a risk for momentum in manufacturing.
	Fedspeak	–	–	–	Fed's Lockhart speaks on the economy in Alabama.
Thu 24					
NZ	Aug trade balance	–649m	–875m	–750m	Seasonal low point for the trade balance.
Aus	RBA Head Econ. Analysis Heath speaking	–	–	–	Topic TBA, UDIA Luncheon, Perth, 2.00 pm AEST.
Ger	Sep IFO business survey	108.3	107.9	–	Robust; current experience more than expectations though.
US	Aug Chicago Fed activity Index	0.34	–	–	Signals moderate growth in activity.
	Initial jobless claims	264k	–	–	Jobless claims remain very low.
	Aug durable orders	2.2%	–2.2%	–1.8%	Poor underlying trend continuing; ex transport broadly flat.
	Aug new home sales	5.4%	1.6%	2.0%	Has lacked the momentum of existing sales. Modest gain likely.
	Sep Kansas city Fed manuf. activity	–9.0	–	–	Weakness in the energy sector is dampening activity.
	Fedspeak	–	–	–	Fed's Lockhart speaks on the economy in Georgia.
Fri 25					
Eur	Aug M3 money supply	5.3%	5.4%	–	Updated credit figures due out.
US	Q2 GDP (annualised, revised)	3.7%	3.7%	3.7%	Revisions (if any) to second estimate should be minimal.
	Sep Markit composite PMI (provisional)	55.7	–	–	Momentum in services sector remains robust; composite at 55.7.
	Uni. Of Michigan confidence (final)	85.7	87.0	–	Confidence above average of late; stronger consumption to follow?
	Fedspeak	–	–	–	Fed's Yellen to deliver lecture at Amherst.
	Fedspeak	–	–	–	Fed's Bullard speaks on monetary policy in St Louis.
Sat 26					
US	Fedspeak	–	–	–	Fed's George speaks on the economy in Nebraska.

New Zealand forecasts

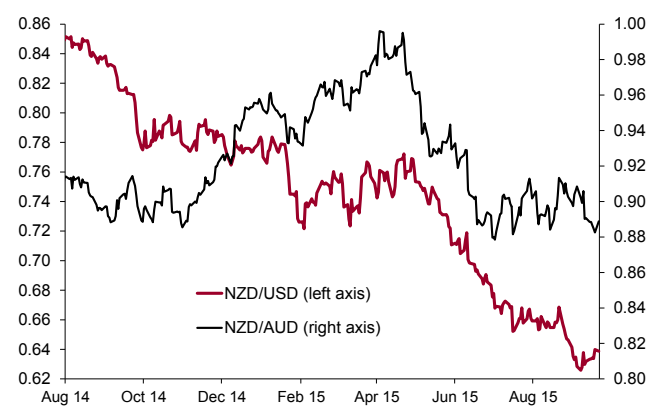
Economic Growth Forecasts	March years				Calendar years			
	2014	2015	2016f	2017f	2013	2014	2015f	2016f
% change								
GDP (Production) ann avg	2.5	3.2	1.8	2.0	2.3	3.3	2.1	1.7
Employment	3.8	3.2	0.5	2.1	2.9	3.6	0.9	1.8
Unemployment Rate % s.a.	6.0	5.8	6.5	6.3	6.1	5.7	6.4	6.3
CPI	1.5	0.3	1.5	1.6	1.6	0.8	0.7	1.9
Current Account Balance % of GDP	-2.6	-3.4	-5.6	-4.7	-3.2	-3.1	-4.8	-5.2

Financial Forecasts	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Cash	2.75	2.50	2.00	2.00	2.00	2.00
90 Day bill	2.80	2.40	2.10	2.10	2.10	2.10
2 Year Swap	2.70	2.50	2.30	2.20	2.20	2.20
5 Year Swap	3.10	3.10	3.10	3.10	3.20	3.20
10 Year Bond	3.20	3.40	3.40	3.60	3.70	3.70
NZD/USD	0.63	0.62	0.61	0.61	0.62	0.63
NZD/AUD	0.90	0.91	0.92	0.92	0.92	0.92
NZD/JPY	76.2	76.3	75.0	75.6	77.1	79.9
NZD/EUR	0.56	0.57	0.57	0.57	0.57	0.58
NZD/GBP	0.42	0.42	0.42	0.42	0.42	0.42
TWI	67.8	67.9	67.8	67.8	68.2	69.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 21 September 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.75%	3.00%	3.00%
30 Days	2.85%	2.95%	3.06%
60 Days	2.83%	2.91%	2.98%
90 Days	2.85%	2.89%	2.92%
2 Year Swap	2.73%	2.80%	2.85%
5 Year Swap	3.10%	3.13%	3.13%

NZ foreign currency mid-rates as at Monday 21 September 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6312	0.6303	0.6660
NZD/EUR	0.5568	0.5646	0.5852
NZD/GBP	0.4089	0.4152	0.4248
NZD/JPY	76.03	74.95	81.15
NZD/AUD	0.8910	0.9099	0.9134
TWI	68.49	68.73	71.83



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	2.2	2.2
Unemployment %	5.2	5.3	5.8	6.2	6.5	6.3
Current Account % GDP	-2.8	-4.4	-3.4	-3.0	-4.3	-4.6
United States						
Real GDP %yr	1.6	2.3	1.5	2.4	2.4	2.8
Consumer Prices %yr	3.1	2.1	1.5	1.6	0.2	2.0
Unemployment Rate %	8.9	8.1	7.4	6.2	5.4	5.1
Current Account %GDP	-2.9	-2.9	-2.2	-2.2	-2.3	-2.3
Japan						
Real GDP %yr	-0.5	1.8	1.6	-0.1	0.6	1.3
Euroland						
Real GDP %yr	1.6	-0.8	-0.3	0.9	1.3	1.1
United Kingdom						
Real GDP %yr	1.6	0.7	1.7	3.0	2.5	2.5
China						
Real GDP %yr	9.3	7.8	7.8	7.3	7.0	6.8
East Asia ex China						
Real GDP %yr	4.4	4.5	4.3	4.1	3.5	4.0
World						
Real GDP %yr	4.2	3.4	3.4	3.4	3.1	3.6
Forecasts finalised 4 Sep 2015						

Interest Rate Forecasts	Latest	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.18	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.77	2.85	3.10	3.25	3.40	3.60
International						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	2.19	2.40	2.80	3.00	3.20	3.40
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
AUD/USD	0.7194	0.70	0.68	0.66	0.66	0.67
USD/JPY	119.96	121	123	123	124	125
EUR/USD	1.1397	1.12	1.09	1.07	1.07	1.07
AUD/NZD	1.1293	1.11	1.10	1.08	1.08	1.09

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