



Hobbiton, Matamata

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Remain in a holding pattern

In this week's report we set out our reasoning for a downgrade to our OCR forecast. We now expect that the OCR will remain on hold until late-2016, and that the subsequent hiking cycle will result in the OCR peaking at a mere 4%. However, we also argue against the notion that the Reserve Bank will reduce the OCR this year.

Low for longer...

As discussed in our latest *Market Outlook* report, the global economy remains sluggish and global inflation is virtually non-existent. Consequently, more than 20 central banks have eased monetary policy recently. These conditions look set to persist for a while yet. For New Zealand, this is going to mean limited imported inflation and sustained upward pressure on the exchange rate vis-à-vis the Australian dollar, the euro, and the yen.

What's more, global oil prices have remained low. And after carefully considering the likely state of supply and demand in the market, we have adopted a forecast of only gradually rising oil prices over the coming two years.

All of this is going to provide a brake on inflation in New Zealand for some time. We expect that inflation will remain below the RBNZ's target band through 2015, and below the 2% target mid-point until mid-2017. This will result in a full five years of sub-2% inflation.

We've noted before that the RBNZ won't be lifting the OCR while inflation is below 1%, and that it will want to be confident that underlying inflation pressures have materially lifted before it seriously considers hikes. It now looks likely that this will take longer than previously assumed. Consequently, we now expect that the RBNZ will keep the OCR on hold until September 2016. Furthermore, the eventual hiking cycle is expected to be more muted than previously assumed, with only two hikes expected in September and December 2016, taking the OCR to a stunted peak of only 4% (previously we expected a series of four hikes starting in June 2016).

Remain in a holding pattern continued

...but hikes still needed...

The RBNZ's recently published forecasts showed interest rates remaining unchanged for the foreseeable future, while the economy grows at rates of over 3% per annum and house prices rise vigorously. It's true that inflation has tended to surprise on the downside for a number of years now. However, we're not quite as optimistic as the RBNZ that New Zealand will get away with absolutely no hikes under these circumstances.

The economy has been growing at a robust pace for some time. In the year to December, GDP increased by 3.3% - its fastest pace in seven years, and above anyone's estimate of the economy's long-run potential growth rate. Looking forward, we see strong reason to expect that domestic demand will remain robust for some time. This includes the likelihood of continued strong population growth, strength in house prices, and increases in construction in Canterbury, Auckland and more widely.

These conditions have eliminated the spare capacity that was prevalent in the economy in recent years, and will likely lead to eventual increases in wage and price pressures. On top of this, the Fed is expected to begin increasing rates over the coming year, which will further reduce pressure on the NZD. This combination of conditions is likely to result in the need for some late-cycle OCR hikes.

...though the cycle will be muted

While we expect that some rate hikes will be necessary, the eventual hiking cycle is expected to be muted. By the time that 2017 rolls around, some of the current strong momentum in the New Zealand economy will have started to fade. In particular, by that point net immigration is likely to have begun easing back, and the pace of reconstruction work in Canterbury will be slowing. As the impulse from these factors starts to fade, we'll see growth in the economy starting to soften, which will eliminate the need for further rate hikes.

Why not cut?

Over the coming months, inflation will drop to its lowest level in well over a decade, which has prompted some commentators to suggest that the RBNZ should be cutting rates. We would retort that monetary conditions have actually already eased dramatically in recent months. The weak near-term inflation outlook has seen financial markets pricing in some chance of OCR cuts over the coming year, resulting in downwards pressure on fixed mortgage rates. In addition, there is a risk that market pricing moves further in this direction over the coming months as we see the impact of recent oil price declines in official inflation statistics. This is providing the RBNZ with a proxy easing in near-term financial conditions – low fixed interest rates are stimulating short-term growth by encouraging borrowing and discouraging savings in exactly the same fashion as a reduction in the OCR.

Forecast update: Fonterra's payout

The other key development over the past week was a downgrade to our forecasts of Fonterra's farmgate milk price for both this season and next season: we've shaved off 10c for this season (down to \$4.90/kg, still higher than Fonterra's current guidance) and 30c off next season (down to \$6.10/kg). This reflects that the impact of recent dry conditions, and hence the impact on global supply, has not been as bad as feared. We are now forecasting Fonterra's full-season production to be down 0.5% on the previous season (a more modest impact than the 3.3% reduction that was initially feared). We'll get an update on these conditions Wednesday when Fonterra reports its half year earnings.

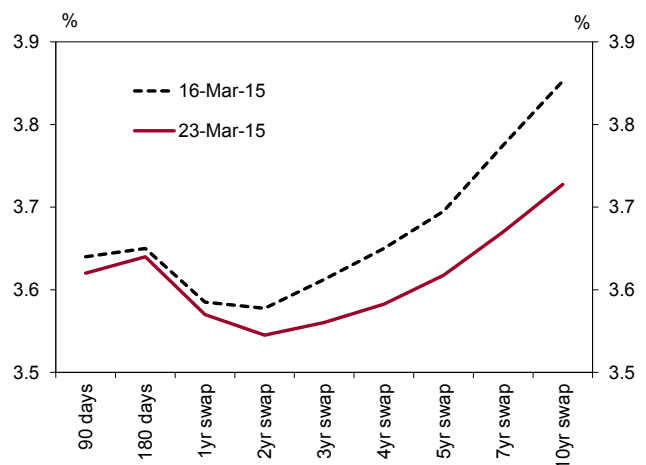
Fixed vs Floating for mortgages

Among the current standard fixed rates, the best value for borrowers with a deposit of 20% or more probably lies in the two-year and three-year terms. However, there is a possibility that fixed mortgage rates will fall even further over the weeks ahead. Waiting a while before fixing might offer even better value.

Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the coming four or five years, though the gap has narrowed in recent weeks, and these longer-term rates do offer the benefit of 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

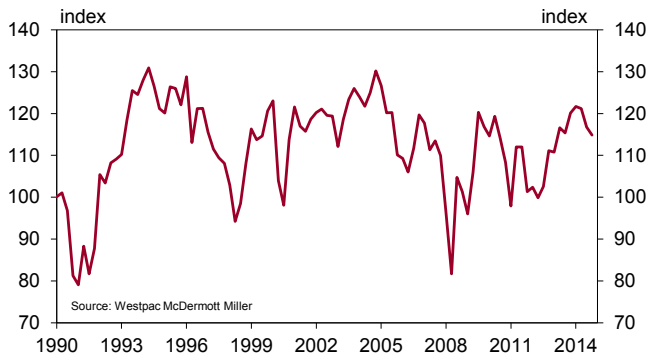


NZ Q1 Westpac-MM Consumer Confidence

Mar 23, Last: 114.8

- Consumer confidence continued to fall in the December quarter. The drop was particularly sharp in rural and provincial New Zealand, suggesting that concerns around a lower dairy payout were weighing on consumers' minds.
- Consumers in the main urban centres were more upbeat, but less so than might have been expected given falling petrol prices and mortgage rates.
- The March quarter survey was in the field over 1-11 March.

Westpac-McDermott Miller consumer confidence

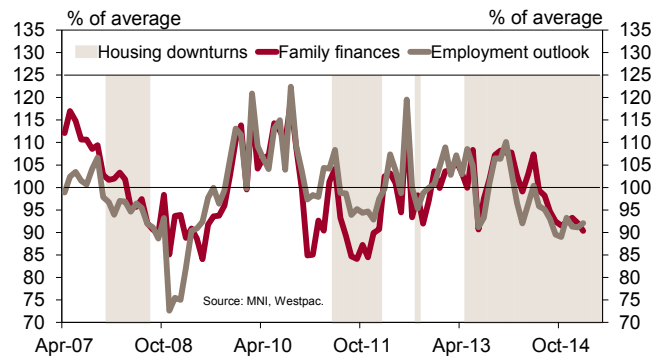


China Mar Westpac MNI Consumer Sentiment

Wed Mar 25, Last: 112.0

- The headline index was basically flat at 112 in February. Consumers are thus still relatively anxious about their own financial wellbeing and the economy more broadly.
- The survey period captures both the post-LNY rate cut as well as the intense media coverage of the lowering of the annual growth target. Note that the November cut had a clearly discernible positive impact on the December survey.
- We will be looking for the following in March: 1) Which is the stronger force in the minds of consumers: the interest rate cut or the growth target? 2) The evolving attitude of consumers towards housing, noting that the November rate cut had a material impact in this space. 3) Any further signs that responses on 'business conditions' are picking up, given the lack of useful data on this front from other sources at this time of year, plus the conflicting forces described in point 1).

Westpac MNI China CSI & housing downturns



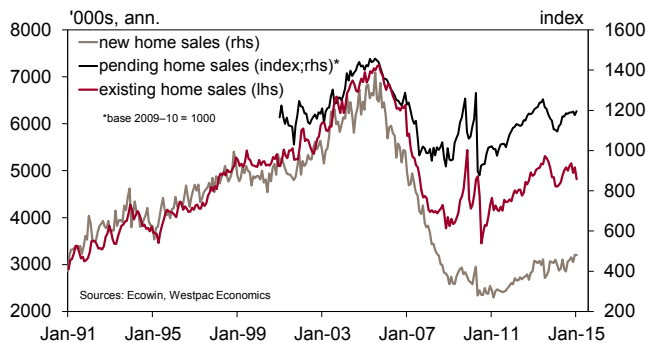
US Feb existing/new home sales

Mar 23, Existing: Last: -4.9%, WBC f/c: 2.0%

Mar 24, New: Last: 0.2%, WBC f/c: -10.0%

- Existing home sale completions fell by 4.9% in January, for an annualised pace of 4.82mn, its weakest since April last year and down 5% on July 2014 but up 3% on January last year. In contrast, pending home sales (agreed but not completed), which rose 1.5% in Jan, were down just 1.5% on their mid-year peak and were 10% higher than a year earlier. Although there is weather impact risk in the next month or so's data, some catch up is likely in completions, and we expect a 2% rise in Feb.
- New home sales are volatile and often revised. Homebuilder sentiment has softened and housing starts and permits for single family homes have been soft lately even after weather effects. We expect snowstorm disruptions on top of this to drive a spectacularly weak new home sales print, whether in the revisions or a sharp Feb fall.

US housing sales



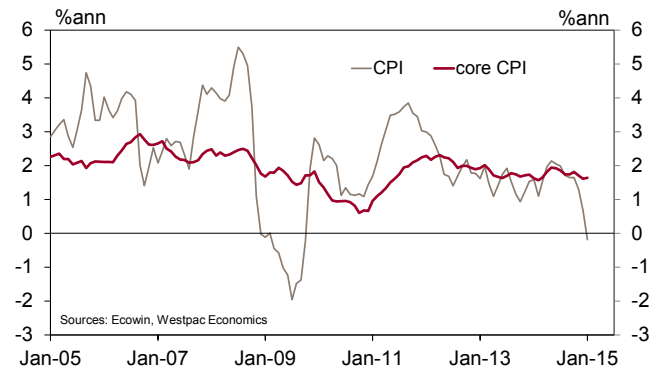
US Feb CPI

Mar 24, CPI: Last: -0.7%, WBC f/c: 0.1%

Mar 24, CPI core: Last: 0.2%, WBC f/c: 0.0%

- The CPI fell for three months running in Nov-Jan as gasoline prices plunged, but in February they rose more than they fell in January so will add to the CPI for the first month since the middle of last year.
- Food prices rarely fall but the PPI showed steepening declines in wholesale prices between Dec-Feb and food prices were flat in the Jan CPI. Hence they are likely to post a modest fall in Feb.
- The core CPI's above trend 0.2% rise in Jan is unlikely to be repeated with apparel prices expected to reverse their 0.3% Jan rise. But auto prices have been flat to lower for several months and may pose upside risk.
- We expect a subdued Feb inflation outcome of 0.1% headline and 0.0% core.

US consumer price inflation

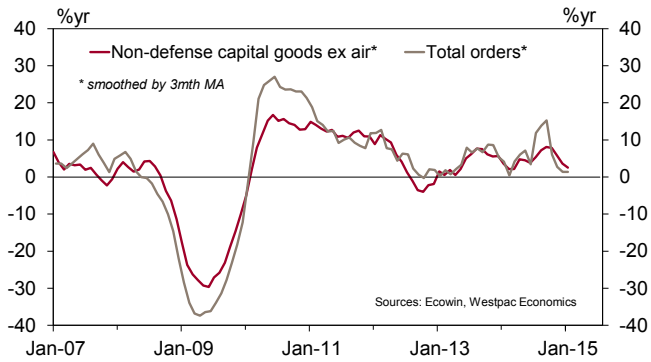


US Feb durable goods orders

Mar 25, Last: 2.8%, WBC f/c: -2.0%

- Durable goods orders posted their first substantive gain in Jan since July but it was mostly due to a 129% jump in aircraft orders. Ex transport, orders rose only 0.3% after falls in the previous three months. Core capital goods orders ex defence and aircraft rose 0.5% after falls in five of the previous six months and were down 9% annualised in the three months to Jan; shipments of same were down 3% in that trimester.
- ISM factory orders fell to a 21 month low in Jan. Boeing took just 5 orders in Jan after 174 in Dec but that recovered to 72 in Feb (Jan is typically a slow month but the seasonal adjustment looks excessive). Auto sales and production fell again in Feb, the latter steeply, and business equipment output was also lower. All this points to a weak orders picture albeit with aircraft seasonality a wild card; core capital goods orders probably slipped a little after Jan's modest gain.

US durable goods orders



Data calendar

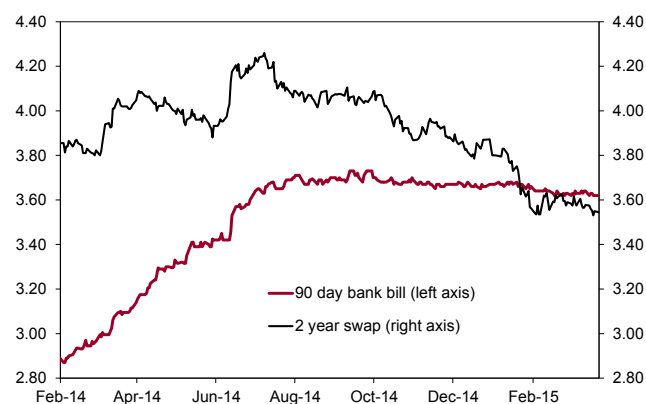
		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
NZ	Q1 consumer confidence	114.8	–	–	Confidence fell back in late 2014.
Eur	Mar consumer confidence adv	–6.7	–5.8	–6.0	ECB QE underway, growth forecasts being talked up.
UK	Mar CBI industrial trends	–14	–15	–	Total orders index.
US	Feb Chicago Fed national activity index	0.13	–	–	Based on 80 or so data inputs, not a business survey.
	Feb existing home sales	–4.9%	2.5%	2.0%	Pending sales suggest upswing in completions likely.
	Fedspeak	–	–	–	Mester in Paris.
Tue 24					
Aus	RBA Assist. Gov Edey speaking	–	–	–	Panel participant at ASIC Annual Forum, Sydney 3.50pm AEDT.
Chn	Mar HSBC manufacturing PMI - flash	50.7	50.4	–	Surprisingly firm in Feb, not 'franked' by subsequent Jan-Feb IP report.
Eur	Mar PMI manufacturing adv.	51.0	51.5	51.3	Jan-Feb saw tentative Dec rise extended with composite PMI rising ...
	Mar PMI services adv.	53.7	53.9	54.0	... from 51.1 to 53.3 in Feb, compared to 54.0 multi-year high last April.
UK	Feb PPI %yr	0.5%	0.3%	–	Core output measure.
	Jan house prices %yr	9.8%	–	–	Official ONS measure peaked at 12.1% yr in Sep 2014.
	Feb CPI %yr	0.3%	0.1%	–	BoE MPC debating risks around near zero CPI and policy response.
US	Feb CPI	–0.7%	0.2%	0.1%	Gasoline prices higher for first month since mid last year ...
	Feb core CPI	0.2%	0.1%	0.0%	... but food prices and nil core price pressures to largely offset.
	Jan house prices	0.8%	0.5%	–	FHFA index.
	Mar PMI factory prelim	55.1	54.7	–	Not always reliable guide to the factory ISM.
	Feb new home sales	0.2%	–1.3%	–10.0%	Builder sentiment and starts data soft; weather impact.
	Feb Richmond Fed factory index	0	2	3	Feb saw lowest reading since Feb-Mar 2014 snow storm disruption.
	Fedspeak	–	–	–	Bullard in London.
Wed 25					
NZ	Feb Merchandise trade balance \$m	56	325	600	Strong meat exports, cheaper oil imports.
Aus	Mar RBA Financial Stability Review	–	–	–	Heightened interest given RBA/APRA efforts to contain investor housing.
Chn	Mar Westpac MNI Consumer Sentiment	112.0	–	–	Tussle between rate cut and lower growth target.
Ger	Mar Ifo business climate index	106.8	107.2	107.0	Up in Nov, Dec, Jan, Feb; Q4 GDP jump looks sustainable on this basis.
UK	Feb mortgages	36.4k	–	–	BBA data covering 70% of market.
US	Feb durable goods orders	2.8%	0.5%	–2.0%	Aircraft noise masking underlying weak story.
	Fedspeak	–	–	–	Evans in London.
Thu 26					
Eur	Feb money supply M3 %yr	4.1%	4.4%	–	New post 2009 high in Jan. Private loans down just –0.1% yr.
Ger	Apr GfK consumer confidence	9.7	9.9	–	Surveyed early Mar but labelled April.
UK	Feb retail sales inc fuel	–0.3%	0.2%	0.4%	BRC steady in Feb, CBI retail survey quite a bit lower.
	Mar CBI retail survey	8	–	–	Retailing might be losing some momentum so far this year.
US	Initial jobless claims w/e 24/2	291k	295k	286k	Claims in renewed downtrend after weather disruption earlier in year.
	Mar PMI services prelim	57.1	57.0	–	Some tracking identifiable with services ISM.
	Mar Kansas City Fed factory index	1	–	0	Feb lower than at any point in 2014.
	Fedspeak	–	–	–	Bullard in Frankfurt, Lockhart in Detroit.
Fri 27					
Ger	Feb retail sales	2.3%	–1.5%	–1.0%	Due 27/3-3/4. Big swings in Dec-Jan, Feb likely to correct lower.
US	Q4 GDP final % annualised	2.2%	2.4%	2.2%	Q1 likely to be significantly weaker.
	Mar UoM consumer sentiment final	91.2 a	91.8	92.0	Weekly confidence data higher; renewed declines in gasoline prices.

New Zealand forecasts

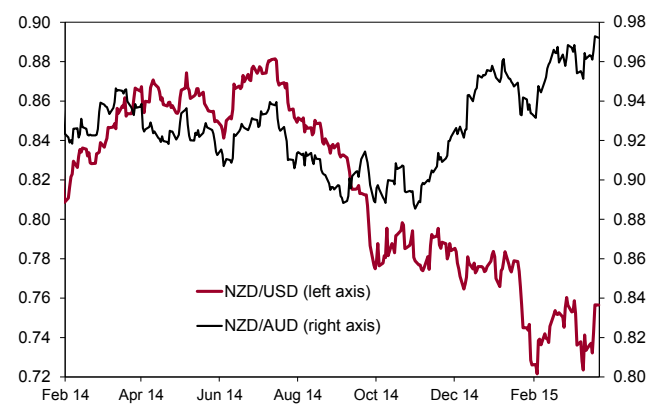
Economic Growth Forecasts	March years				Calendar years			
	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
% change								
GDP (Production) ann avg	2.2	2.5	3.3	3.0	2.3	3.3	3.0	3.4
Employment	0.4	3.8	2.9	3.0	2.9	3.5	2.6	2.5
Unemployment Rate % s.a.	6.2	6.0	5.5	4.7	6.0	5.7	4.8	4.3
CPI	0.9	1.5	0.3	0.9	1.6	0.8	0.3	1.7
Current Account Balance % of GDP	-3.7	-2.6	-4.3	-4.9	-3.3	-3.3	-5.0	-4.6

Financial Forecasts	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Cash	3.50	3.50	3.50	3.50	3.50	3.75
90 Day bill	3.70	3.70	3.70	3.75	3.75	4.00
2 Year Swap	3.50	3.40	3.50	3.70	3.90	4.00
5 Year Swap	3.60	3.50	3.60	3.80	4.00	4.20
10 Year Bond	3.30	3.20	3.30	3.60	3.80	4.00
NZD/USD	0.73	0.73	0.74	0.76	0.78	0.78
NZD/AUD	0.97	0.97	0.97	0.97	0.98	0.96
NZD/JPY	89.1	90.5	93.2	95.8	99.1	99.8
NZD/EUR	0.68	0.68	0.69	0.70	0.71	0.70
NZD/GBP	0.49	0.49	0.49	0.49	0.49	0.49
TWI	78.5	78.7	79.7	81.0	82.2	81.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 23 March 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.63%	3.62%	3.63%
60 Days	3.62%	3.63%	3.63%
90 Days	3.62%	3.63%	3.63%
2 Year Swap	3.55%	3.61%	3.63%
5 Year Swap	3.62%	3.72%	3.73%

NZ foreign currency mid-rates as at Monday 23 March 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7565	0.7362	0.7527
NZD/EUR	0.6977	0.6794	0.6605
NZD/GBP	0.5054	0.4895	0.4888
NZD/JPY	90.68	88.91	89.74
NZD/AUD	0.9721	0.9547	0.9595
TWI	79.19	77.28	78.07

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014e	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.4	3.0
CPI inflation % annual	3.0	2.2	2.7	1.7	2.1	3.0
Unemployment %	5.2	5.3	5.8	6.2	6.7	6.4
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-2.5	-1.7
United States						
Real GDP %yr	1.6	2.3	2.2	2.4	2.8	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.6	1.0	2.1
Unemployment Rate %	8.9	8.1	7.4	6.2	5.2	4.9
Current Account %GDP	-2.9	-2.9	-2.4	-2.4	-2.5	-2.5
Japan						
Real GDP %yr	-0.4	1.7	1.6	-0.1	1.0	1.7
Euroland						
Real GDP %yr	1.6	-0.6	-0.4	0.8	1.0	1.0
United Kingdom						
Real GDP %yr	1.1	0.3	1.7	2.6	2.5	2.7
China						
Real GDP %yr	9.3	7.7	7.7	7.4	7.3	7.5
East Asia ex China						
Real GDP %yr	4.5	4.5	4.3	4.1	4.8	5.3
World						
Real GDP %yr	4.1	3.4	3.3	3.3	3.5	4.1
Forecasts finalised 9 March 2015						

Interest Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Australia						
Cash	2.25	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	2.38	2.50	2.90	3.00	3.10	3.40
International						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	1.96	2.10	2.50	2.70	2.90	3.20
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
AUD/USD	0.7674	0.75	0.75	0.76	0.78	0.80
USD/JPY	120.74	122	124	126	126	127
EUR/USD	1.0680	1.07	1.07	1.07	1.08	1.10
AUD/NZD	1.0325	1.03	1.03	1.03	1.03	1.03

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