

Weekly Commentary

1 August 2016



Building up to something

New Zealand's construction sector is on a roll at the moment. Building consents are rising strongly in many parts of the country, and employment in the industry has risen by more than 10% over the last year. But there's a lot more work that needs to be done, and removing the constraints to growth will be essential.

Building consents rose sharply in June, with the number of residential consents up 16% in seasonally adjusted terms, and the value of non-residential consents spiking to a record high of \$739m. This was a welcome change in direction after a period of decidedly mixed performance, especially in Auckland where housing consents had actually been trending lower in recent months. While June was an improvement, the monthly numbers are still running below last year's highs.

It may be that developers in Auckland have been holding back until the city's Unitary Plan (UP) is signed off. After a years-long process, the Independent Hearings Panel last week delivered its proposed plan. The Auckland Council is now reviewing the plan and is due to decide later this month whether to adopt it in whole or in part.

The UP contains a huge amount of detail, including changes to density restrictions and easing building requirements. All together, the proposed UP creates the capacity for more than 420,000 new dwellings in Auckland over the next 25 years, more than enough to meet the city's expected population growth.

The UP is a necessary step in accommodating Auckland's long-term growth. But for now, a lot more needs to be done to address Auckland's existing shortage of housing, and a united coherent plan has been only one of the constraints. In a report last year, we examined the need for more

homebuilding in Auckland and what could be achieved. We noted three factors in particular: whether the regulatory environment is supportive of development; how quickly land is actually supplied to the market; and whether the building industry has the capacity to deliver those new homes.

The latter is especially important, as the building industry is already running up against capacity constraints. The number of workers required is not in itself the biggest problem: we find that construction booms tend to draw in locals from outside the workforce or from other industries. Even in the Christchurch earthquake rebuild, one of the biggest building booms in this country's history, much of the demand for construction workers has been met by locals.

Instead, the real problem is skills. In the latest QSBO survey, builders reported that the difficulty of finding skilled workers was at its highest in 20 years. And build quality is suffering – as many as a third of building inspections in Auckland are failed.

Given these constraints as they currently stand, we estimate that the building industry could realistically deliver between 11,000 and 12,000 new homes each year in Auckland. That's a slower pace than many have aspired to, but it would still represent a significant increase on the current rate (9,650 homes consented in Auckland in the year to June). This pace of building would be enough to eat into Auckland's housing shortage, albeit gradually. And it

Building up to something continued

would give the building industry some certainty around the flow of work for years to come, allowing them to plan and resource accordingly.

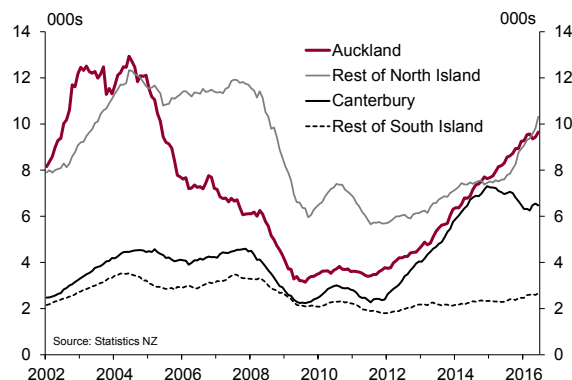
In addition to the strong rise in building consents, the rest of the economic news last week was generally positive. Business confidence was marginally lower in July, but at current levels it suggests that GDP growth has picked up the pace a little since the 0.7% increase in the March quarter. The construction and services sectors remain upbeat, balancing out the gloom in the agricultural sector.

The overseas trade figures for June also highlighted that other sectors have gone some way toward making up for the dairying downturn. The trade balance remained in deficit in seasonally adjusted terms, but it was an improvement on the same time last year.

Kiwifruit exports were a particular highlight. The industry has recovered strongly from the Psa virus that devastated many orchards in 2013, and export earnings have surged above previous highs. Our latest Industry Insights report, released last week, highlights that many parts of the horticulture sector have seen rapid growth in the last few years. Factors such as more effective industry organisation, use of technology and improved practices have accounted for this success at least as much as free trade agreements.

This week's data highlight was going to be the Household Labour Force Survey for the June quarter, but Statistics NZ has decided to delay the release for two weeks. The survey was recently redeveloped, and the latest results are being quality-checked to ensure that they are comparable with

Dwelling consents, annual total



history. The other employer-focused labour market reports will still be released on schedule on Wednesday. We expect the Quarterly Employment Survey to show further solid growth in job numbers, while the Labour Cost Index is likely to show that wage growth remains subdued in the face of persistently low inflation.

The other highlight will be the Reserve Bank's survey of inflation expectations, which is the last major data point before the 11 August *Monetary Policy Statement*. The survey was held just after the release of the weaker than expected June quarter CPI, so the risks around this survey would seem to be to the downside, even for a two-year-ahead forecast horizon.

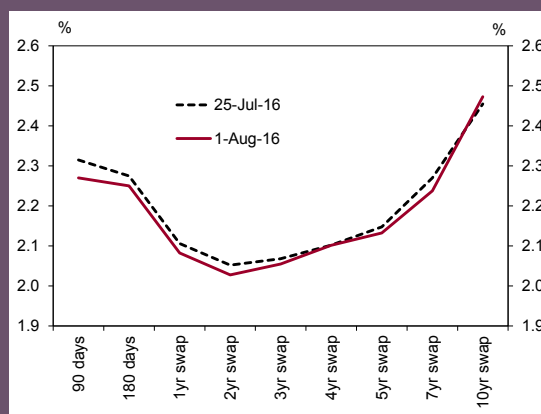
Fixed vs Floating for mortgages

Fixed rates have fallen a long way recently, and are becoming a more attractive option for borrowers.

For borrowers with a deposit of 20% or more, the best value probably lies in the two-year rate or shorter terms. Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the next four or five years. That said, fixing for a longer term does offer the borrower greater 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



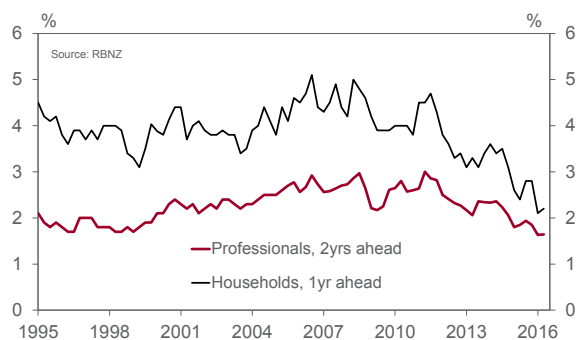
The week ahead

NZ Q2 survey of inflation expectations

Aug 2, 2 yrs ahead - Last: 1.64%

- Most surveys of inflation expectations have trended down in recent years, leaving them at very low levels. This is a key concern for the RBNZ given the potential for low expectations to translate into downward pressure on wages and prices. The most closely watched measure of inflation expectations is the RBNZ's own survey of two year ahead expectations. After falling to a low not seen for more than 20-years earlier in 2016, this measure appeared to be finding a base in Q2. However, with the latest expectations survey occurring very soon after the lower than expected Q2 inflation result was announced, there is a risk that expectations take another step down. A further downside surprise would strengthen the case for a sub-2% cash rate. However, even if expectations remain stable (or if they edge higher), this would not be enough to dissuade the RBNZ from cutting at its upcoming August interest rate review.

RBNZ survey of inflation expectations



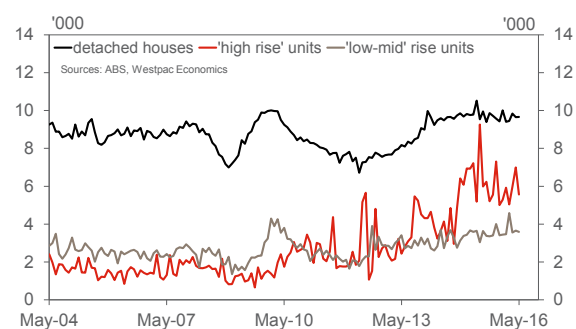
Aus Jun dwelling approvals

Aug 2 Last: -5.2%, WBC f/c: 1.0%

Mkt f/c: 0.5%, Range: -3.0% to 5.0%

- Dwelling approvals posted a bigger than expected 5.2% fall in May – the fall led by a sharp 20% drop in 'high rise' approvals with ex high-rise approvals broadly stable. The May pull-back in high rise reversed a spike in April. Looking through what is a very choppy monthly profile, the segment is showing signs of a trend decline since mid 2015 suggesting the tightening in investor credit conditions locally and a range of other factors are curtailing activity. We remain wary of the potential for a further sharp pull-back in high rise – another 30% drop for example would still only bring approvals back to their average level over H1 2014. While that is a risk our central case is for a more orderly wind down. Meanwhile, activity outside this segment still looks well supported. On balance we expect June to show a 1% gain in approvals with risks to the downside.

Dwelling approvals: houses, low-mid & high rise



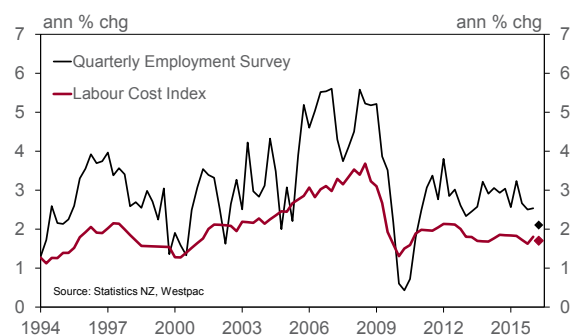
NZ Q2 labour cost index

August 3, Private sector (incl. overtime), last: 0.4%

WBC f/c: 0.4%, Mkt f/c: 0.4%

- Strong growth in the labour force and a subdued inflation backdrop is likely to translate into ongoing softness in wage growth. We're forecasting a 0.4% lift in the private sector LCI, which would leave annual wage inflation at 1.7% on this measure.
- But while there is no sign of a turnaround yet, we are conscious that this dynamic will not continue indefinitely. Inflation is forecast to increase from current lows, and will eventually drag inflation expectations with it. In addition, net migration is forecast to slow from here, dampening growth in the labour force. Against this backdrop we could see growing pressure on wages.

LCI and QES wages



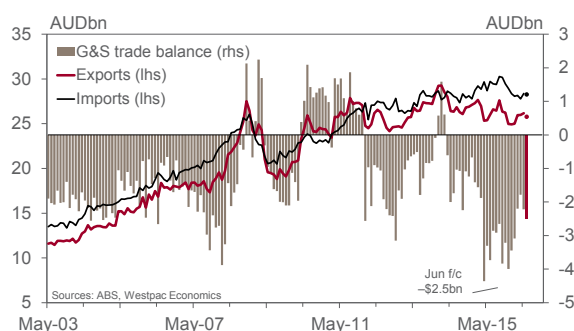
Aus Jun trade balance, AUDbn

Aug 2, Last: -2.2, WBC f/c: -2.5

Mkt f/c: -2.0, Range: -2.75 to -1.60

- Australia's trade balance is expected to be a \$2.5bn deficit in June. While a \$0.3bn deterioration on the outcome for May it is still an improvement on the \$3bn plus deficits prior to March.
- Export earnings fell by a forecast 1.5% in June, following a near 5% partial rebound over the previous 3 months. Iron ore and coal prices slipped in the month, while coal and LNG shipments appear to have moderated.
- For imports, we anticipate a small decline, -0.4%, on lower prices, as the AUD was a little firmer, and on softer volume.
- NOTE: Since January, there is additional uncertainty around the import and trade forecast. The ABS no longer publishes the customs goods imports ahead of the trade release.

Australia's trade position



The week ahead

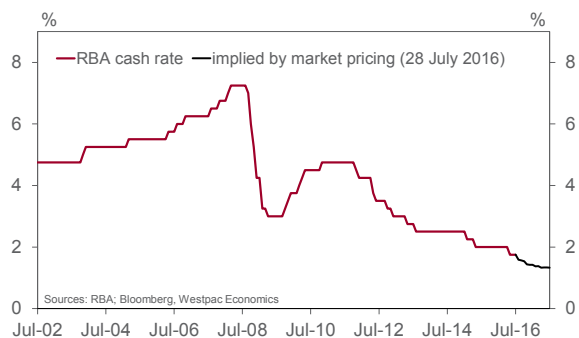
Aus RBA policy decision

Aug 2, Last: 1.75%, WBC f/c: 1.50%

Mkt f/c: 1.50%, Range: 1.50% to 1.75%

- We expect the RBA to cut the cash rate by 25bps to at its Aug meeting although the decision may be finely balanced. The RBA cut rates by 25bps back in May after a surprise, broad-based weakening in inflation. The Bank's May Statement on Monetary Policy (SoMP) included heavy downward revisions to its inflation forecasts which only saw inflation return to the bottom of the 2-3% target band at the end of the forecast horizon. This view was also on a 'market pricing' assumption on rates that included a further easing. The Board held rates steady in June and July, awaiting more information, the Q2 CPI update in particular. This confirmed the weak inflation trajectory in line with the RBA's May forecast. While not a further downside surprise (we expect no changes to the Bank's forecasts in its Aug SoMP) the result confirms the sharply weaker May view and should see the Bank cut rates again.

RBA cash rate & market pricing



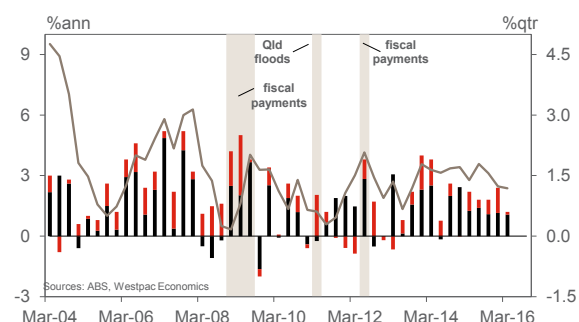
Aus Q2 real retail sales

Aug 4, Last: 0.5%, WBC f/c: 0.6%

Mkt f/c: 0.5%, Range: 0.3% to 0.9%

- Real retail sales rose 0.5% in Q1, following a 0.6% rise in Q4 and a 0.5% gain in Q3 2015. Note that annual growth in retail has held at 2.4% and has not shown the slight pick-up evident in the broader total consumer spending measure in the national accounts (from 2.7%yr in 2015 Q1 to 3%yr in Q1 2016). Indeed, nominal retail sales growth has slowed over the same period as price discounting has become more aggressive.
- The picture for Q2 suggests a slightly better gain in nominal sales (+0.7%qtr vs +0.6%qtr) with the detail from the Q2 CPI pointing to another weak quarter for retail prices - we expect another 0.1%qtr gain taking annual retail inflation to just 1.1%yr. That should see real retail sales up 0.6%qtr, in line with subdued recent reads.

Quarterly retail volumes and prices



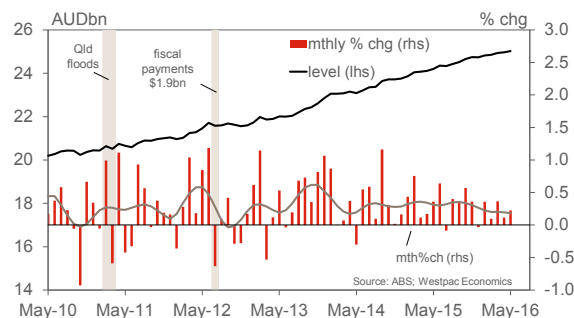
Aus Jun retail trade

Aug 4, Last: 0.2%, WBC f/c: 0.4%

Mkt f/c: 0.3%, Range: 0.1% to 0.5%

- Retail sales rose 0.2% in May, a disappointing result following a 0.1% gain in April. The detail showed a poor 'mix' pointing to continued lacklustre demand and aggressive price discounting.
- June should see some improvement. Consumer sentiment remained more upbeat after a rate cut driven bounce in May with a continued easing in job loss fears. The rate move would have impacted household cash flows in the June month. Business surveys have shown improved conditions across the broader consumer sector since mid 2015 but with mixed signals in the June month, particularly around the more specific retail sector. On balance we expect June to show an improved 0.4% gain.

Monthly retail sales

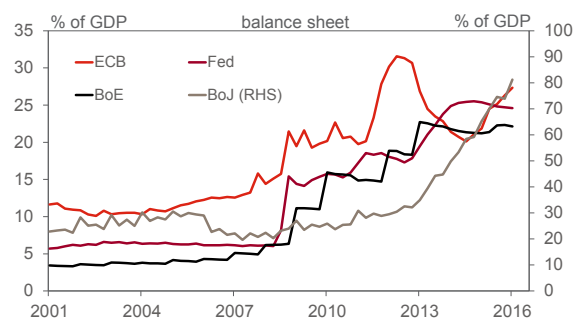


Aug Bank of England policy decision

Aug 4, Last: 0.50%, WBC 0.25%

- Having been swift to provide liquidity and support belief in the banking system immediately after the Brexit referendum result, the BoE surprised the market and ourselves by holding fire on monetary policy at its July meeting. Instead they decided to wait until a full assessment of conditions had been made and forecasts updated - to be released to the public in the August Inflation Report, after this meeting. We now know that the Brexit result has led to: a material deterioration in consumer confidence; the UK Markit PMI falling to its lowest level since 2009; and the CBI retail sales volume index declining to its lowest level in four years. At this meeting, the Committee is therefore likely to not only cut the Bank Rate by 25bps, but also to re-introduce asset purchases. A program of around £5bn per month from Q4 2016 to end-2017 would support confidence and weaken sterling, but also give the BoE room to act again (if necessary).

Central bank balance sheets



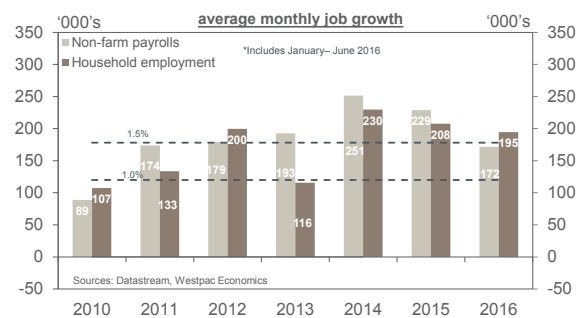
The week ahead

Jul US employment report

Aug 5, Last: 287k, WBC 185k

- Following a five-month downtrend in three-month average nonfarm payrolls growth, from 282k in December 2015 to 114k in May, nonfarm payrolls bounced sharply in June, recording an out-sized gain of 287k.
- Meanwhile, in the household survey, month-to-month volatility in the participation rate continued to create instability in the unemployment rate – it rose to 4.9% in June.
- In coming months, it is likely that the 3-month average employment gain will stabilise around 150–170k. That is a robust pace of growth, particularly given unemployment is at its full employment level.
- Consistent with this expectation, in July we look for a 185k payrolls gain. For the household survey, stability in the participation rate is likely to see the unemployment rate remain unchanged at 4.9%.

US job creation robust



Data calendar

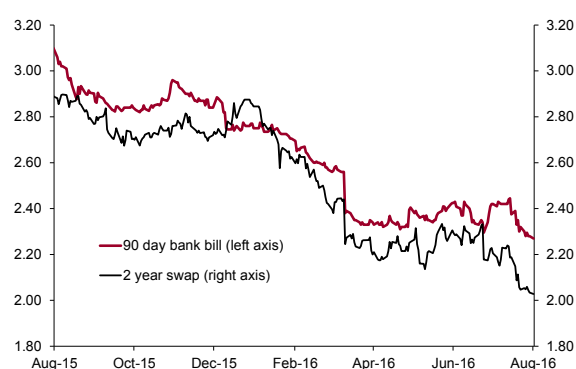
		Last	Market median	Westpac forecast	Risk/Comment
Mon 1					
Aus	Bank holiday	-	-	-	Banks and some other financial institutions closed in NSW & ACT.
	Jul CoreLogic home value index	0.5%	-	0.7%	Another solid gain but at a slower pace than Apr-May's odd-looking burst.
	Jul AiG PMI	51.8	-	-	Manufact'g index > 50, sector boosted by lower AUD & housing upswing.
	Jul MI inflation gauge	0.6%	-	-	A tricky indicator to interpret but still worth watching.
Chn	Jul manufacturing PMI	50	50	-	Manufacturers remain under material pressure ...
	Jul non-manufacturing PMI	53.7	-	-	... services sector in slightly better situation, but conditions soft.
	Jul Caixin China PMI	48.6	48.8	-	A greater weight to large exporters begets weaker trend.
Eur	Jul Markit manufacturing PMI	51.9	51.9	-	Ger (Jun: 53.7), UK (49.1) and US (52.9) measures also due.
US	Fedspeak	-	-	-	Dudley delivers keynote at Bank of Indonesia/NY Fed seminar.
	Jun construction spending	-0.8%	0.5%	-	Structures investment to remain soft; non-res construction poor.
	Jul ISM manufacturing	53.2	53.0	-	Big manufacturing firms seeing okay momentum.
Tue 2					
NZ	Jul QV house prices %yr	13.5%	-	-	House price growth has been strengthening nationwide.
	Q3 RBNZ inflation expectations	1.6%	-	-	RBNZ will be looking to see if the slide in expectations has been arrested.
Aus	Jun dwelling approvals	-5.2%	0.5%	1.0%	High rise spike unwound in Jun, ex high rise firm.
	Jun trade balance, AUDbn	-2.2	-2.0	-2.5	Exports f/c -1.5%, lower prices & vols. Imports f/c -0.4%.
	RBA policy decision	1.75%	1.50%	1.50%	Q2 CPI confirmed RBA's low inflation outlook & should see another cut.
US	Jun personal income	0.2%	0.3%	0.3%	Wages seeing moderate gains; other income also solid ...
	Jun personal spending	0.4%	0.3%	0.3%	... spending picking up again, albeit slowly ...
	Jun PCE deflator	0.2%	0.2%	0.2%	... headline inflation to slowly tend to core measure and FOMC target.
	Fedspeak	-	-	-	Kaplan speaks in Beijing on economic conditions and policy.
Can	Jul RBC Canadian Manufacturing PMI	51.8	-	-	Pulse softened in June, although new business firmed.
Wed 3					
NZ	GlobalDairyTrade auction results	0%	-	-	Futures suggest firmer WMP prices.
	Q2 LCI wage inflation (private, ord. time)	0.4%	0.5%	0.4%	Low inflation backdrop weighing on wage growth.
	Jul commodity prices	3.7%	-	-	Sectors of strength outside dairy.
Aus	Jul AiG PSI	51.3	-	-	Dipped in June but with strong read on jobs and retail conditions.
Chn	Jul Caixin China PMI services	52.7	-	-	Broadly in line with official NBS measure.
Eur	Jul Markit services PMI	52.7	52.7	-	Ger (54.6), UK (47.4) and US measures and composites also due.
US	Jul ADP employment change	172k	170k	165k	Robust gains in employment to continue.
	Jul ISM non-manufacturing	56.5	56.0	-	Current activity and new orders strong.
Thu 4					
Aus	Jun retail sales	0.2%	0.3%	0.4%	Rate cut, sentiment lift should see a bit of improvement although ...
	Q2 real retail sales	0.5%	0.5%	0.6%	... slight pick-up in consumer spend has largely bypassed retailers to date.
Chn	Q2 current account balance, USDbn	39.3	-	-	Narrowed sharply in Q1 on weaker trade surplus.
UK	BoE policy decision	0.50%	0.25%	0.25%	Recent data requires action: asset purchases and rate cut.
US	Fedspeak	-	-	-	Fed's Kaplan Speaks in Shanghai.
	Initial jobless claims	266k	-	-	Remains at historic lows.
	Jun factory orders	-1.0%	-1.9%	-	Durable orders weak again in Jun.
Fri 5					
Aus	RBA Statement on Monetary Policy	-	-	-	RBA unlikely to change forecasts - horizon extends to Dec 2018.
UK	Jul Halifax house prices	1.3%	-	-	Heightened uncertainty and policy changes dampening house prices.
US	Jun trade balance \$bn	-41.1	-42.1	-	Any concern FOMC had over net exports drag is fading.
	Jul non-farm payrolls	287k	180k	185k	3-month pace likely to stabilise around 150-170k in coming months.
	Jul unemployment rate	4.9%	4.8%	4.9%	Unemployment impacted by participation; to remain below 5.0%.
	Jun consumer credit \$bn	18.6	15.5	-	Demand for student and auto loans persists.
Can	Jul Ivey PMI	51.7	-	-	Has underperformed RBC measure, but closed the gap in Jun.
Sun 7					
Chn	Jul foreign reserves \$bn	3205.2	-	-	Have been little changed in recent months.

New Zealand forecasts

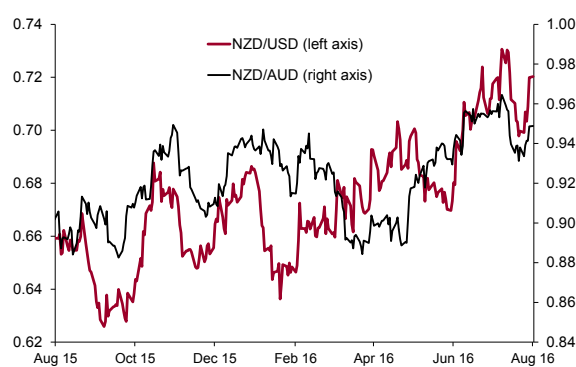
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.9	3.7	2.5	2.9	2.7
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.3	0.8	0.1	1.1	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.0	-3.7	-3.1	-3.2	-3.3	-3.9

Financial Forecasts	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.20	2.20	2.20	2.20	2.20	2.20
2 Year Swap	2.00	2.10	2.20	2.20	2.20	2.20
5 Year Swap	2.20	2.30	2.40	2.50	2.60	2.60
10 Year Bond	2.20	2.30	2.40	2.60	2.70	2.80
NZD/USD	0.68	0.66	0.63	0.63	0.62	0.62
NZD/AUD	0.93	0.93	0.93	0.93	0.90	0.89
NZD/JPY	70.0	67.3	63.6	63.6	63.2	64.5
NZD/EUR	0.62	0.61	0.59	0.60	0.58	0.58
NZD/GBP	0.52	0.52	0.50	0.49	0.48	0.48
TWI	73.6	72.2	69.9	70.1	68.7	68.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 1 August 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.25%	2.33%	2.38%
60 Days	2.26%	2.35%	2.40%
90 Days	2.27%	2.38%	2.43%
2 Year Swap	2.03%	2.20%	2.19%
5 Year Swap	2.13%	2.29%	2.29%

NZ foreign currency mid-rates as at Monday 1 August 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7203	0.7139	0.7164
NZD/EUR	0.6449	0.6462	0.6435
NZD/GBP	0.5447	0.5410	0.5409
NZD/JPY	73.50	75.25	73.54
NZD/AUD	0.9488	0.9399	0.9619
TWI	76.65	76.37	76.69

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.7	2.5	3.0	3.0
CPI inflation % annual	2.2	2.7	1.7	1.7	2.0	1.5
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.5
Current Account % GDP	-4.4	-3.4	-3.0	-4.8	-4.7	-4.7
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.9	1.9
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.1	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.8	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.6	0.5
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.5	1.2
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.1	0.5
China						
Real GDP %yr	7.7	7.7	7.3	6.9	6.4	6.2
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.7	3.7	3.9
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.2	3.4

Forecasts finalised 15 July 2016

Interest Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Australia						
Cash	1.75	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.87	1.80	1.80	1.80	1.80	1.80
10 Year Bond	1.90	1.95	2.15	2.20	2.30	2.45
International						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.52	1.50	1.70	1.80	2.00	2.10
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
AUD/USD	0.7531	0.73	0.71	0.68	0.68	0.69
USD/JPY	103.39	103	102	101	101	102
EUR/USD	1.1078	1.10	1.08	1.07	1.05	1.06
AUD/NZD	1.0618	1.07	1.08	1.08	1.08	1.11

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