

# Weekly Commentary

4 July 2016



## London calling

The past week has been dominated by heightened uncertainty following the unexpected result of the UK's referendum on EU membership.<sup>1</sup> While some sense of calm crept back into markets over the course of the week, we are likely to see a period of increased volatility in financial markets and disruptions to economic activity for some time, and this will affect New Zealand.

New Zealand is exposed to developments in the UK through a number of channels. The most immediate impact is through financial conditions. Nervousness in global financial markets has meant that expectations for monetary policy have been scaled back. In particular, expectations for a rate hike from the US have been pushed out, which has supported the NZ dollar. At the same time, credit spreads pushed higher following the vote. If sustained, this could pass through to higher bank funding costs, which affect borrowing rates for businesses and households.

Developments in the UK have also directly added to the downside risk for economic activity in New Zealand over the

short term. The UK accounts for around 3% of our goods exports and around 9% of our service exports (mainly tourism). While existing trade agreements remain in place, the softer activity outlook in the UK and the increase in the NZ dollar / British pound exchange rate are likely to weigh on export demand.

We are also watching to see what recent developments mean for global demand more broadly. Uncertainty and changing financial conditions could dampen activity in the EU more widely, and the flow on effects to other economies that are key trading partners for New Zealand (such as China) would compound headwinds locally.

<sup>1</sup> Our recent bulletin takes a closer look at the Brexit vote and the implications for New Zealand: <http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Breaking-up-is-hard-to-do-The-aftermath-of-the-Brexit-vote-June-2016.pdf>

## News from the Westpac economists

Westpac's New Zealand Chief Economist, Dominick Stephens, will take a one year sabbatical from this week, returning as Chief Economist in July 2017.

While Dominick is away, Michael Gordon will be Acting Chief Economist. Michael has been a key member of the Westpac Economics Team for 10 years and will lead the team as they continue to provide a high standard of economic insight. Sarah Drought will also join the Westpac Economics Team on secondment from the Reserve Bank during this time.

# London calling continued

More generally, the increased nervousness around the economic outlook may weigh on domestic business confidence and spending decisions. Consequently, we will be keeping a close eye on sentiment surveys over the next few months.

Nervousness following the Brexit vote has added an extra layer of complexity around the outlook for monetary policy in New Zealand. Over the past year, the RBNZ cut the Official Cash Rate to a record low in response to sharp falls in inflation. And in their latest policy statement, the RBNZ signalled that some further easing may be required. However, since then the inflation outlook in New Zealand has actually strengthened, casting doubt on whether further cuts were still necessary.

The oil price declines that contributed to much of the earlier weakness in inflation are slowly fading away. At the same time, indications for construction activity (the key driver of domestic inflation at the current time) remain strong. Indeed, despite easing back a little in May, last week's building consent numbers showed a solid 16% increase in residential consent numbers over the past year and an 8.5% increase in non-residential activity. On top of these factors, the recently announced increase in the tobacco excise tax will boost inflation over the next four years. Combined, these factors will contribute to a sizeable lift in inflation.

However, balanced against these inflation positive developments is the NZ dollar, which continues to defy gravity. In fact, despite the heightened nervousness in the global economy, on a trade-weighted basis the kiwi is currently around 5% higher than the RBNZ was projecting at the time of its last policy assessment. On top of this, the

downside risks for global growth have increased materially, while conditions in financial markets have tightened.

Weighing it all up, the strength in the exchange rate and increased risk around the global environment are likely to resonate strongly with the RBNZ. Consequently, an August rate cut from the RBNZ is now looking more likely, despite the other factors that have boosted the inflation outlook. Market pricing for an August rate cut is now around 58% (compared to 38% before the UK referendum), but we would put the odds a little higher than that.

Another factor that has made the policy environment more complex for the RBNZ is inflation expectations. Expectations are a key influence on how businesses set wages and prices, and hence have a direct bearing on inflation. Over the past year, weakness in inflation expectations was a key reason behind the RBNZ decisions to cut the OCR.

However, recent research from the RBNZ suggests that inflation expectations may be lower than surveys suggest. And surveys already signal that inflation expectations are very low. The RBNZ's research also suggests that inflation expectations are more 'backwards looking'. In other words, the RBNZ will likely have to actually push inflation higher before expectations pick up again.

These concerns reinforce the need for an August OCR cut. Given the importance of inflation expectations in the RBNZ's thinking, we will be watching upcoming gauges of business activity (including this week's Survey of Business Opinion) closely to see how inflation expectations and price setting behaviour are evolving.

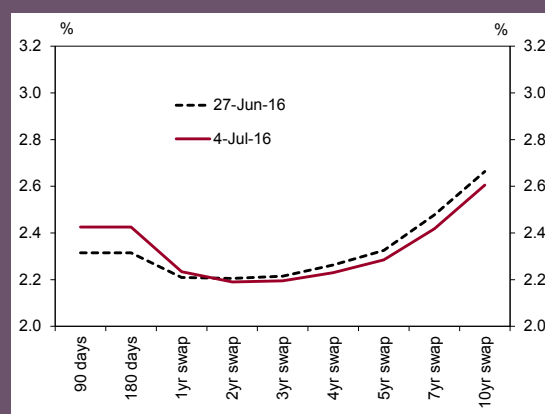
## Fixed vs Floating for mortgages

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



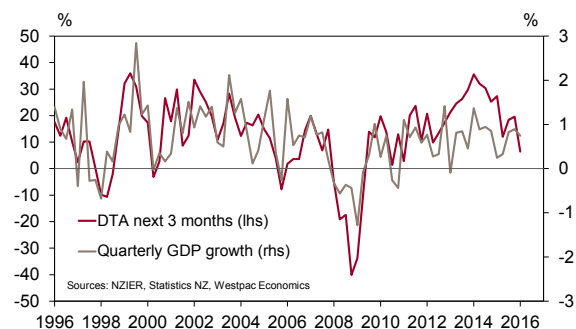
# The week ahead

## NZ Q2 Quarterly Survey of Business Opinion

Jul 5, General business confidence last: -1

- The March Quarterly Survey of Business Opinion saw firms report solid results for early 2016, but with a growing degree of concern about the near-term outlook as a result of the dairy downturn.
- That said, activity has held up reasonably well in recent months and rural confidence has seen a small uptick despite another very low milk price being signalled for the new dairying season.
- The survey's measures of costs and prices will be of particular interest. There has been little evidence to date that firms have been able to increase prices, aside from in the construction sector where capacity constraints are evident.

## QSBO domestic trading activity and GDP

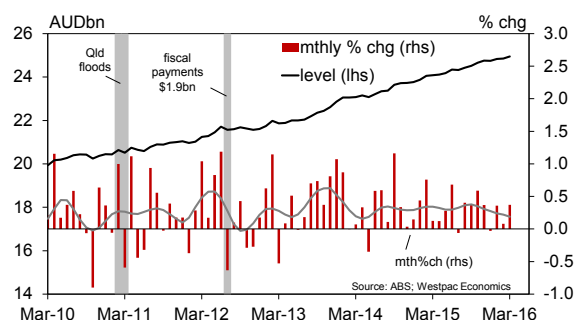


## Aus May retail trade

Jul 5, 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 April, the trend growth rate slowing to a 3.4% annualised pace. Recent softness reflects both lacklustre consumer demand for retail items and aggressive price discounting in key segments.
- Consumer sentiment posted a robust bounce in May, a positive reaction to the RBA's surprise rate cut more than offsetting more downbeat views on the Federal Budget. Notably, consumers' expectations around the labour market have shown steady improvement, a factor that can often be a catalyst for a pick up in spending on discretionary or big ticket items. Private sector business surveys suggest retail conditions have been patchier since the start of the year but conditions across the broader 'consumer sector' remain buoyant. On balance we expect May to show an improved 0.4% gain with uncertainties mainly around price effects.

## Monthly retail sales



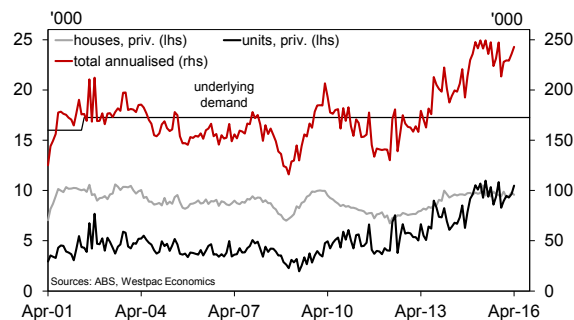
## Aus May dwelling approvals

Jul 4 Last: 3.0%, WBC f/c: -2.0%

Mkt f/c: -3.5%, Range: -6.0% to 3.0%

- Dwelling approvals have posted a surprising resurgence in recent months with gains of around 3% in both April and March. However, the detail carries a strong warning that this mini-revival is unlikely to sustain - all of the gains have come from a surprise resurgence in 'high rise' approvals with other segments much more subdued.
- A retracement looks overdue. Activity in 'high rise' segments is coming under pressure from multiple angles and, given elevated levels, is vulnerable to a sharp pull back at some stage. Meanwhile, the abrupt slowdown in housing markets since mid 2015 is likely to exert more downward pressure near term. Any positive boost from recent and prospective rate cuts will take time to come through and may be quite muted given other factors weighing on buyer sentiment. Overall we expect a 2% decline in approvals with risks to the downside.

## Dwelling approvals

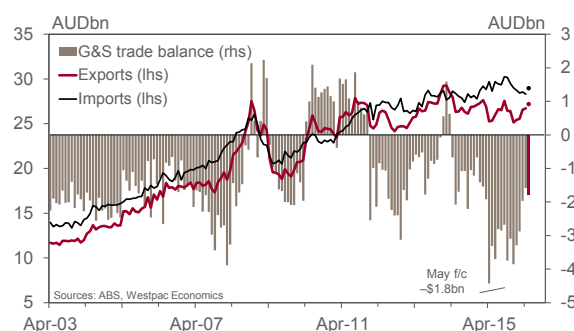


## Aus May trade balance, AUDbn

Jul 5, Last: -1.6, WBC f/c: -1.8, Mkt f/c: -1.5, Range: -2.2 to -0.9

- Australia's trade deficit narrowed to \$1.6bn in April, a marked improvement on \$3bn plus deficits through much of April 2015 to January 2016 - supported by a bounce in the iron ore price.
- For May, we anticipate a small deterioration in the deficit, widening by \$0.2bn to \$1.8bn.
- Export earnings are forecast to rise by 1.7% (+\$460mn) as higher prices for the majority of commodities more than offset a slip in the iron ore price.
- Imports are forecast to increase by 2.3% (\$660mn) on higher fuel prices and a weaker currency, down 3.8% on a TWI basis.
- 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

Jul 5, Last: 1.75%, WBC f/c: 1.75%

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

- Despite dramatic events in the UK, we expect the Board to again leave rates unchanged. While 'Brexit' will clearly figure in the Bank's deliberations it looks unlikely to tip the balance on a decision.
- With the impact on Australia still highly uncertain and a critical update on inflation due later in the month the Bank will be inclined to hold off on any moves with an eventual 25bp cut only coming in August once it has made a full reassessment of the outlook for growth and inflation.
- The Governor's statement will likely acknowledge the 'Brexit' event and associated uncertainties but give little or no near term policy guidance. See p2 for the full run down.

## RBA cash rate & market pricing



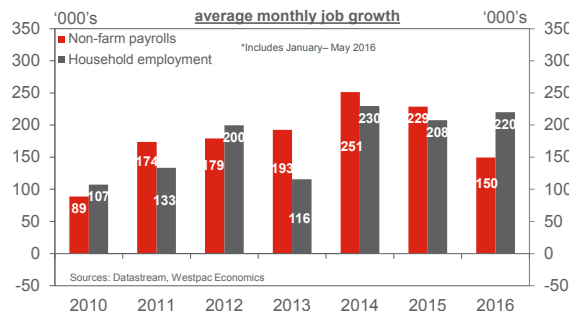
## Jun US nonfarm payrolls and unemployment

Jul 8, nonfarm payrolls Last: 38k, WBC 190k

Jul 8, unemployment rate Last: 4.7%, WBC 4.7%

- Nonfarm payrolls surprised with a particularly weak outcome in May, a jobs gain of just 38k. Adding to the downbeat news was a further 59k in downward revisions to the prior two months.
- As such, the 3-month average pace of gain slowed to 116k. That compares to an average of 201k in January/February, and 229k throughout 2015.
- Come June, a bounce is anticipated, albeit not quite back to the prior-period averages. While the Verizon strike has ended, job creation has obviously slowed. A gain of around 190k seems most probable. Upward revisions are possible though.
- The unemployment rate has been shocked by a short-lived rise in participation over the past eight months. Stability is likely come June, with job gains offsetting any labour force rise.

## US job creation



# Data calendar

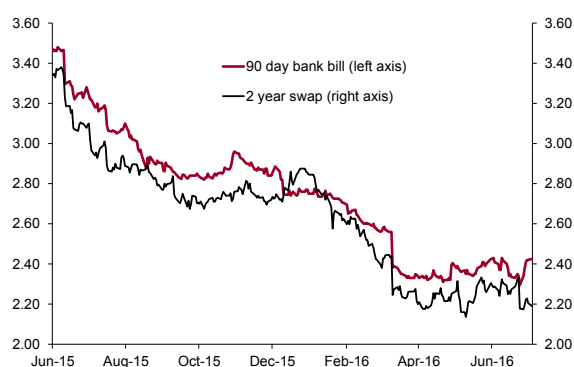
		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 4</b>					
<b>Aus</b>	Jun MI inflation gauge	1.0%	-	-	Following the Q1 print we are more judicious when using this measure.
	Jun ANZ job ads	2.4%	-	-	Was there a pause in job ads heading into the election?
	May dwelling approvals	3.0%	-3.5%	-2.0%	Mar-Apr 'high rise' resurgence unlikely to sustain.
<b>Eur</b>	Jul Sentix investor confidence	9.9	8.0	-	Brexit the main factor in coming months.
<b>Can</b>	Jun RBC Canadian Manufacturing PMI	52.1	-	-	Energy continues to weigh; but modest growth continuing.
<b>US</b>	Independence Day	-	-	-	Public holiday, markets closed.
<b>Tue 5</b>					
<b>NZ</b>	Q2 Quarterly Survey of Business Opinion	-1	-	-	Dairy woes weighed heavily on confidence in early 2016.
	Jun QV house prices %yr	12.4%	-	-	House price gains are spreading nationwide.
	Jun ANZ commodity price index	1.0%	-	1.0%	Modest rebound in dairy export prices.
<b>Aus</b>	Jun AiG PSI	51.5	-	-	Services +1.8pts to 51.5 in May. Strength in retail, finance & health.
	May retail sales	0.2%	0.3%	0.4%	May rate cut lifted sentiment and should see better retail momentum.
	May trade balance, \$bn	-1.6	-1.5	-1.8	Small deterioration. Exports f/c +1.7% & imports f/c +2.3%.
	RBA policy decision	1.75%	1.75%	1.75%	Despite 'Brexit', RBA still likely to wait for Q2 CPI (July 27) before next cut.
<b>Chn</b>	Jun Caixin China PMI services	51.2	-	-	Lags official measure; points to modest pace of growth for services.
<b>Eur</b>	Jun Markit services PMI	52.4	52.4	-	Moderate growth continuing...
<b>Ger</b>	Jun Markit services PMI	53.2	53.2	-	... but impact of Brexit looms as risk to outlook.
<b>UK</b>	Jun Markit services PMI	53.5	52.7	-	Service sector activity has been moderating.
<b>US</b>	Jun ISM New York	37.2	-	-	Some recovery after last month's sharp decline likely.
	May factor orders	1.9%	-0.8%	-	Durables disappointed again in June.
	Fedspeak	-	-	-	Dudley on local economy in NY state (Binghamton).
<b>Wed 6</b>					
<b>NZ</b>	GlobalDairyTrade Auction	0.0%	-	-	Futures prices have been flat.
<b>Aus</b>	RBA Assist. Gov Debelle speaking	-	-	-	Panel, "Examining the FX Code of Conduct", Sydney, 5.30pm AEST.
<b>US</b>	Jun Markit service PMI	51.3	51.5	-	Continues to print below ISM measure.
	Jun ISM non-manufacturing	52.9	53.4	-	ISM signals moderate growth continuing for services sector.
	FOMC minutes	-	-	-	Discussion of updated forecasts of interest; global risks also of note.
	Fedspeak	-	-	-	Tarullo on regulation and monetary policy.
<b>Thu 7</b>					
<b>Chn</b>	Jun foreign reserves \$bn	3191.7	3166.0	-	Have been broadly stable of late.
<b>Ger</b>	May industrial production	0.8%	flat	-	Soft trend apparent in recent months; further weakness likely in May.
<b>UK</b>	Jun Halifax house prices	0.6%	-	-	Stamp duty, pre-vote jitters to dampen house prices.
	May industrial production	2.0%	-0.6%	-	A correction after last month's surge likely; other indicators have fallen.
<b>US</b>	Jun ADP employment change	173k	150k	185k	Remains a very poor indicator of payrolls.
	Initial jobless claims	268k	-	-	Very low historically.
<b>Can</b>	Jun Ivey PMI	49.4	-	-	Likely further disruption to activity from wildfires.
<b>Fri 8</b>					
<b>Chn</b>	Jun foreign direct investment %yr	-1.0%	-	-	Limited appetite for real investment across the globe; tentative date.
<b>Ger</b>	May trade balance €bn	25.6	24.2	-	April was a record high for the surplus.
<b>UK</b>	May trade balance, £bn	3.3	-3.0	-	Soft external demand has been weighing on exports.
<b>US</b>	Jun non-farm payrolls	38k	180k	190k	A solid bounce likely, albeit not quite back to Jan/Feb average.
	Jun unemployment rate	4.7%	4.8%	4.7%	Participation volatility to subside, see stale unemployment rate.
	May consumer credit	13.42	17.0	-	Demand for student and auto loans remains robust.
<b>Sun 10</b>					
<b>Chn</b>	Jun CPI %yr	2.0%	1.9%	-	CPI benign despite prior food price jolt; well below 3.0%yr target.
	Jun PPI %yr	-2.8%	-2.4%	-	Weak commodity prices continue to impact upstream inflation.
	Jun aggregate financing, CNYbn	659.9	1100	-	Tentative date, 10-15 Jul.
	Jun new loans, CNYbn	985.5	1000	-	Tentative date, 10-15 Jul.
	Jun M2 money supply %yr	11.8%	11.9%	-	Tentative date, 10-15 Jul.

# New Zealand forecasts

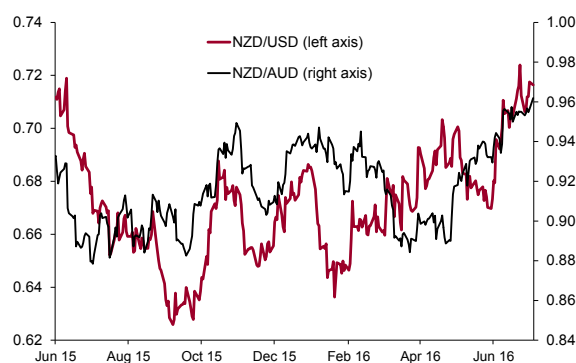
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.9	3.7	2.5	2.9	2.7
Employment	3.8	3.2	2.0	2.5	3.6	1.4	2.9	2.4
Unemployment Rate % s.a.	6.0	5.8	5.7	5.4	5.8	5.4	5.7	5.0
CPI	1.5	0.3	0.4	1.6	0.8	0.1	1.3	2.1
Current 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	2.10	2.20	2.30	2.30	2.30	2.30
5 Year Swap	2.40	2.50	2.60	2.70	2.80	2.90
10 Year Bond	2.50	2.60	2.70	2.90	3.00	3.10
NZD/USD	0.68	0.66	0.64	0.63	0.62	0.62
NZD/AUD	0.94	0.94	0.94	0.93	0.90	0.89
NZD/JPY	70.0	67.3	64.6	64.3	63.9	65.7
NZD/EUR	0.62	0.61	0.60	0.59	0.58	0.58
NZD/GBP	0.52	0.51	0.49	0.48	0.47	0.47
TWI	73.6	72.0	70.5	69.6	68.4	68.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 4 July 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.38%	2.31%	2.28%
60 Days	2.40%	2.33%	2.36%
90 Days	2.43%	2.35%	2.39%
2 Year Swap	2.19%	2.29%	2.26%
5 Year Swap	2.29%	2.41%	2.43%

NZ foreign currency mid-rates as at Monday 4 July 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7164	0.7075	0.6923
NZD/EUR	0.6435	0.6244	0.6096
NZD/GBP	0.5409	0.4894	0.4793
NZD/JPY	73.54	74.09	74.47
NZD/AUD	0.9619	0.9520	0.9398
TWI	76.69	75.44	74.02

# International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
<b>Australia</b>						
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	1.9	1.7
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.4
Current Account % GDP	-4.4	-3.4	-3.0	-4.8	-4.7	-4.7
<b>United States</b>						
Real GDP %yr	2.2	1.5	2.4	2.4	2.0	2.1
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	4.9	4.7
Current Account %GDP	-2.9	-2.3	-2.3	-2.4	-2.4	-2.4
<b>Japan</b>						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.5
<b>Euroland</b>						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.6	1.4
<b>United Kingdom</b>						
Real GDP %yr	1.2	2.2	2.9	2.2	1.9	2.1
<b>China</b>						
Real GDP %yr	7.7	7.7	7.3	6.9	6.5	6.2
<b>East Asia ex China</b>						
Real GDP %yr	4.6	4.2	4.1	3.7	3.8	4.1
<b>World</b>						
Real GDP %yr	3.5	3.3	3.4	3.1	3.3	3.5

Forecasts finalised 17 June 2016

Interest Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
<b>Australia</b>						
Cash	1.75	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.95	1.80	1.80	1.80	1.80	1.80
10 Year Bond	1.95	2.15	2.25	2.30	2.45	2.75
<b>International</b>						
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125
US 10 Year Bond	1.43	1.70	1.80	1.90	2.15	2.40
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	0.7458	0.72	0.70	0.68	0.68	0.69
USD/JPY	102.77	103	102	101	102	103
EUR/USD	1.1090	1.10	1.09	1.07	1.06	1.06
AUD/NZD	1.0435	1.06	1.08	1.08	1.10	1.11

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# Contact the Westpac economics team

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# Disclaimer continued

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