

Weekly Commentary

7 November 2016



The winning trifecta

Last Wednesday saw the final trifecta of major data points ahead of the Reserve Bank's *Monetary Policy Statement*. And all three painted quite a positive picture for the New Zealand economy. We think that this week the RBNZ will still deliver the rate cut that has long been signalled, but after that it will move into more of a watch-and-wait mode.

The first major news was another big jump in dairy prices at the GlobalDairyTrade auction. Prices overall were up 11%, with whole milk powder prices jumping by 20%. That gives a 44% cumulative increase in world dairy prices since August.

The latest auction was notable because it was preceded by Fonterra announcing that it now expects its milk collection for this season to be down almost 7% on last season. New Zealand supplies almost a third of internationally-traded dairy products, so a shortfall of that size would have a major impact on the global dairy market. The details of the auction result suggest that 'fear of missing out' has re-motivated Chinese buyers in particular.

We remain a little sceptical about the extent of the decline in milk production. Certainly the October figures will be well down, due to unusually wet weather in the North Island in particular. But that shortfall would have to persist all the way through to the end of the season in May to meet Fonterra's forecast, which doesn't square with the 'wet spring' explanation. And with milk prices where they are now, there's an incentive again for farmers to bring in extra feed and increase milk production per cow. We expect that dairy auction prices will fall back again later in the season, as the true picture on milk production is revealed.

Nevertheless, the recent boost to prices has come at a time when a large share of the season's volume is being priced,

so the impact on this season's payout will be significant. We now expect a farmgate milk price for this season of \$5.80 per kilo of milksolids (previously \$5.30/kg). That's still only around the average of the last decade, but it would go some way towards easing the financial strain on the industry.

The second piece of news was the labour market surveys for the September quarter. Employment continues to grow strongly, and the unemployment rate has fallen below 5% for the first time since the Global Financial Crisis. Labour costs have remained quite contained, suggesting that the jobs market hasn't entered outright 'tight' territory yet. Strong demand for workers is being partly met through net inward migration and rising rates of participation in the labour force. But at this rate of improvement, we would expect signs of upward pressure on wages to emerge in the coming year.

The final data point was the Reserve Bank's survey of inflation expectations. This isn't normally much of a headline-grabber, but it's an issue that the RBNZ has been highlighting as a key risk to its view. Headline inflation has been below the 1-3% target range for the last two years, and recent research by the RBNZ suggested that inflation expectations may have become more backwards-looking. If low inflation were to become embedded in people's wage- and price-setting decisions, it would be that much harder for the RBNZ to get inflation back on target.

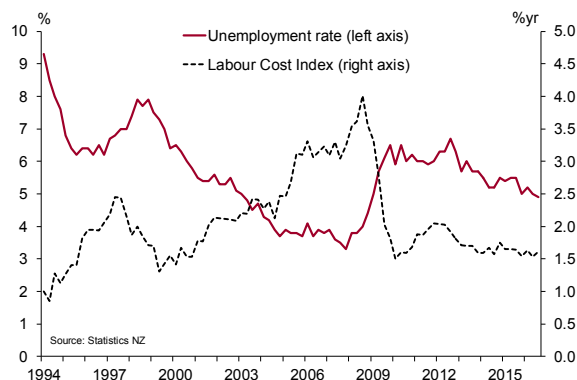
The winning trifecta continued

Fortunately, after a step down early in the year, surveyed expectations have been steady lately in the face of low headline inflation. The average forecast for two years ahead actually ticked up slightly to 1.68%. However, that's still not quite consistent with a belief that the RBNZ will meet its inflation target over the medium term, and highlights the need for an extended period of easy monetary policy.

As for Thursday's *Monetary Policy Statement*, we and the rest of the market expect a 25 basis point cut in the OCR to 1.75%. The RBNZ has been giving strongly-worded signals about its intentions: in the August and September OCR decisions, and again in a speech in October, it noted that "further policy easing will be required to ensure that future inflation settles near the middle of the target range". A failure to deliver at this point would likely see a sharp rise in market interest rates and the exchange rate – effectively an unwanted tightening of monetary policy.

The messaging around this week's decision will be crucial. With domestic conditions remaining strong and the downside risks for inflation fading, we suspect the RBNZ will no longer see a case for further easing into next year. But at the same time, it will be wary of sending interest rates higher again. The market seems at particular risk of this right now. Global interest rates have been heading higher in recent weeks, with the US Federal Reserve on the verge of a rate hike (notwithstanding the results of the US election on

Labour market indicators



Wednesday) and traders sensing that other central banks are shying away from further easing.

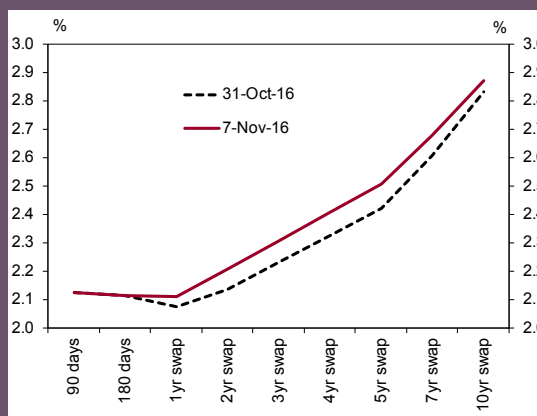
Consequently, we expect the RBNZ to retain a mild bias towards easing, without committing to further action. Such a message would probably leave interest rates and the New Zealand dollar unchanged or slightly higher. Given the trend in global markets, we suspect it would be very difficult to engineer a fall in market rates on the day. And for the same reasons, it looks increasingly likely that current fixed-term borrowing rates will mark the low point for the near future.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three- to five-year rates seem high relative to where we think short-term rates are going to go over that time. That said, these rates are most likely to be pressured higher by global market trends, so borrowers who prefer the security of a longer term should lock it in now.

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



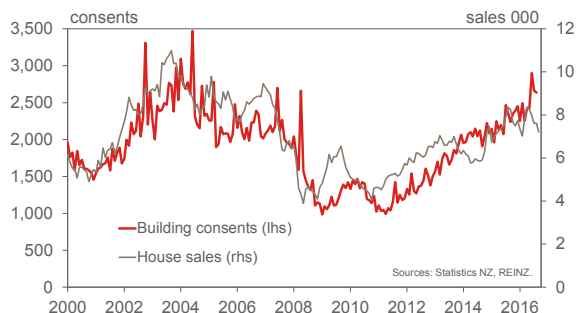
The week ahead

NZ Oct REINZ house prices and sales

Nov 10 (tbd), Sales last: -5.2%, Prices last: 9.7%^{yr}

- The tightening of loan-to-value ratio restrictions in July has had its expected impact to date. House sales and loan approvals have dropped, and the rate of house price growth has slowed. We think that the impact of the restrictions will prove to be temporary, but this will take several more months to play out.
- While house price growth has slowed in the regions where it was previously most rampant, there are indications that it has actually accelerated in other regions, which again casts doubt on the effectiveness of lending restrictions.
- Note that the annual rate of house price growth could lift sharply in October due to base effects. Prices fell by 4% last October (albeit temporarily) as changes to the tax treatment of investment properties came into force.

NZ housing activity

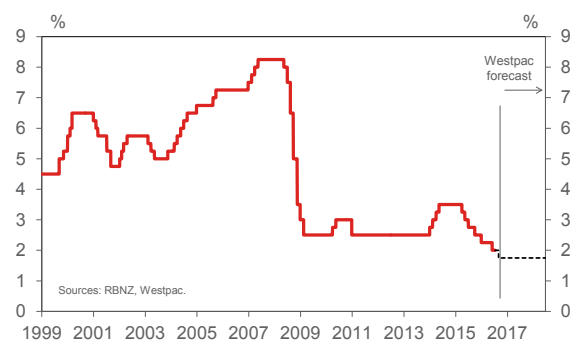


NZ RBNZ Monetary Policy Statement

Nov 10, Last: 2.00%, Westpac: 1.75%, Market: 1.75%

- We expect the Reserve Bank to reduce the OCR to 1.75% next week. The RBNZ has been strongly signalling a further easing in recent statements. Failing to deliver could lead to an unwanted and self-defeating market response.
- Developments for the New Zealand economy have been positive over the last few months. Inflation remains very low, but the downside risks to the RBNZ's view have diminished.
- Beyond next week's decision, the RBNZ is likely to retain a mild bias towards further easing. But we expect the OCR to remain on hold through 2017.

NZ OCR

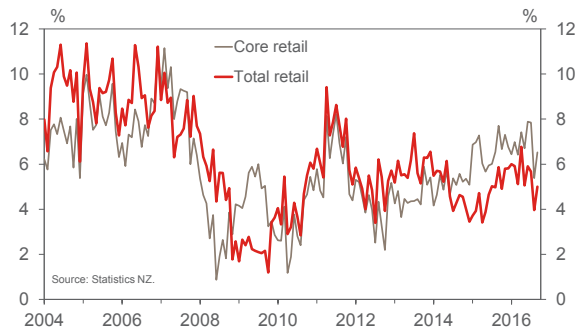


NZ Oct retail card spending

Nov 8, Last: +1.9%, WBC: f/c +0.3%, Mkt f/c: 0.4%

- Spending on electronic cards rose 1.9% in September, underpinned by gains in the durable and hospitality categories. However, those gains came on the back of a sharp 1.1% drop in August. Smoothing through recent volatility, retail spending has been growing at a solid pace over the past year.
- We expect that spending growth eased back to a more moderate 0.3% in October. Although durables spending growth is likely to be limited, gains in other areas, and an increase in fuel prices will support a rise in the overall level of nominal spending.
- Looking at the household sector more generally, the outlook for spending has been strengthening as conditions in the labour market and economy more broadly have picked up

Card transactions, annual % change



Aus Nov Westpac-MI Consumer Sentiment

Nov 9 Last: 102.4

- The **Westpac-Melbourne Institute Consumer Sentiment Index** rose 1.1% in October to 102.4 from 101.4 in September. Sentiment has been both firmer and stabler over the last six months despite being buffeted by numerous factors, both positive and negative.
- This month's survey is in the field over the week ended Nov 6. The backdrop locally has again been fairly quiet with the RBA leaving rates on hold as expected and other news essentially mixed - labour markets a bit softer, housing reportedly firming, and coal prices surging strongly. Financial markets have been softer with the ASX down 4.4% since last month's survey period - recent declines partly reflecting global jitters ahead of a hotly contested and fractious US Presidential election, a factor that may also influence local consumer sentiment directly.

Consumer Sentiment Index



The week ahead

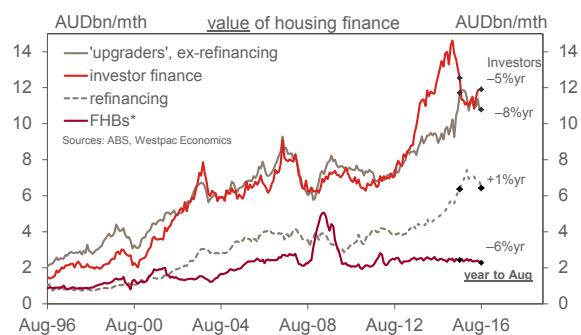
Aus Sep housing finance (no.)

Nov 10, Last: -3.0%, WBC f/c: -2.0%

Mkt f/c: -1.6%, Range: -3.0% to 1.5%

- Australian housing finance approvals have softened in recent months despite rate cuts in May and Aug. Owner occupier approvals declined by 3% in Aug following a 4.5% fall in July to be down 4.2%yr. That said the Aug detail was a little more positive with a milder decline in new loans ex refi and a stable month for the value of loans to investors and the total combined value of all loans ex refi.
- Industry data points to another soft month for owner occupier loans - we expect the number of loans to decline a further 2% for Sep. That in turn suggests the apparent firming in housing market conditions since mid-year has been driven by other segments - as such the update on the value of investor loans (for which we have no industry indicators) will again be of close interest.

Value of finance approvals by segment



Data calendar

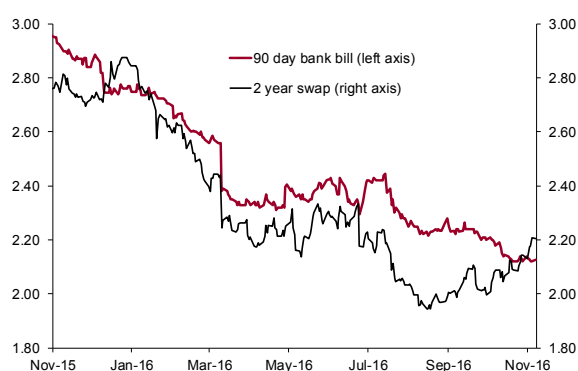
		Last	Market median	Westpac forecast	Risk/Comment
Mon 7					
Aus	Oct ANZ job ads	-0.3%	-	-	Up only 3% ytd, after rebounding in 2014, +12%, & in 2015, +10%.
Chn	Oct foreign reserves \$bn	3166	3140	-	Pressure on FX reserves light for now; USD uptrend helpful.
Eur	Nov Sentix investor confidence	8.5	8.9	-	Confidence still robust despite rising political concerns.
Ger	Sep factory orders	1.0%	0.2%	-	Stronger trend emerging for orders.
UK	Oct Halifax house prices	0.1%	-	-	The housing market has lost momentum.
US	Oct labour market conditions index	-2.2	-	-	The Fed's composite measure of labour market conditions.
	Sep consumer credit, \$bn	25.9	17.5	-	Auto and student loans continue to drive headline outcomes.
Tue 8					
Aus	Oct NAB business survey	8	-	-	Conditions index at +8, down from +11 Q2 avg but still above LR avg.
	RBA Head of International Department	-	-	-	Chris Ryan, speaking regulatory summit, Hong Kong, 5:15pm AEDT.
Chn	Oct trade balance USDbn	41.99	52.45	-	Exports on the rise -10%/yr to -6%/yr; imports little changed, -1.5%/yr.
	Oct foreign direct investment %yr	1.2%	3.0%	-	Tentative date, due 8-18/11.
Ger	Sep industrial production	2.5%	-0.2%	-	Dip expected after strong August.
	Sep trade balance, €bn	20.1	23.0	-	Modest global growth continues to restrain exports.
UK	Sep industrial production	-0.4%	-	-	Lower sterling supporting manufacturing despite domestic headwinds.
US	US Presidential election	-	-	-	First good read on results likely from midday Sydney ADST.
	Oct NFIB small business optimism	94.1	94.5	-	Smaller firms in more challenging position to large competition.
	Fedspeak	-	-	-	Evans Speaks on Economy and Policy in New York.
	Sep JOLTS job openings	5443	-	-	Hires, fires, quits, and job openings.
Wed 9					
NZ	Oct retail card spending	1.9%	0.4%	0.3%	Some moderation after last month's strong gain.
Aus	Nov Westpac-MI Consumer Sentiment	102.4	-	-	Firmer, stabler readings the last few months.
Chn	Oct CPI %yr	1.9%	2.1%	-	Underlying inflation asserting control; 3%/yr target still a long way off.
	Oct PPI %yr	0.1%	0.9%	-	Commodity price rally continues to feed through to producer prices.
UK	Sep trade balance, £bn	4.7	-	-	Lower sterling is supporting exports, especially services.
US	Sep wholesale inventories (final)	0.2%	0.2%	-	Inventories supportive in Q3; risk to Q4.
	Fedspeak	-	-	-	Kashkari speaking in Wisconsin.
Thu 10					
NZ	RBNZ MPS, policy announcement	2.00%	1.75%	1.75%	After a cut this month, firming activity means an extended pause likely.
	Oct REINZ house sales	-5.2%	-	-	Tentative date. Turnover has slowed after LVR restrictions in July...
	Oct REINZ house prices %yr	9.7%	-	-	...but prices have remained firm, especially outside Auckland.
Aus	Nov MI consumer inflation expectations	3.7%	-	-	Stabilising of late after softening over first half of 2016
	Sep housing finance	-3.0%	-1.6%	-2.0%	Another soft month for owner-occupiers. Investors could show a lift.
Chn	Oct aggregate financing, CNYbn	1720	950	-	Tentative date, 10-15/11...
	Oct new loans, CNYbn	1220	655	-	... volatility in credit growth likely to persist.
	Oct M2 money supply %yr	11.5%	11.4%	-	Tentative date, 10-15/11.
UK	Oct RICS house prices balance	17%	-	-	Conditions have softened, though low supply is still supporting prices.
US	Initial jobless claims	265k	-	-	Claims picked up over October, but remain at historically low levels.
	Fedspeak	-	-	-	Williams speaks on the economic outlook in San Francisco.
	Fedspeak	-	-	-	Bullard speaks on economic outlook in St Louis.
Can	Sep new house price index	0.2%	-	-	Gains centred on Vancouver and Toronto, but softness elsewhere.
Fri 11					
NZ	Oct BusinessNZ PMI	57.7	-	-	Surveys have pointed to firming manufacturing sector activity.
	Oct food prices	0.9%	-	-0.8%	Easing from winter highs; annual inflation still near zero.
Aus	RBA Deputy Governor	-	-	-	Guy Debelle, on panel, FINSIA's regulators, Melbourne, 12:00pm.
Ger	Oct CPI (final)	0.2%	0.2%	-	Annual inflation remains weak at 0.7%/yr.
UK	Sep construction output	-1.5%	-	-	Uncertainty, rising costs weighing on activity.
US	Nov Uni of Michigan consumer confidence	87.2	87.3	-	Momentum in confidence lost in recent months.
	Fedspeak	-	-	-	Vice Chair Fischer talks on US monetary policy and the global economy.

New Zealand forecasts

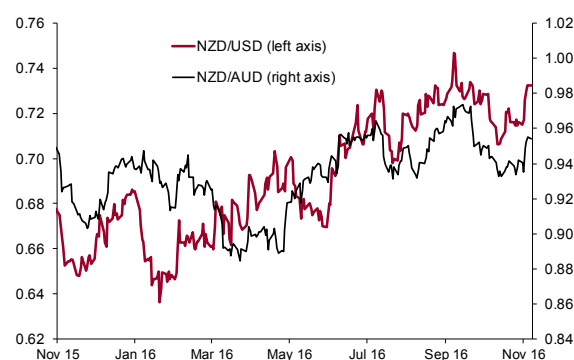
Economic Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2014	2015	2016f
GDP (Production) ann avg	3.6	2.5	3.5	2.9	3.8	2.5	3.4	3.1
Employment	3.2	2.0	3.9	1.6	3.6	1.4	4.7	2.0
Unemployment Rate % s.a.	5.4	5.2	5.0	4.5	5.5	5.0	5.1	4.6
CPI	0.3	0.4	1.2	1.6	0.8	0.1	1.0	1.5
Current Account Balance % of GDP	-3.5	-3.1	-3.3	-3.8	-3.2	-3.4	-3.1	-3.9

Financial Forecasts	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	2.00	2.00	2.00	2.00	2.00
2 Year Swap	2.00	2.10	2.10	2.10	2.10	2.00
5 Year Swap	2.30	2.40	2.50	2.50	2.50	2.50
10 Year Bond	2.50	2.50	2.60	2.70	2.80	2.80
NZD/USD	0.70	0.69	0.67	0.65	0.63	0.62
NZD/AUD	0.95	0.95	0.94	0.94	0.93	0.91
NZD/JPY	72.1	69.7	69.7	68.3	66.2	65.7
NZD/EUR	0.64	0.64	0.64	0.63	0.61	0.60
NZD/GBP	0.56	0.56	0.55	0.53	0.51	0.51
TWI	75.7	75.2	73.8	72.2	70.3	69.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 7 November 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.00%	2.00%
30 Days	2.08%	2.13%	2.18%
60 Days	2.11%	2.13%	2.20%
90 Days	2.13%	2.13%	2.19%
2 Year Swap	2.21%	2.08%	2.09%
5 Year Swap	2.51%	2.31%	2.26%

NZ foreign currency mid-rates as at Monday 7 November 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7323	0.7130	0.7180
NZD/EUR	0.6589	0.6557	0.6419
NZD/GBP	0.5850	0.5835	0.5788
NZD/JPY	75.74	74.31	74.15
NZD/AUD	0.9543	0.9382	0.9437
TWI	78.58	77.03	76.91

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015	2016f	2017f
Australia						
Real GDP % yr	3.6	2.0	2.7	2.4	3.0	3.0
CPI inflation % annual	2.2	2.7	1.7	1.7	1.5	1.8
Unemployment %	5.3	5.8	6.2	5.8	5.6	5.8
Current Account % GDP	-4.4	-3.4	-3.0	-4.7	-3.3	-4.2
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.5	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.2	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.9	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.6	-2.7	-2.6
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	1.6	1.2
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	1.6	0.6
China						
Real GDP %yr	7.7	7.7	7.3	6.9	6.5	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 14 October 2016

Interest Rate Forecasts	Latest	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.75	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.35	2.20	2.20	2.30	2.45	2.65	2.75	2.80
International								
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125	1.125	1.375
US 10 Year Bond	1.80	1.70	1.80	2.00	2.10	2.25	2.35	2.40
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
AUD/USD	0.7680	0.74	0.73	0.71	0.69	0.68	0.68	0.68
USD/JPY	102.90	103	101	104	106	105	106	106
EUR/USD	1.1100	1.10	1.07	1.05	1.04	1.03	1.03	1.03
AUD/NZD	1.0500	1.06	1.06	1.06	1.06	1.08	1.10	1.11

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- (iii) and well defined wall/cell crossing procedures;
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