

Weekly Commentary

15 February 2016



Two toned

Further positive news on growth in the domestic economy contrasted starkly with the worsening international developments last week. Meanwhile housing market data confirmed that one of the key roadblocks to further OCR cuts from the RBNZ is gradually being eroded. This week's inflation expectations data will be scrutinised for signs that inflation expectations are coming under increasing downward pressure.

Data on the New Zealand economy, for now, continues to paint a fairly upbeat picture. Last week's electronic card transactions data showed retail spending rose 0.3% in January, leaving the annual pace of growth in card spending at a solid 5.2%. There were also significant upward revisions to spending data in the previous few months which means the Q4 retail trade data out this week are likely to show retail spending maintained a pretty robust pace of growth in the final months of 2015. We're forecasting 1.6% growth in the quarter.

One factor supporting retail spending of late has been falling fuel prices (just last week we observed a fresh round of price cuts at the pump). And while very low international oil prices are at least partly a function of strong growth in supply, prices at these levels are also a signal that all is not well with the global economy. Indeed right now the international picture is becoming pretty worrying. Equity markets around the world have come under renewed pressure, global interest rates have fallen as markets reassess the likelihood of Fed rate cuts, investors have swung away from risk and toward safe haven assets, and international banks' strength have once again been placed under the microscope.

It's only a matter of time before these conditions have a bigger impact locally. One of the most direct channels is via the price of New Zealand's commodity exports. The most

recent dairy auction saw a 10% fall in the price of whole milk powder, and futures markets are pointing to another decline at this week's event. As a result, we've downgraded our own forecasts of the milk price Fonterra will pay its farmers both this season and next. Our forecast is now just \$4/kg for the 2015/16 season and \$4.60/kg for 2016/17. If we're right, it will mean many dairy farmers are staring down the barrel of three consecutive seasons of negative cash flow. This is likely to be another knock to fragile rural confidence. And with the latest Federated Farmers confidence survey showing that 43% of farmers already intended to reduce spending over the next year (compared with just 15% who expect spending to increase) even before the latest step down in prices, it probably won't be long before the downbeat outlook is being reflected in confidence further afield.

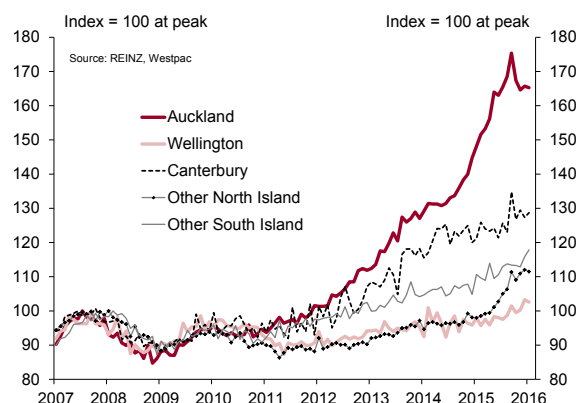
Increased concern about prospects for the global economy, financial market conditions and weaker dairy prices have all been identified by the Reserve Bank as downside risks to its policy outlook which may require "some further policy easing" over the coming year. But on the other side of the ledger the RBNZ has been wary of stoking the rampant Auckland housing market by cutting interest rates. In this regard, January housing data (from both the REINZ and QV) should have gone a little further toward allaying these concerns. It confirmed that the Auckland housing market has certainly turned down since the RBNZ's lending

Two toned continued

restrictions and tax changes came into effect. REINZ data on house sales showed Auckland house sales were down 6.2% in the most recent month, and a massive 27% below the August peak. Prices also eased a little further (down 0.3%) in January, and have now fallen almost 6% from the peak to be back to their July 2015 level.

International developments aside, the Reserve Bank will also be wary of the risk of inflation expectations becoming unanchored in the current environment of very low inflation. Inflation expectations are a significant influence on wage and price setting decisions, and as a result play an important role in determining actual inflation. A point highlighted by RBNZ Governor Wheeler in his recent speech. If inflation expectations continue to fall away from the mid-point of the target band, it will make the uphill battle the RBNZ has been fighting to generate a sustained lift in inflation that much harder. Consequently, this week's release of the RBNZ's own survey of inflation expectations will be worth keeping a close eye on. The headline two year ahead measure of inflation expectations has already fallen to 1.85% and has been hovering a bit below the 2% midpoint of the RBNZ's target band for a year now. But just how low will prove too low for the RBNZ? Our sense is that pressure is mounting.

REINZ house price indexes, seasonally adjusted



Finally, a quick plug for our Economic Overview we published last week (http://www.westpac.co.nz/assets/Business/Economic-Updates/2016/Bulletins-2016/Westpac-QEO-February-2016_EMAIL.pdf). This quarterly document provides updated forecasts and an in-depth overview of NZ and international developments, the outlook for the NZ dollar and interest rates. This quarter we also take a look at what the Paris Agreement on climate change means for the New Zealand economy. Well worth a read.

Fixed vs Floating for mortgages

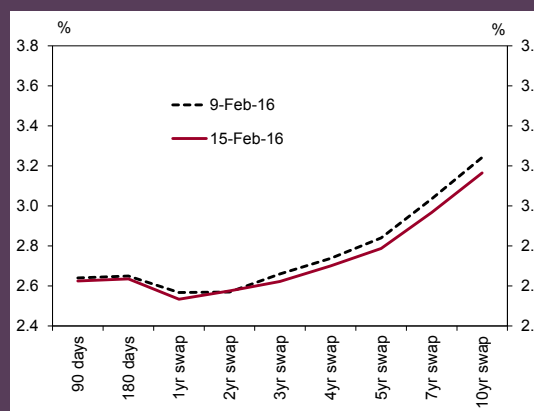
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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 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



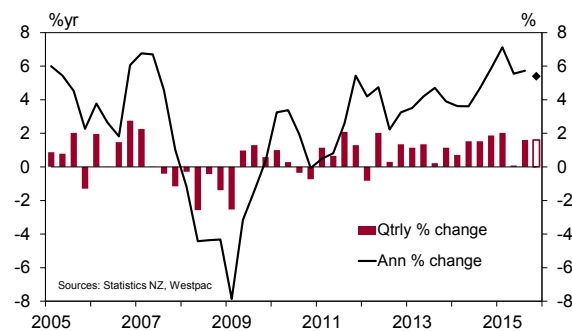
The week ahead

NZ Q4 retail sales

Feb 16, Last: 1.6%, Westpac f/c: 1.6%, Mkt f/c: 1.3%

- Retail spending has been growing at a solid pace over the past few months. Electronic card spending data points to growth in nominal sales of 1.6% over Q4. And, with lingering weakness in prices, volumes are also expected to be up 1.6% (including strong growth in core sales).
- As well as softness in prices (especially petrol prices), retail spending has been boosted by low borrowing costs. Together, these factors are allowing households' budgets to stretch further. On top of this, record levels of tourist inflows are giving a lift to spending in sectors such as hospitality.

Real retail sales

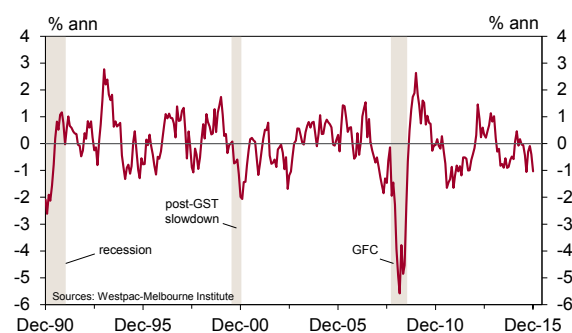


Aus Jan Westpac-MI Leading Index

Feb 17, Last: -1.03%

- The 6mth annualised growth rate of the Leading Index, decreased from -0.40% in Nov to -1.03% in Dec. The growth pulse has weakened materially since mid-2015, with Dec the weakest sub-trend read since Aug and, prior to that, Apr 2012.
- The Jan read will include a mixed bag of updates: the ASX200 -5.5% vs +2.5% last month; commodity prices flat (in AUD terms) vs -4.9% last month; a strong bounce back in dwelling approvals (+10.2% vs -12.7% last month); and another decent read on hours worked (+0.2% vs flat last month). Sentiment based indicators have also been mixed, the Westpac-MI Consumer Expectations Index up 2.5% vs -2.4% last month against a 1.9% deterioration in the Westpac-MI Unemployment Expectations after a milder 0.7% adverse move last month. The yield spread also narrowed a further 2.7bps vs a 12.5bps narrowing last month, a weaker signal for growth.

Westpac-MI Leading Index

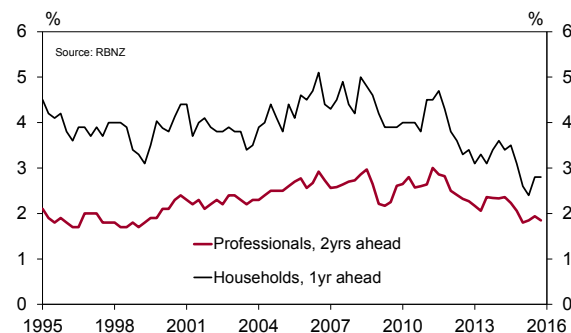


NZ Q1 survey of inflation expectations

Feb 16, 2 yrs ahead - Last: 1.85%

- RBNZ Governor Wheeler's recent speech highlighted the importance of inflation expectations for achieving the inflation target, and that the RBNZ did not want expectations to decline significantly.
- The past year has seen most measures of expectations shifting down, including measures of longer term expectations. On top of this, the start of this year has seen continued low inflation, falls in oil prices, and a deterioration in the global environment. Against this backdrop, expectations will be under downward pressure. The question is "how far is too far" for the RBNZ?
- The RBNZ's survey of two year ahead inflation expectations is the mostly closely watched measure of expectations. It's fallen to 1.85% and has been hovering a bit below the 2% midpoint of the RBNZ's target band for a year now. If it continues to push down, this would strengthen the case for cuts over coming months.

RBNZ survey of inflation expectations

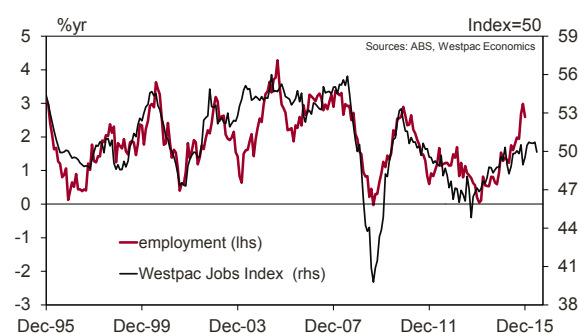


Aus Jan Labour Force - employment '000

Feb 18 Last: -1.0k, WBC 15k, Mkt f/c: 13k, Range: -30k to 40k

- The Dec Labour Force Survey revealed a smaller than expected correction. While we may still question the magnitude of the recent strength, overall you can describe the Australian labour market as being robust outside of WA.
- Employment grew 301.3k (or 2.6%/yr) in the year to Dec, a moderation from Nov's 3.0%/yr pace. The mix was very interesting, with a 17.6k rise in full-time employment (187.2k; 2.3%/yr) and an 18.5k decline in part-time employment (114.1k; 3.2%/yr). Still, over the year, part-time employment continues to grow faster than full-time employment.
- Growth in employment outpaced our preferred leading indicators in the last half of 2015. When this has happened in the past, employment growth has snapped back in line with the indicators. We expect this to happen gradually through 2016.

Employment outpacing jobs index, a rare event



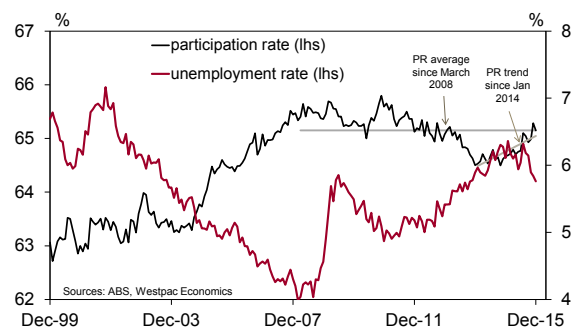
The week ahead

Aus Jan Labour Force - unemployment %

Feb 18 Last: 5.8%, WBC 5.9%, Mkt f/c: 5.8%, Range: 5.7% to 6.0%

- In Dec there was an as-expected moderation in participation (from 65.28% to 65.15%), enough for a flat unemployment rate of 5.8% despite a 1k fall in employment. In fact, at two decimal places, there was a small fall to 5.76% from 5.84%
- From 2010 to 2014, the participation rate was in a trend decline, mostly due to a larger than usual exit of +55 year olds from the workforce. There was some debate at the time if this was structural (that is due to an ageing population) or cyclical. Since early 2014, the trend has reversed, with participation lifting from 64.5% to a recent peak of 65.3%.
- Westpac is forecasting that the +15k gain in employment will be associated with a moderate rise in participation to 65.2% which is enough to lift the unemployment rate to 5.9%.

Unemployment and participation rates

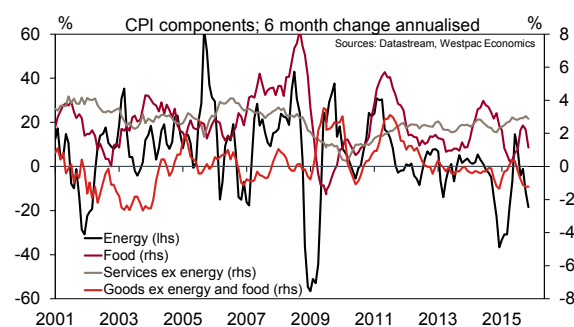


US Jan CPI

Feb 19, Last: -0.1%, WBC f/c: -0.1%

- The US inflation narrative has had a constant refrain over the past year, with the trend decline in the price of oil acting as a persistent deflationary force. At December, annual headline inflation stood at just 0.7%.
- Come January, we are likely to see another soft result circa -0.1%, again owing to the price of oil. However its deflationary influence is abating: the annual pace of inflation should jump from 0.7% to around 1.3% in January.
- Core inflation (excluding energy and food) has remained much more robust in recent months around 2.1%/yr. A 0.2% gain in January should sustain the annual pace at this level. Key to the core inflation trend is persistent growth in the price of services, most notably for rents and recreational services, but also health care and insurance. Against this, the strong USD is resulting in deflation for ex energy goods.

Energy prices stabilising; USD impact to lessen



Data calendar

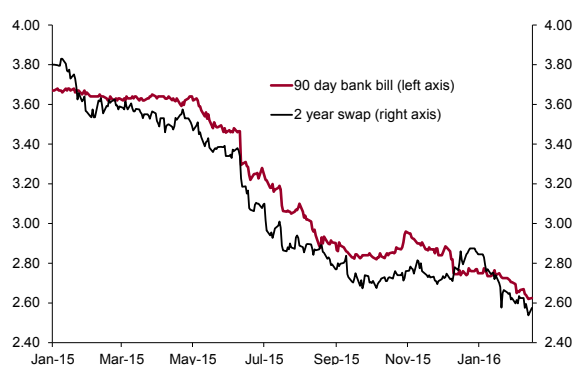
		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Jan BusinessNZ PSI	58.9	-	-	Service sector conditions have remained firm.
Aus	Jan new vehicle sales	-0.5%	-	-0.5%	FCAI report strong start for business sales but softer consumer demand.
Chn	Jan trade balance, \$bn	60.09	60.60	-	Standard Jan/Feb LNY volatility warning.
	Jan exports, %yr	-1.4%	-2.0%	-	External demand an obvious hindrance for exports...
	Jan imports, %yr	-7.6%	-3.9%yr	-	... although weak commodity prices helping curtail import bill.
Eur	Dec trade balance	22.7b	-	-	Conditions remain challenging; external demand needed for growth.
	ECB President Draghi	-	-	-	Speaks at EU Parliament Committee.
UK	Feb Rightmove house prices	0.5%	-	-	Low mortgage rates are supporting housing demand.
US	US Presidents Day	-	-	-	Markets closed for public holiday.
Tue 16					
NZ	Q4 retail sales	1.6%	1.3%	1.6%	Low prices, borrowing rates, and tourist arrivals are boosting spending.
	Q1 RBNZ 2yr inflation expectations	1.85%	-	-	Will be closely watched ahead of the RBNZ's March decision.
Aus	RBA minutes	-	-	-	Expect key themes from SoMP to be repeated.
Eur	ZEW Survey of Expectations	22.7	-	-	How will investors react to recent circumstances? -'vely one assumes.
UK	Jan CPI	0.1%	-0.7%	-	Oil prices are weighing on headline inflation; core higher but modest.
	Dec ONS house prices %yr	7.7%	-	-	Dated relative to other measures. Remains firm.
US	Feb Empire manufacturing survey	-19.4	-10.0	-	The manufacturing sector remains in the doldrums; USD key.
	Feb NAHB housing market index	60	61	-	Remains near highs despite loss of momentum for sales.
	Fedspeak	-	-	-	Harker speaks on the outlook at Uni of Delaware.
	Fedspeak	-	-	-	Kashkari delivers first public speech at Brookings as Minn. President.
Wed 17					
NZ	GlobalDairyTrade auction results	-7.4%	-	-	Market signalling that further falls are likely.
Aus	Jan Westpac-MI Leading Index	-1.03%	-	-	Dec was weakest sub-trend read since Aug and, prior to that, Apr 2012.
UK	Dec ILO unemployment rate	5.1%	5.0%	-	Firm domestic demand has seen unemployment pushing down.
US	Minutes of Jan 26 to 27 FOMC meeting	-	-	-	How great a weight is placed on markets? Employment?
	Jan housing starts	-2.5%	2.3%	1.5%	Sales trend has flattened; likely to progressively impact...
	Jan building permits	-6.1%	-0.1%	-0.5%	... starts and permits in coming months
	Jan PPI	-0.2%	-0.2%	-	Low input costs and the strength in the USD are dampening prices.
	Jan industrial production	-0.4%	0.4%	-	USD and weakness in energy sector major impediments.
	Fedspeak	-	-	-	Rosengren speaks at Colby College.
Thu 18					
NZ	Feb ANZ consumer confidence	121.4	-	-	Confidence has improved but remains below its 2014 peak.
Aus	Jan employment chg	-1.0k	13.0k	15k	Leading indicators suggest employment growth has overshoot but any ...
	Jan unemployment rate	5.8%	5.8%	5.9%	... correction will be defined by usual monthly survey volatility.
	RBA Assist Governor Financial System	-	-	-	Malcolm Edey, Australian Shareholders Investor Forum, Sydney.
Chn	Jan CPI, %yr	1.6%	1.9%	-	Consumer inflation pressures benign...
	Jan PPI, %yr	-5.9%	-5.4%	-	... as commodities continue to weigh heavily on upstream prices.
Eur	Dec current account balance	26.4b	-	-	Conditions remain challenging; external demand needed for growth.
	ECB meeting minutes	-	-	-	Clear intent to stoke inflation, 'whatever it takes'.
US	Feb Philly Fed business survey	-3.5	-2.9	-	Remains low, dampened by external headwinds and the USD.
	Initial jobless claims	269k	-	-	Claims have remained at low levels for an extended period.
	Fedspeak	-	-	-	Bullard speaks in St Louis.
	Fedspeak	-	-	-	Williams gives outlook speech in LA.
Fri 19					
Eur	Feb consumer confidence	-6.3	-6.5	-	Has been strong of late; markets to curb enthusiasm.
UK	Jan retail sales	-1.0%	0.6%	-	The strengthening in the labour market is supporting spending.
	Nov public sector borrowing, £b	6.9b	-	-	Policy focused on a return to surplus; risk that goal isn't met this year.
US	Jan CPI	-0.1%	-0.1%	-0.1%	Oil prices weigh (again); but annual inflation to firm to circa 1.3%/yr.
	Fedspeak	-	-	-	Mester speaks at Global Interdependence Centre.
Can	Jan CPI, nsa	-0.5%	0.1%	-	Falls in the dollar are boosting inflation despite low fuel prices.

New Zealand forecasts

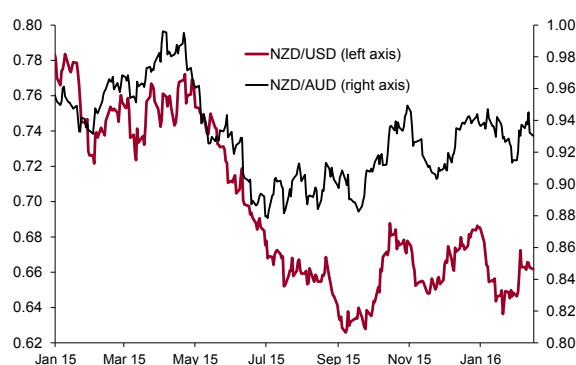
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015e	2016f
GDP (Production) ann avg	2.7	3.6	2.2	2.2	3.7	2.4	2.0	2.9
Employment	3.8	3.2	1.1	2.4	3.6	1.2	2.1	2.1
Unemployment Rate % s.a.	6.0	5.8	5.8	5.2	5.7	5.3	5.3	5.3
CPI	1.5	0.3	0.3	1.3	0.8	0.1	0.8	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.3	-2.7	-3.1	-3.3	-2.9	-3.0

Financial Forecasts	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Cash	2.50	2.25	2.00	2.00	2.00	2.00
90 Day bill	2.60	2.30	2.10	2.10	2.10	2.10
2 Year Swap	2.60	2.40	2.20	2.20	2.20	2.20
5 Year Swap	2.90	2.90	3.00	3.00	3.10	3.10
10 Year Bond	3.10	3.30	3.50	3.70	3.70	3.70
NZD/USD	0.65	0.63	0.61	0.61	0.62	0.62
NZD/AUD	0.93	0.93	0.92	0.91	0.90	0.89
NZD/JPY	79.5	77.7	75.9	76.5	75.9	75.9
NZD/EUR	0.61	0.61	0.59	0.58	0.57	0.57
NZD/GBP	0.44	0.44	0.43	0.42	0.41	0.40
TWI	71.1	70.1	68.4	68.0	67.7	67.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 February 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.57%	2.59%	2.60%
60 Days	2.60%	2.65%	2.67%
90 Days	2.63%	2.70%	2.74%
2 Year Swap	2.58%	2.60%	2.71%
5 Year Swap	2.79%	2.92%	3.05%

NZ foreign currency mid-rates as at Monday 15 February 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6617	0.6523	0.6422
NZD/EUR	0.5890	0.5988	0.5873
NZD/GBP	0.4562	0.4518	0.4505
NZD/JPY	75.06	78.98	74.98
NZD/AUD	0.9303	0.9187	0.9397
TWI	72.17	71.69	71.39

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.3	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	1.9	3.1
Unemployment %	5.3	5.8	6.2	5.8	6.1	5.9
Current Account % GDP	-4.4	-3.4	-3.0	-4.4	-5.0	-4.6
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	2.4	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.7	1.8
Unemployment Rate %	8.1	7.4	6.2	5.3	4.7	4.4
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.6	-0.1	0.6	1.3	0.7
Euroland						
Real GDP %yr	-0.8	-0.3	0.9	1.5	1.3	1.4
United Kingdom						
Real GDP %yr	0.7	1.7	3.0	2.5	2.5	2.0
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	3.9	4.3
World						
Real GDP %yr	3.4	3.3	3.4	3.0	3.4	3.5

Forecasts finalised 12 Feb 2016

Interest Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.28	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.39	2.50	2.70	2.90	3.30	3.55
International						
Fed Funds	0.375	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	1.67	1.80	2.20	2.60	3.00	3.25
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
AUD/USD	0.7102	0.70	0.68	0.66	0.67	0.69
USD/JPY	113.29	117	119	121	123	125
EUR/USD	1.1280	1.11	1.10	1.08	1.05	1.03
AUD/NZD	1.0627	1.08	1.08	1.08	1.10	1.12

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