

Weekly Commentary

15 August 2016



Inflation tailing the pack

Last week the Reserve Bank cut the Official Cash Rate to a new record low of 2% and signalled at least one more easing to come, as they face an uncomfortably slow pickup in inflation. Indeed, even with further easing factored in, the RBNZ's inflation forecasts don't reach 2% until September 2018, nine months later than they forecast in June. We agree with this assessment. Our forecasts from our Quarterly Overview released last week show a similar path for inflation over the next couple of years, highlighting the need for a further 25 basis point cut later this year.

In the August *Monetary Policy Statement*, the RBNZ lay the blame for low inflation firmly at the feet of import prices and the high NZ dollar, which have resulted in tradables inflation being negative for the past four years. While part of this weakness is because of earlier falls in oil prices (that will soon drop out of the annual calculation), inflation is also being held down by broader weakness in global prices – a consequence of persistently subdued global growth. The RBNZ is certainly not the only central bank grappling with this. Weak price pressures from abroad have been an important factor dragging inflation lower in Australia, forcing the RBA to ease the cash rate by 50 basis points over the past few months.

The high NZ dollar has reinforced this weak inflation dynamic by reducing the landed cost of imported goods and services. Indeed, it was the RBNZ's updated forecast for the NZ dollar TWI, which is 6% higher than assumed in the June *MPS*, that put a significant dent in their inflation forecasts.

It's tough to catch a break with the NZ dollar, as New Zealand's positive interest rates stand out like a sore thumb on the global stage. Even with last week's cut in the OCR and signalling of more easing to come, markets were disappointed, pushing the NZD/USD over 1 cent higher on the day. Markets had expected an even more dovish

shift from the RBNZ, and talk of a 50 basis point cut had gathered momentum in the days prior to the release. We had viewed these expectations as being overdone, and in the end the RBNZ's forward guidance on rates was broadly in line with our expectations.

While the RBNZ is cognisant that much of the weakness in tradables inflation is out of their hands, a big concern is that persistently low inflation feeds into lower inflation expectations. This would affect firms' price and wage setting behaviour, making it harder for the RBNZ to generate a lift in inflation. Therefore, to mitigate the risk of weaker expectations, the RBNZ needs to work harder with interest rates to stimulate more domestic activity and generate stronger home-grown inflation.

One key to this is the degree of capacity constraints in the economy. This week's labour market data will provide an update on how capacity pressures evolved in the June quarter. We're picking that the unemployment rate edged up to 5.3%, suggesting some degree of capacity remaining as strong population growth boosts labour supply. That said, conditions are mixed across sectors with construction firms highlighting more difficulty in finding skilled labour, translating into higher construction cost inflation.

Also key for inflation is the transmission of monetary policy into domestic spending. REINZ data for July suggests that

Inflation tailing the pack continued

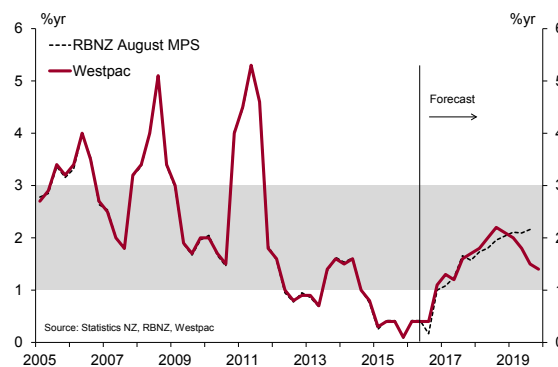
low interest rates are boosting house prices nationwide. House prices rose 2.4% in the month, to be 16.3% higher than a year ago. And in contrast to last year, prices are now rising strongly across all of the major regions. In fact, Auckland had the smallest increase in July.

Continued strong growth in house prices is despite a downturn in house sales in the past couple of months. The fall in sales potentially reflects the lack of opportunities as available listings have been trending sharply lower for some time. Mortgage approvals have been edging lower in recent weeks, and we would expect to see further drop-off in house sales in August as the impact of tighter lending restrictions come into play. While this should dampen house prices from August, international experience suggests that lending restrictions have only a temporary effect on the rate of house price growth.

The housing market didn't feature much in the August *MPS*, despite forecasts for house price inflation revised higher to peak at an eye-watering 18% in early 2017. While these rapid gains in house prices will add to concerns about financial stability, from a monetary policy point of view the housing market matters to the extent that it affects inflation. And from that perspective, the RBNZ has down-weighted the link from house prices to household spending compared to what we've seen in previous cycles.

That's not to say that household spending is weak. The latest figures on retail spending showed that retail volumes surged by 2.3% in the June quarter. That's the strongest

CPI inflation forecasts



quarterly gain since 2006, and leaves volumes up 6% over the past year. Card spending in July also suggests that momentum remained solid moving into the September quarter. While a rapidly growing population and strong growth in tourist numbers are providing a boost to spending, low interest rates and accelerating house prices are also flowing through. Indeed, in the June quarter it was growth in durables spending, especially the building and housing-related categories, at the top of the leaderboard.

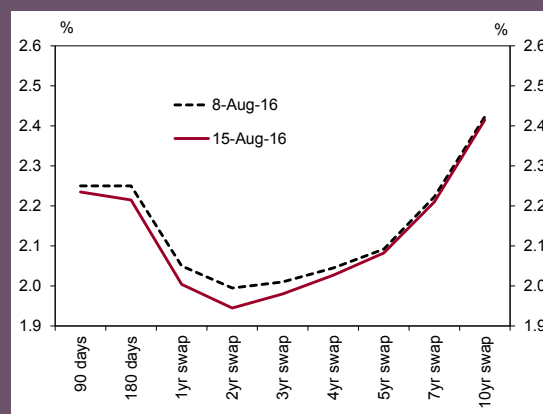
Fixed vs Floating for mortgages

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



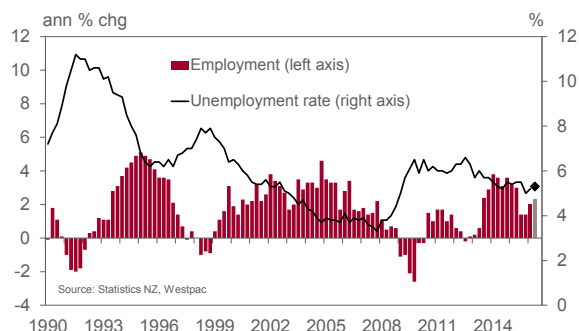
The week ahead

NZ Q2 Household Labour Force Survey

Aug 17, Employment, last: 1.2%, WBC f/c: 0.6%, Mkt f/c: +0.6%
Unemployment, last: 5.2%, WBC: 5.3%, Mkt f/c: 5.3%

- Delayed from 3 August following changes to the survey.
- Broad indications are that the labour market continued to strengthen in the June quarter. However, employment growth in the recent Quarterly Employment Survey was quite weak.
- We expect next week's data to show a third consecutive quarter of employment growth. We are forecasting a solid 0.6% gain which would leave annual employment growth at 2.3%.
- Combined with a modest lift in the participation rate, this is likely to see the unemployment rate increase a touch to 5.3% in the June quarter.

Household labour force survey

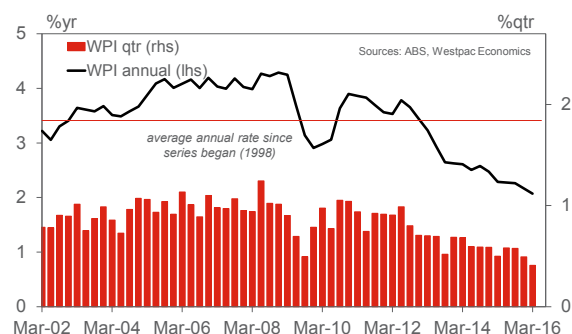


Aus Q2 Wage Price Index %qtr

Aug 17 Last: 0.4%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.3% to 0.7%

- Total hourly wage rates ex bonuses (WPI) lifted 0.4% in Q1, less than the market's expectation for a 0.5% rise. Westpac forecast was for a 0.4% gain. This follows on from a rise of 0.5% in Q4 and a 0.6%qtr increase in each of the two quarters before that.
- The annual pace is at a new record low for the Index, 2.1%yr, a moderation from 2.2%yr in Q4 and the recent peak of 2.6%yr in Q3 2014. The WPI started in the September quarter of 1997.
- More dramatic has been the deceleration in private sector wage inflation, with the annual pace hitting a record low of 1.9%yr. The recent peak was 4.0%yr in Q1 2011.
- There is little to suggest we will see any meaningful pickup in wages in Q2. Westpac's forecast for a 0.5%qtr rise will see the annual rate dip to a new record low of 2.0%.

Wage inflation holds record lows

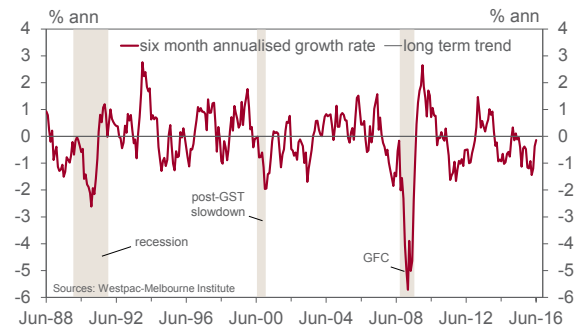


Aus Jul Westpac-MI Leading Index

Aug 17, Last: -0.14%

- The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index rose from -0.37% in May to -0.14% in June. While the growth rate remains below zero, indicating below trend momentum, it has improved markedly from the -1.19% average reading of the first three months of 2016.
- The July read will include mostly positive updates: the ASX200, up 6.3% vs -2.7% last month; the Westpac-MI Consumer Expectations Index up 2.4% vs -2.9% last month; and commodity prices up 1.1% in AUD terms vs -1.8% last month. Although still negatives, the drags from dwelling approvals and the labour market components also look to be a touch milder.

Westpac-MI Leading Index

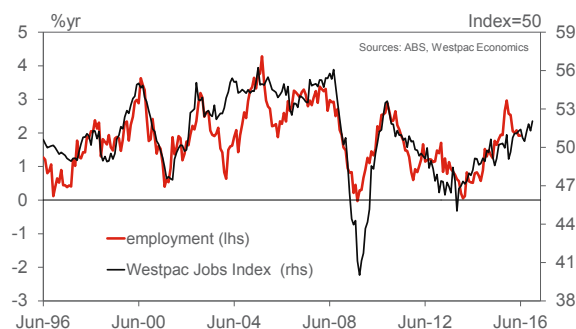


Aus July Labour Force Survey employment '000

Aug 18 Last: 7.9k, WBC f/c: 25k
Mkt f/c: 10k, Range: -20k to 30k

- In June, employment in Australia rose modestly, up 7.9k, broadly as expected (mkt median 10k; Westpac 12k). That modest jobs result for June came on the heels of a solid 19.2k increase in May, revised higher from 17.9k.
- Annual jobs growth was flat at 1.9% in June. However, over the past six months, employment rose by only 0.4%, or 0.7% annualised. The overshoot of 2015, when employment surged by 3.0% in the year to November, has given way to a consolidation.
- For the near term at least, the business surveys, as summarised by the Westpac Jobs Index, have continued to paint a robust picture of employment growth. Westpac's July forecast of 25k will see the annual pace ease to 1.8%yr.

Jobs Index continues to firm



The week ahead

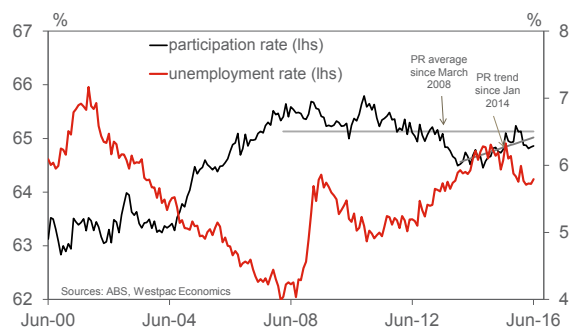
Aus July Labour Force Survey unemployment %

Aug 18 Last: 5.7%, WBC f/c: 5.8%

Mkt f/c: 5.8%, Range: 5.6% to 5.9%

- In June, the unemployment rate rounded higher to 5.8% (5.79%), up from 5.7% (5.72%). While the participation rate was flat at 64.8%, at two decimal places it rose ever so slightly, to 64.86% from 64.84%, which was enough to lift the labour force 17.7k in the month. If the participation rate had held steady, the labour force would have grown 14.1k.
- A strong rise in employment does not normally happen in isolation of a rise in participation. As such, Westpac is forecasting a 0.08ppt rise in participation, which should generate a 29.9k rise in the labour force. Given our forecast for a 25k rise in employment, the unemployment rate should round down to 5.8% in July (flat with June if there are no revisions).

Unemployment and participation rates

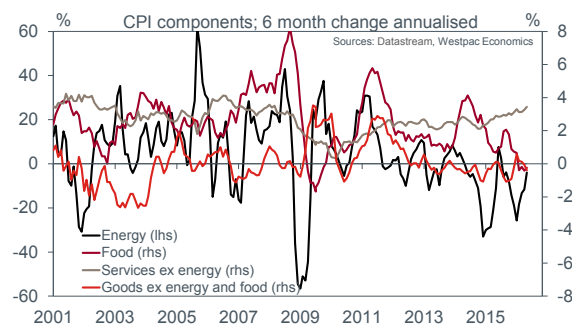


July US CPI

Aug 16, Last: 0.2%, WBC 0.1%

- There remains a considerable gap between annual headline inflation and the core measure, respectively 1.0%/yr and 2.3%/yr in June. Though, with both indexes registering a 0.2% gain in the month, the June report provided some evidence in favour of a (very slow) normalisation in the pace of headline inflation back toward the FOMC's 2.0%/yr medium-term target.
- Of course, this discrepancy is the legacy impact of weak energy prices through 2015 and early 2016.
- Come July, energy prices are again likely to weigh on the headline index, albeit to a much smaller extent than in 2015. A 0.1% rise in headline prices should see the annual rate remain unchanged at 1.0%/yr. Meanwhile, core prices are likely to see another 0.2% gain in the month, resulting in a circa 2.2%/yr annual pace. Within the core component, service price growth remains the driving force.

Services inflation the driving force



Data calendar

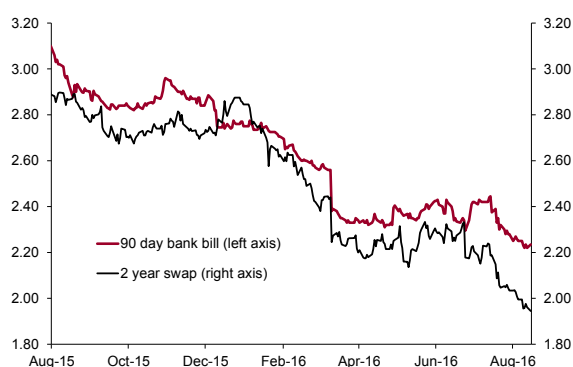
		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Jul BusinessNZ PSI	56.7	-	-	Has eased back, but still points to solid activity.
UK	Aug Rightmove house prices	-0.9%	-	-	Economic uncertainty and policy changes have dampened price growth.
US	Aug Empire manufacturing survey	0.55	2.00	-	Points to around trend growth in manufacturing.
	Aug NAHB housing market index	59	60	-	Low interest rates continues to support momentum in sector.
Tue 16					
Aus	RBA minutes	-	-	-	SoMP highlighted RBA expectations and risks; minutes to do the same.
	Jul new vehicle sales	3.1%	-	-1.0%	A softer month. Annual sales growth tracking in 1-2% range.
Eur	Jun trade balance, €bn	24.5	-	-	In May, exports gained 2% as imports fell 2%.
	Aug ZEW survey of expectations	-14.7	-	-	Investors have had a good run recently; and its summer.
UK	Jul CPI	0.2%	-0.1%	-	Inflation has been rising, GBP's drop will boost prices later in the year.
US	Jul housing starts	4.8%	-1.1%	-	Partial unwind of Jun gain expected.
	Jul building permits	1.5%	0.6%	-	Permits expected to continue on modest uptrend.
	Jul CPI	0.2%	0.0%	0.1%	Food and energy expected to be a drag in Jul; core prices up 0.2%.
	Jul industrial production	0.6%	0.2%	-	External demand continues to weigh on production.
	Fedspeak	-	-	-	Lockhart Speaks to Rotary Club of Knoxville.
Wed 17					
NZ	GlobalDairyTrade auction	6.6%	-	-	Futures suggesting another positive outturn.
	Q2 unemployment rate	5.2%	5.3%	5.3%	A touch higher on solid employment growth and lift in participation.
	Q2 employment growth	1.2%	0.6%	0.6%	Third consecutive quarter of solid employment growth.
Aus	Jul Westpac-MI Leading Index	-0.2%	-	-	Has improved markedly in 2016. Latest component updates positive.
	Q2 wage cost index	0.4%	0.5%	0.5%	The annual pace hit record low of 2.1%/yr in Q2; Q3 could see 2.0%/yr.
UK	Jun ILO unemployment rate	4.9%	4.9%	-	Likely to have found a base as economic uncertainty weighs on hiring.
US	FOMC minutes	-	-	-	Focus to remain on consumer and labour market.
	Fedspeak	-	-	-	Bullard speaks on the economy and policy in St Louis.
Thu 18					
Aus	Jul employment	7.9k	10k	25k	Following a soft patch, the leading indicators suggest employment is...
	Jul unemployment rate	5.8%	5.8%	5.8%	... robust; however the 25k rise is only enough to steady unemployment.
	RBA speak	-	-	-	RBA's Hancock in Panel Participation in Sydney.
Chn	Jul property prices	-	-	-	Tier-1 momentum peaking; some tier-2 benefitting, but not majority.
Eur	Jul CPI	0.2%	-	-	Recent gains for inflation to see annual rate trend higher in 2016.
	ECB policy meeting minutes	-	-	-	Waiting to see how domestic and global conditions develop.
UK	Jul retail sales	-0.9%	0.2%	-	Low confidence and softer housing market dampening spending.
US	Initial jobless claims	266k	-	-	Claims remain at very low levels.
	Aug Philadelphia Fed business survey	-2.9	1.3	-	Remains consistent with around trend rates of growth.
	Fedspeak	-	-	-	Dudley speaks on regional economic conditions in New York.
	Fedspeak	-	-	-	Williams speaks on the economic outlook in Anchorage.
Fri 19					
NZ	Jul net migration	5670	-	5400	Expecting annual population growth to stabilise at very high level.
UK	Jun public sector borrowing, £bn	7.3	-2.4	-	The softer outlook for growth casts doubt on deficit reduction aims.
Can	Jul CPI	0.2%	-	-	Core inflation has picked up, but remains contained.

New Zealand forecasts

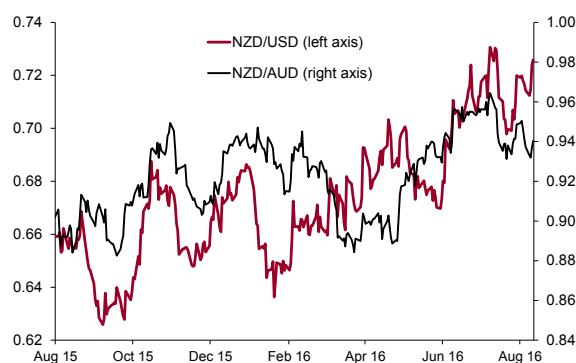
Economic Growth Forecasts	March years				Calendar years			
	% change	2015	2016	2017f	2018f	2014	2015	2016f
GDP (Production) ann avg	3.6	2.4	3.3	2.7	3.7	2.5	3.2	2.9
Employment	3.2	2.0	2.6	1.7	3.6	1.4	3.1	2.2
Unemployment Rate % s.a.	5.4	5.2	4.9	4.6	5.5	5.0	5.1	4.6
CPI	0.3	0.4	1.3	1.8	0.8	0.1	1.0	1.7
Current Account Balance % of GDP	-3.4	-3.0	-3.3	-3.6	-3.1	-3.2	-3.0	-3.7

Financial Forecasts	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Cash	2.00	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.00	1.90	2.00	2.00	2.00	2.00
5 Year Swap	2.10	2.10	2.20	2.30	2.40	2.50
10 Year Bond	2.10	2.20	2.30	2.50	2.60	2.70
NZD/USD	0.72	0.69	0.67	0.65	0.63	0.63
NZD/AUD	0.94	0.93	0.92	0.92	0.91	0.91
NZD/JPY	73.4	71.1	68.3	65.7	64.3	65.0
NZD/EUR	0.65	0.64	0.63	0.62	0.59	0.58
NZD/GBP	0.55	0.54	0.53	0.51	0.49	0.48
TWI	76.9	74.8	73.3	71.7	69.9	68.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



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

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.00%	2.25%	2.25%
30 Days	2.10%	2.25%	2.33%
60 Days	2.17%	2.26%	2.35%
90 Days	2.24%	2.27%	2.38%
2 Year Swap	1.95%	2.03%	2.20%
5 Year Swap	2.08%	2.13%	2.29%

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

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7190	0.7203	0.7139
NZD/EUR	0.6437	0.6449	0.6462
NZD/GBP	0.5561	0.5447	0.5410
NZD/JPY	72.74	73.50	75.25
NZD/AUD	0.9388	0.9488	0.9399
TWI	76.39	76.65	76.37

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	1.2	2.0
Unemployment %	5.3	5.8	6.2	5.8	5.7	5.6
Current Account % GDP	-4.4	-3.4	-3.0	-4.8	-4.6	-4.6
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	1.6	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	4.8	4.6
Current Account %GDP	-2.9	-2.3	-2.3	-2.4	-2.3	-2.3
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	1.6	0.6
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 12 August 2016

Interest Rate Forecasts	Latest	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Australia						
Cash	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
10 Year Bond	1.91	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	1.56	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	0.7677	0.77	0.74	0.73	0.71	0.69
USD/JPY	102.15	103	102	101	101	102
EUR/USD	1.1135	1.10	1.08	1.07	1.05	1.06
AUD/NZD	1.0659	1.07	1.07	1.09	1.09	1.10

Contact the Westpac economics team

Michael Gordon, Acting Chief Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

David Norman, Industry Economist +64 9 336 5656

Sarah Drought, Economist +64 9 336 5696

Any questions email: economics@westpac.co.nz

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