

Weekly Commentary

18 April 2016



Put it on the house

Market pricing for a cut at the 28 April OCR review has receded a little in the last week, having been close to 50:50 at one point. The housing market has staged a surprisingly strong rebound, while a rise in food prices has reduced the risk of an uncomfortably soft inflation print for the March quarter. That brings the market more in line with our own assessment of the odds: we do expect another OCR cut in the near future, but we currently lean towards June rather than April.

We've long been making the case for the OCR to fall to 2% this year, and by the March *Monetary Policy Statement* the Reserve Bank had joined us in that view. The timing of rate cuts, however, has never been crucial to our view, and we think the next move will come down to tactics as much as fundamentals. Once the OCR reaches 2%, the RBNZ will need to provide some signal as to whether this is likely to mark the end point, or if further easing will be needed.

Unless there's an overwhelming case one way or the other – and we don't think there is just yet – the RBNZ can defer making that judgement until the full *MPS* in June.

We'll set out our thinking in more detail in our OCR preview later this week, once we've had time to digest today's March quarter CPI release. We expect a mild 0.1% increase in the CPI for the quarter (last week's higher than expected food prices for March prompted us to revise up our forecast from zero). This would see the annual inflation rate rise to 0.3%, from an historic low of 0.1%.

Our forecast of annual inflation is only slightly below the RBNZ's forecast of 0.4%, and the difference is entirely on the tradables side, where the RBNZ has more scope to look through temporary price movements. Our sense is that an inflation outturn in line with our forecast would not, on its own, be enough to prompt an OCR cut as soon as this month. However, a substantially weaker result would make the April review a genuine contender for an OCR cut.

The RBNZ's interest rate deliberations will also need to take account of the latest developments in the housing market. Late last year, the Government and the RBNZ introduced a suite of restrictions on property buyers, aimed at investors in the hot Auckland market in particular. These restrictions initially had the desired effect – in Auckland and its surrounds, house sales and prices fell sharply from their pre-restriction peaks. At the same time, the housing market picked up steam in many other parts of the country.

That regional divergence is no longer. The REINZ house sales figures for March showed that the Auckland market has exploded back into life, with prices almost back to their pre-restriction highs, while prices in the rest of the country continued to march higher. We're not surprised that there was only a temporary effect on the trajectory of house prices. The restrictions only applied to particular segments of the market, namely: investors who planned to buy and sell within two years, foreign buyers who were unwilling to share their tax details, and investors in Auckland who could stump up a 20% deposit but not a 30% one. It's likely that these rules took some players out of the market – and it should be noted that housing turnover in Auckland is still well down from its highs. But for the majority of potential buyers, the new rules simply aren't binding, and will have no real bearing on what they're willing to pay for a house.

We have to admit, though, that the power of the housing

Put it on the house continued

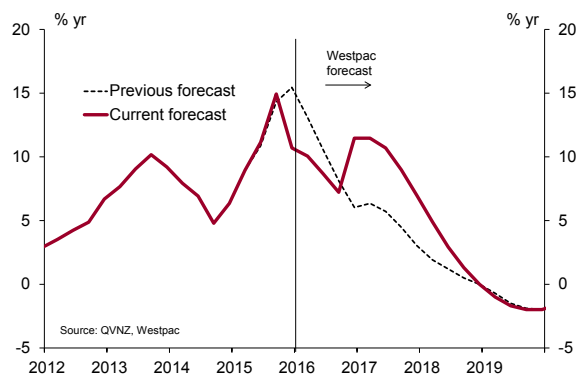
market's rebound has surprised us. And the fact that rising house prices are becoming widespread, and have been accompanied by rising household borrowing, strongly suggests that low mortgage rates are proving to be a powerful driver of the market.

We've made some substantial revisions to our house price forecasts. We now expect an 11.5% rise in nationwide house prices this year, from 6% previously. Part of the change in our forecast is due to timing. The recently-released Quotable Value quarterly house price index, the best-quality measure of New Zealand house prices, showed that the initial impact of last year's restrictions came through sooner than we expected. House prices fell 1.1% in the December quarter, leaving them up 10.7% last year compared to our estimate of 15.5%.

What the housing market means for the RBNZ is not entirely straightforward. From a monetary policy perspective, rising house prices are actually helpful. The RBNZ's forecasts require some fairly strong economic growth over the next couple of years in order to bring inflation back to the middle of the inflation target. Rising house prices are one channel for stimulating the required growth in spending and investment. As it happens, the March MPS already assumed a 15% rise in house prices last year and 12% this year. To date, house prices are actually tracking below the RBNZ's forecast, not above it.

From a financial stability perspective, though, the RBNZ may be less sanguine. For a time, the RBNZ took heart from the fact that the Auckland housing market was

Westpac annual house price inflation forecast



cooling down; rising house prices in other regions were of less concern as there was no sign that valuations were becoming stretched. But with the Auckland market springing into back into life, the RBNZ may be wary of adding fuel to the fire by taking interest rates ever lower.

That also means there's a growing risk of another round of macro-prudential measures before the end of the year. The RBNZ has not yet raised that possibility, but the next twice-yearly *Financial Stability Report* on 11 May would be an opportunity to do so.

Fixed vs Floating for mortgages

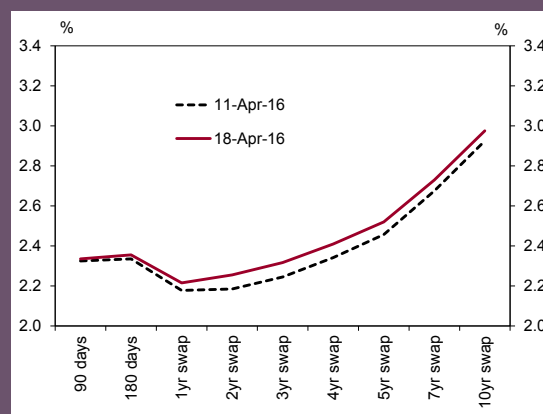
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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



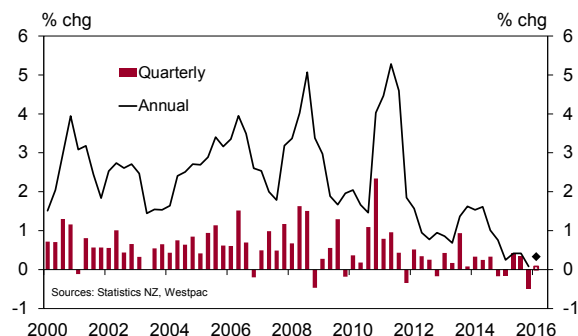
The week ahead

NZ Q1 CPI

Apr 18, Last: -0.5%, Westpac f/c: 0.1%, Mkt f/c: 0.1%

- We expect a 0.1% increase in the Consumer Price Index (CPI) for the March quarter, which would see annual inflation tick up from 0.1% to 0.3%.
- The plunge in world oil prices will again have a major impact on the CPI, particularly through lower petrol prices and airfares.
- The fall in the New Zealand dollar over the last year is expected to have a modest impact on retail prices.
- Our forecast is only slightly below the Reserve Bank's, and in our view would not be enough on its own to warrant an OCR cut as early as this month.

NZ CPI inflation

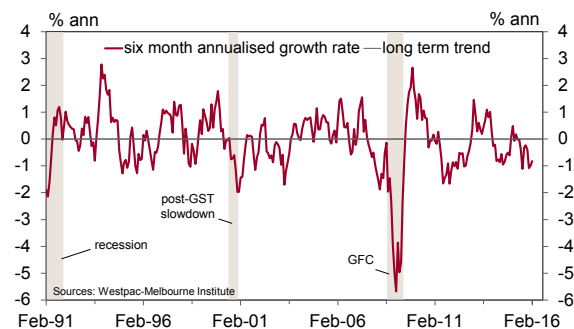


Aus Mar Westpac-MI Leading Index

Apr 20, Last: -0.82%

- The Leading Index growth rate lifted from -0.99% in Jan to -0.82% in Feb. Despite some improvement in early 2016, the Index continues to point to sub-trend growth momentum heading into mid 2016.
- The March read will include a mixed bag of updates. On the positive side, the ASX200 was up 4.1% vs -2.5% last month; dwelling approvals recovered (up 3.1% vs -6.6% last month); the yield spread widened; commodity prices edged 0.3% higher (in AUD terms) and the Westpac-MI Unemployment Expectations Index showed a 1.8% improvement. Against this, the Westpac-MI Consumer Expectations Index dropped 6% (vs 1.7% last month); US industrial production slipped -0.2% (vs -0.5% last month); and total hours worked declined 1.1%.

Westpac-MI Leading Index



Data calendar

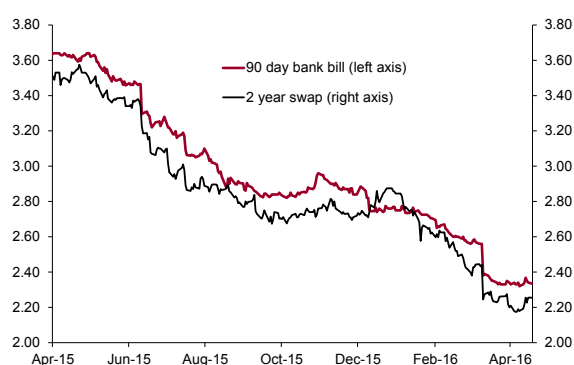
		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	Q1 CPI	-0.5%	0.1%	0.1%	Lower oil prices balanced against the earlier fall in the NZD.
Aus	Mar new vehicle sales	-0.1%	-	-	Vehicle sales have strengthened since mid-2014, trend is +4%/yr.
Chn	Mar property prices	-	-	-	Tier 1 has momentum; the others not so much.
UK	Apr Rightmove house prices	1.3%	-	-	Changes to stamp duty may weigh on prices over the coming months.
US	Apr NAHB housing market index	58	59	-	Remains at a robust level, indicative of confidence in outlook.
	Fedspeak	-	-	-	Dudley gives opening remarks at Economics Conference
	Fedspeak	-	-	-	Kashkari speaks in Minneapolis.
Tue 19					
NZ	Mar PSI	56.9	-	-	While still healthy, services sector gauges have eased.
Aus	RBA minutes	-	-	-	Focus on growth outlook – potential impact of a higher AUD.
	RBA Governor Stevens speaking	-	-	-	Speech, Credit Suisse Global Macro Conference, 11:30pm AEST
Eur	Apr ZEW survey of expectations	10.6	-	-	Investors wary of outlook.
	Feb current account balance, €bn	25.4	-	-	Global growth key impediment.
US	Mar housing starts	5.2%	-0.7%	-	Uptrend intact...
	Mar building permits	-3.1%	2.0%	-	... pipeline of activity remains dependent on multiples.
Wed 20					
NZ	GlobalDairyTrade auction results	2.1%	-	-	Futures pointing to a lift in WMP prices.
Aus	Mar Westpac-MI Leading Index	-0.82%	-	-	Has been pointing to sub-trend momentum heading into Q2-Q3.
UK	Feb ILO unemployment rate	5.1%	5.1%	-	Remains low supported by improvements in the service sector.
US	Mar existing home sales	-7.1%	3.7%	-	Volatility continues, but interest rates and labour market supportive.
Thu 21					
NZ	Mar net migration	6070	-	6070	Has levelled off, but remains extremely strong.
	Apr consumer confidence	118	-	-	Confidence is split; urban regions more upbeat than rural.
Aus	Q1 NAB business survey	-	-	-	In month of March, conditions index rose to +12, an 8yr high.
Eur	ECB policy decision, refinance rate	0.0%	0.0%	0.0%	Months ahead will be used to assess impact of recent actions.
	Apr consumer confidence	-9.7	-9.2	-	Has lost momentum recently, but remains positive.
UK	Mar retail sales	-	-	-	Gains in employment and real earnings are supporting spending.
	Mar public sector borrowing £bn	6.5	-	-	The UK government will face an uphill battle to achieve its surplus aims.
US	Mar Chicago Fed activity index	-0.29	-	-	Indicative of growth near trend.
	Initial jobless claims	-	-	-	At very low level.
	Apr Philly Fed index	12.4	8.0%	-	Manufacturing to remain under pressure.
	Feb FHFA house prices	0.5%	0.4%	-	House prices continue to show decent momentum.
	Mar leading index	0.1%	0.3%	-	Growth running at trend.
Fri 22					
Eur	Apr Markit manufacturing PMI	51.6	51.8	-	A weaker EUR would help, but external demand the prime determinant.
	Apr Markit services PMI	53.1	53.3	-	Domestic demand aiding services.
	Apr Markit composite PMI	53.1	53.4	-	Composite consistent with modest growth.
Ger	Apr Markit manufacturing PMI	50.1	51.0	-	Broadly standing still.
	Apr Markit services PMI	55.1	55.1	-	Unemployment at historic low; good conditions for services.
US	Apr Markit manufacturing PMI	51.5	51.1	-	USD and energy having persistent impact.
Can	Mar CPI %/yr	0.2%	0.4%	-	Lingering capacity and the lift in the CAD are weighing on prices.

New Zealand forecasts

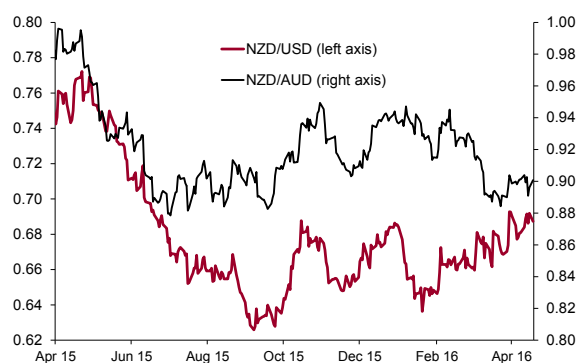
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.8	3.7	2.5	2.8	2.6
Employment	3.8	3.2	1.4	2.5	3.6	1.4	2.7	1.5
Unemployment Rate % s.a.	6.0	5.8	5.8	5.6	5.8	5.3	5.6	5.9
CPI	1.5	0.3	0.3	1.1	0.8	0.1	0.7	2.2
Current Account Balance % of GDP	-2.5	-3.4	-3.2	-3.4	-3.1	-3.1	-3.4	-3.7

Financial Forecasts	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.10	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.10	2.10	2.10	2.10	2.10	2.10
5 Year Swap	2.60	2.70	2.80	2.90	3.00	3.10
10 Year Bond	3.00	3.10	3.20	3.40	3.50	3.60
NZD/USD	0.65	0.65	0.62	0.62	0.62	0.62
NZD/AUD	0.88	0.88	0.87	0.87	0.86	0.85
NZD/JPY	71.5	72.8	71.3	72.1	74.2	74.4
NZD/EUR	0.60	0.60	0.58	0.58	0.58	0.57
NZD/GBP	0.47	0.47	0.45	0.45	0.45	0.44
TWI	69.3	69.5	67.4	67.3	67.3	66.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 18 April 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.26%	2.30%	2.31%
60 Days	2.32%	2.32%	2.33%
90 Days	2.34%	2.33%	2.36%
2 Year Swap	2.26%	2.20%	2.24%
5 Year Swap	2.52%	2.51%	2.53%

NZ foreign currency mid-rates as at Monday 18 April 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6873	0.6891	0.6798
NZD/EUR	0.6077	0.6046	0.6038
NZD/GBP	0.4834	0.4846	0.4708
NZD/JPY	74.35	76.95	75.88
NZD/AUD	0.9008	0.8983	0.8939
TWI	72.80	72.88	72.17

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.5	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	2.1	2.3
Unemployment %	5.3	5.8	6.2	5.8	5.5	5.3
Current Account % GDP	-4.4	-3.4	-3.0	-4.6	-4.3	-3.9
United States						
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	1.3	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.7	4.5
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.7
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.3	1.3
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	2.2	2.2
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	4.1
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.3	3.5

Forecasts finalised 15 Apr 2016

Interest Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.28	2.30	2.30	2.30	2.30	2.30
10 Year Bond	2.57	2.60	2.75	2.75	2.90	3.10
International						
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125
US 10 Year Bond	1.79	2.00	2.15	2.25	2.50	2.80
ECB Repo Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
AUD/USD	0.7710	0.74	0.74	0.71	0.71	0.72
USD/JPY	109.60	110	112	115	117	120
EUR/USD	1.1260	1.09	1.08	1.07	1.06	1.07
AUD/NZD	1.1190	1.14	1.14	1.15	1.15	1.17

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