

Weekly Commentary

21 March 2016



Running to stand still

The New Zealand economy put in a reasonable performance over the second half of last year, after a slow spell in the first half. But the details gave no cause for celebration: the economy's momentum has clearly slowed once we account for population growth, and we suspect that the shock to income from lower dairy prices has yet to have its full impact on activity.

GDP rose by 0.9% in the December quarter, matching the rise in the previous quarter and beating market forecasts (including our own) of a 0.7% increase. Construction and services were the main contributors to this increase, while the agricultural sector went backwards (though this was driven by sheep and beef rather than dairying).

It is important to note that population growth, driven by strong net immigration, has played an increasing role in New Zealand's economic growth over the last few years. Over 2015, GDP rose by 2.5%, while the population increased by 1.9%. The net result was per capita growth of just 0.6%, which is well off the pace seen in previous years. Slow per capita growth does not suggest a particularly rapid reduction in the ranks of the unemployed, or an imminent pickup in inflation pressures.

The balance of payments also hints at a subdued pace of growth beyond population pressures. The current account deficit narrowed to 3.1% of GDP in the year to December, compared to 3.3% of GDP in the year to September. The smaller deficit came despite lower export earnings from both dairy and tourism over the latest quarter. Instead, it was driven by a drop in returns earned on overseas investments in New Zealand. The current account deficit tends to move with the economic cycle in this way, widening during booms and narrowing during downturns. As an indicator of where New Zealand currently sits in the cycle, a

more-or-less flat current account deficit over the past year does not paint a picture of strength.

Why has per capita growth slowed so much? The dairy industry's woes may have played a part, although this won't be apparent from looking at the breakdown of GDP. The dairy downturn was initially a shock to incomes, rather than to activity (milk production is still close to its highs). For example, while real GDP rose by 2.5% over the last year, real gross national disposable income – an alternative calculation that accounts for shifts in the terms of trade – was down 0.4% over the same period.

The impact on real GDP is likely to come via second-round effects: reduced spending on farm services, business investment and household consumption, starting in the rural regions but eventually radiating out more broadly. We suspect that this process has much further to play out, especially as the prospect of a third straight season of low milk prices may be only just coming on to the radar of many dairy farmers.

Tourism has provided a useful counterbalance to the weakness in dairying, and in fact the former has overtaken the latter as New Zealand's biggest export earner. In our judgement, though, the dairy downturn has had the more significant influence on economic growth.

There's no doubt that visitor numbers have surged in the last couple of years, topping 3 million people last year.

Running to stand still continued

However, the visitor spending figures also imply a sharp rise in spending per person in December 2014, the same time that a technical change was made to the spending survey. Growth has been modest since then, and in fact it fell in the latest quarter. We suspect that the survey overstates the growth in tourist spending over the last year, the most likely reasons being that spending was being under-reported in previous years.

In our recent report on the tourism, hospitality and recreation sectors, we noted several other factors that may limit tourism's ability to offset the dairy downturn:

Magnitude: Dairy export earnings fell by \$3 billion over the 2015 calendar year. In that time, travel export earnings (including tourism, business travel and overseas students) rose by \$2.6 billion.

Value added: The fall in dairy earnings has largely been due to lower prices, with little change in inputs. In contrast, increasing tourism earnings is likely to require additional inputs, including an imported component.

National income: The dairy sector is overwhelmingly locally-owned, so profits (and losses) remain in New Zealand. Tourism tends to have a higher share of overseas ownership, especially in accommodation, so profits are more likely to be repatriated.

Capacity: The tourism sector is already struggling with capacity during the peak of the season. At the same time, there's some reluctance to invest in capacity, given the uncertainty around the long-term outlook and the long lead times for new buildings such as hotels.

Overseas visitor spending



Geography: Tourism operators reported to us that ease of access is crucial for tourist attractions, even within the major centres. Many rural regions would struggle to switch towards tourism without major investment in transport and other infrastructure.

Our GDP forecasts imply a modest lift in per capita growth over the next couple of years. However, we see construction, more so than tourism, providing the counterbalance to the weakness in the dairy industry. The strong pipeline of work in Auckland and other parts of the North Island should provide a boost to nationwide construction activity, even allowing for the fact that the level of quake rebuild activity in Canterbury has peaked.

Fixed vs Floating for mortgages

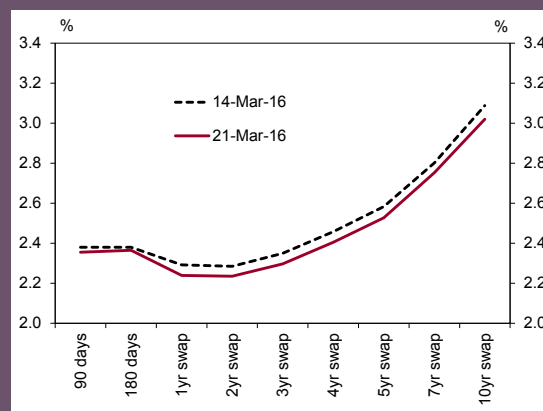
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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



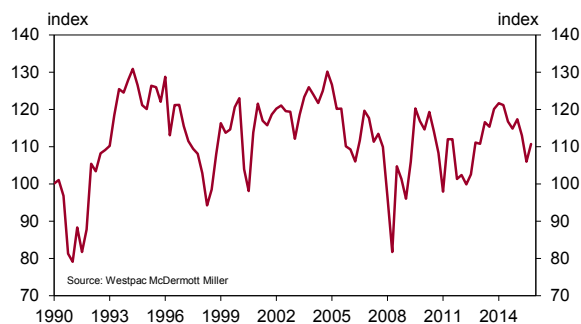
The week ahead

NZ Q1 Westpac-MM Consumer Confidence

March 21, Last: 110.7

- Late 2015 saw a sharp increase in consumer confidence, with sentiment rising in most regions.
- Importantly, the improvement in household sentiment seen in late 2015 was associated with an increased willingness to spend. This was one factor that contributed to the solid growth in retail spending in recent months.
- The March quarter survey was in the field over 1-11 March.

Westpac-McDermott Miller consumer confidence



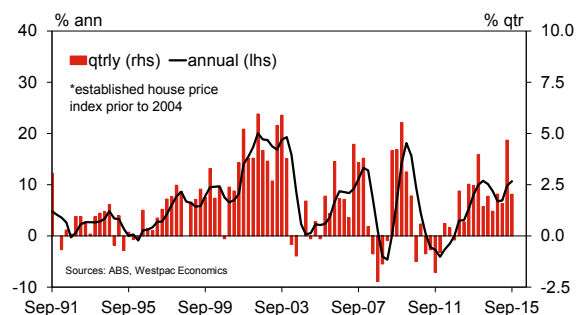
Aus Q4 residential property price index

Mar 22, Last: 2.0%, WBC f/c: -0.5%

Mkt f/c: 0.0%, Range: -1.0% to 2.7%

- Note that the ABS residential property price index is considerably more dated than private sector measures but still gains attention due to its 'official' tag. For Q3, it showed a 2%qtr rise lifting annual price growth to 10.7%.
- It's already clear that Q3 was a high water mark for price growth. Private sector measures registered Q4 price moves ranging from 1.6%qtr, 10.6%yr (Residex), to -0.1%qtr, 9.3%yr (APM), -0.4%qtr, 7.4%yr (REIA, houses only) and -1.4%qtr, 7.9%yr (CoreLogic RP Data). The ABS measure tends to track the APM series - as such we expect it to show a 0.5%qtr fall taking annual growth to 8%. Of more interest for informed observers will be the March update of the CoreLogic RP Data measure (due April 1) - daily updates are tracking a 0.8%qtr gain that would put prices up 2% for Q1 and 7%yr.

Residential property price index, ABS measure



Data calendar

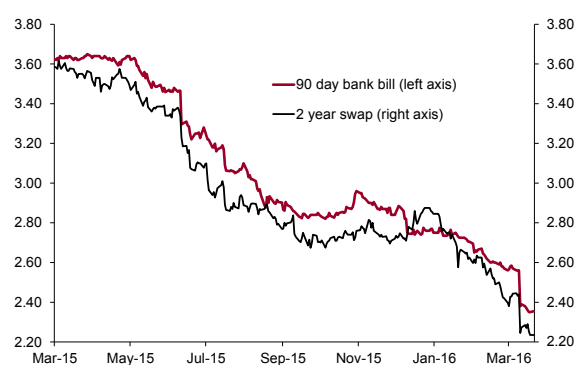
		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
NZ	Q1 Westpac-MM consumer confidence	110.0	-	-	Confidence picked up at the end of 2015.
	Feb net migration	6130	-	6260	Remains extremely strong as fewer kiwis leave and students arrive.
UK	Mar Rightmovehouse prices	2.9%	-	-	Low mortgage rates are supporting housing demand.
US	Feb Chicago Fed activity index	0.28	-	-	Growth remains about trend, albeit likely above long-term potential.
	Feb existing home sales	0.4%	-2.9%	0.2%	Recent months have seen considerable volatility.
	Fedspeak	-	-	-	Lockhart Speaks on U.S. Economy in Savannah, Georgia.
Chn	MNI March Business Indicator	-	-	-	Early barometer of business conditions.
Tue 22					
Aus	Q4 residential price index (ABS measure)	2.0%	0.0%	-0.5%	Q3 was a clear high-water mark for price growth cycle.
	RBA Governor, Glenn Stevens	-	-	-	ASIC Forum, session "Can we withstand a major global shock?", 4:30pm
	RBA Assist' Governor Financial System	-	-	-	Malcolm Edey, panel participant, ASIC Annual Forum, Sydney 11:45am
Eur	Mar ZEW survey of expectations	13.6	-	-	ECB critical to confidence in all sectors...
Ger	Mar IFO business climate survey	105.7	105.7	-	... and all nations.
UK	Feb CPI	-0.8%	0.4%	-	Oil prices are weighing on headline inflation; core higher but modest.
	Jan ONS house prices (% yr)	6.7%	-	-	Dated relative to other measures. Remains firm.
	Nov public sector borrowing, £b	-11.8b	-	-	Policy focused on a return to surplus; risk that goal isn't met this year.
US	Jan FHFA house prices	0.5%	0.4%	-	Moderate price growth continues.
	Mar Richmond Fed index	-4	-	-	Conditions for manufacturers remain challenging.
	Fedspeak	-	-	-	Bullard Speaks at Washington University in St. Louis.
	Fedspeak	-	-	-	Evans Speaks in Chicago.
Wed 23					
Eur	Mar consumer confidence	-8.8	-8.0	-	ECB critical to confidence in all sectors.
US	Feb new home sales	-9.2%	3.2%	-	Uptrend intact; 30-year mortgage rate supportive.
	Fedspeak	-	-	-	Harker Speaks in New York.
Thu 24					
NZ	Feb trade balance NZ\$m	8	100	300	Seasonal pickup in exports and lower fuel import prices.
Eur	Mar Markit manufacturing PMI	51.2	51.4	-	Manufacturing sector feeling impact of global economy...
	Mar Markit services PMI	53.3	53.4	-	... much more than services, which are more focused domestically.
Ger	Mar Markit manufacturing PMI	50.5	50.8	-	As for the region....
	Mar Markit services PMI	55.3	55.2	-	... so too for Germany.
UK	Feb retail sales	2.3%	-0.7%	-	Some pull-back after last month's sharp gain.
US	Initial jobless claims	265k	-	-	Claims remain at a very low level.
	Feb durable goods orders	4.7%	-2.5%	-	Trend in core orders remains very modest.
	Mar Markit manufacturing PMI	51.3	51.5	-	Remains more favourable than ISM survey.
	Mar Kansas City Fed index	-12	-	-	Conditions for manufacturers remain challenging.
	Fedspeak	-	-	-	Bullard speaks in New York.
Fri 25					
-	Good Friday	-	-	-	Public holiday, markets closed Australia, NZ, UK, Eur and Canada.
US	Q4 GDP, "final"	1.0%	1.0%	1.0%	Surprise upward revision in second estimate to be sustained.

New Zealand forecasts

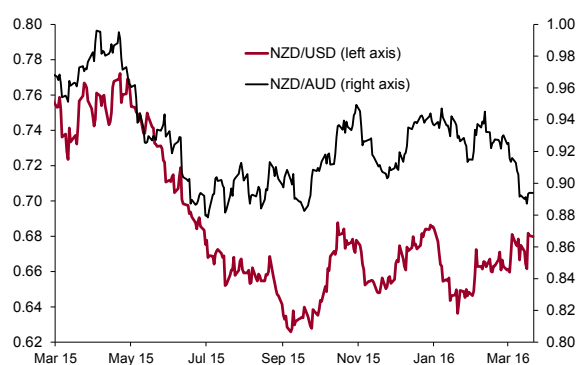
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	3.0	3.7	2.5	2.8	2.9
Employment	3.8	3.2	1.3	2.8	3.6	1.4	2.8	1.7
Unemployment Rate % s.a.	6.0	5.8	5.8	5.2	5.8	5.3	5.3	5.2
CPI	1.5	0.3	0.3	1.1	0.8	0.1	0.7	2.2
Current Account Balance % of GDP	-2.5	-3.4	-3.2	-3.3	-3.1	-3.1	-3.3	-3.6

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	2.80	2.90	3.00	3.10	3.10
10 Year Bond	3.00	3.10	3.30	3.50	3.60	3.60
NZD/USD	0.64	0.62	0.61	0.62	0.62	0.62
NZD/AUD	0.89	0.89	0.88	0.88	0.86	0.85
NZD/JPY	76.2	75.6	75.0	77.0	77.3	77.5
NZD/EUR	0.59	0.57	0.57	0.58	0.58	0.57
NZD/GBP	0.46	0.44	0.44	0.45	0.45	0.43
TWI	69.3	67.8	67.2	68.0	67.8	67.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 21 March 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.50%	2.50%
30 Days	2.31%	2.51%	2.54%
60 Days	2.33%	2.55%	2.57%
90 Days	2.36%	2.58%	2.61%
2 Year Swap	2.24%	2.44%	2.49%
5 Year Swap	2.53%	2.71%	2.75%

NZ foreign currency mid-rates as at Monday 21 March 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6798	0.6796	0.6643
NZD/EUR	0.6038	0.6179	0.5972
NZD/GBP	0.4708	0.4778	0.4660
NZD/JPY	75.88	77.46	74.71
NZD/AUD	0.8939	0.9173	0.9289
TWI	72.17	73.26	72.25

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	1.9	2.2
Unemployment %	5.3	5.8	6.2	5.8	5.9	5.7
Current Account % GDP	-4.4	-3.4	-3.0	-4.6	-4.5	-4.3
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	1.3	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	1.6	-0.1	0.6	1.1	0.7
Euroland						
Real GDP %yr	-0.8	-0.3	0.9	1.5	1.3	1.3
United Kingdom						
Real GDP %yr	0.7	1.7	3.0	2.5	2.3	2.1
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	3.6	3.9	4.2
World						
Real GDP %yr	3.4	3.3	3.4	3.0	3.4	3.5

Forecasts finalised 11 Mar 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	2.33	2.30	2.30	2.30	2.30	2.30
10 Year Bond	2.55	2.70	2.80	3.05	3.05	3.30
International						
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125
US 10 Year Bond	1.87	2.20	2.50	2.75	2.75	3.00
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	0.7650	0.72	0.70	0.69	0.70	0.72
USD/JPY	112.30	119	122	123	125	125
EUR/USD	1.1320	1.09	1.08	1.07	1.06	1.06
AUD/NZD	1.1170	1.13	1.13	1.13	1.14	1.17

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