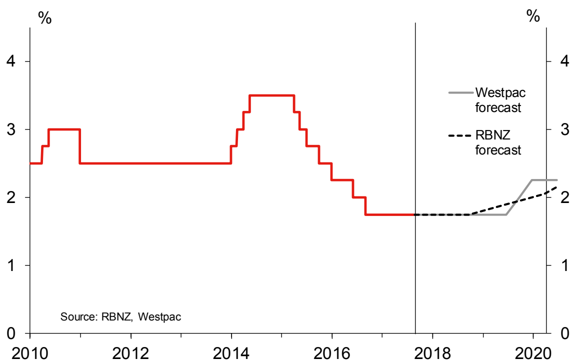
Tumbling Kiwi keeps RBNZ on track

MPS preview November 2017

2 November 2017

- We expect the RBNZ to keep the OCR on hold and give the same neutral policy guidance that it has given all year.
- We expect the OCR forecast to be the same as the August MPS – flat until 2019 and slowly rising beyond that.
- The economic outlook has deteriorated, and the housing market is weaker than the RBNZ anticipated.
- But the exchange rate has fallen sharply, meaning the overall outlook for medium term inflation is broadly unchanged.
- The change of Government makes the economic outlook more uncertain. The RBNZ is better off waiting and seeing how Government policy evolves, rather than making bold changes at this point.
- There would be very little financial market reaction to a neutral MPS along these lines.

RBNZ Official Cash Rate forecasts



Since early this year the RBNZ has been the Switzerland of central banks, remaining strictly and consistently neutral. The RBNZ has repeated the same bottom-line guidance paragraph, more or less unchanged, since February this year:

"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."

Correspondingly, the RBNZ has repeatedly published a flat forecast for the OCR, with OCR hikes in the picture only from 2019.

However, in recent times New Zealand's economic landscape has been changing. The construction sector seemed to stall for much of this year; GDP growth has been below expectations; businesses' confidence in their trading outlook has fallen; the house price boom came to a halt; and consumer spending has flat lined since April. To date the RBNZ has been running with very upbeat forecasts for economic growth and house prices into 2018, but this needs to change. The RBNZ will run with lower near-term GDP and house price forecasts in next week's *Monetary Policy Statement*.

On the other side of the ledger, inflation was higher than expected in the September quarter, and December is also shaping up as a high inflation quarter. But this has been almost entirely due to transitory factors such as petrol prices. It does not affect the deeper fact that underlying inflation is below the RBNZ's 2% forecast. Similarly, unemployment has been falling, but that is a lagging indicator. The outlook for the coming year still suggests that the RBNZ must keep interest rates low if it wants inflation to reach 2% on a sustained basis.

At the time of the September OCR Review, the RBNZ hinted that it was going to lower its GDP forecast. It said GDP growth was going to "maintain its current pace" rather than the previous phrase that growth would "improve". At the time, we argued that this could be a prelude to a more dovish tone in the November MPS. However, there was always an important caveat to that – we said "The remaining determinant of the overall tone in November will be the exchange rate. If it falls by enough to provide some prospective stimulus to inflation, the RBNZ would be able to leave its OCR guidance unchanged."

That is exactly what has happened. The exchange rate has fallen sharply and unexpectedly in recent weeks, mainly due to the election outcome. The Trade Weighted Index is now 6% lower than the RBNZ forecast in the August MPS. This will provide some much-needed stimulus to the RBNZ's inflation forecast, and will allow the RBNZ to run with the same OCR forecast as previously.

We now expect that the RBNZ will repeat the same guidance paragraph and issue the same flat OCR forecast as in recent Monetary Policy Statements.

The other reason to expect a "straight bat" from the RBNZ at next week's Monetary Policy Statement is that the election result has made the economic outlook so much more uncertain. The new Government is intent on change, and is prioritising its housing policies. This will have a difficult-to-determine negative impact on house prices over 2018. The Reserve Bank needs to reduce its house price forecast, which in turn will affect its consumer spending forecast. But it won't know where to pitch these forecasts until it hears more policy specifics. The Government plans to cancel next year's tax cuts, but to spend more over time – it won't be easy to anticipate the net impact on inflation until the exact policies are published. And so on and so forth. At this stage, the Reserve Bank is better off waiting and seeing what happens with Government policy, rather than reacting prematurely to policy changes that may or may not eventuate.

We do not expect the mooted changes to the Reserve Bank Act to make much difference to next week's OCR decision – the Acting Governor will be operating under current law for his entire six-month term, and is legally obliged to heed the current Policy Targets Agreement.

Apart from the unchanged OCR forecast and policy guidance paragraph, the key features of the MPS that we expect are:

- Reference to the improving world economy and rising global equity prices.
- Acknowledgement that the lower exchange rate, if sustained, will help to increase tradables inflation and deliver more balanced growth (previously, "A lower NZD **would** help…").
- Acknowledgement that the GDP outlook is weaker than in previous forecasts, partly due to less growth in construction than anticipated.
- Acknowledgement that house prices are lower than previously anticipated, although the outlook remains uncertain.
- The RBNZ may water down or remove its warning that headline in inflation will fall next year, since the lower exchange rate makes that less certain. However, we expect a repeat of the key sentence that "Non tradables inflation remains moderate but is expected to increase gradually … ,bringing headline inflation to the midpoint of the target range over the medium term."
- There would be very little financial market reaction to an MPS along the lines we propose.

Dominick Stephens
Chief Economist

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Shyamal Maharaj, Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary, and market colour. The material does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the

Disclaimer continued

Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request. Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;

(ii) physical separation of various Business/Support Units;

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

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.