16 September 2013

Weekly Commentary

Spring Lupines, Lake Tekapo

In this issue

Shine a light

The Reserve Bank inched one small step closer to hiking the OCR when it delivered its *Monetary Policy Statement* last Thursday. This time the likely OCR hiking cycle was described as taking place "next year", compared to the July missive which referred to an unspecified date "in the future". However, the RBNZ did reiterate its expectation that the OCR would be unchanged through 2013.

Compared to the pallid series of OCR hikes that was projected in the June *MPS*, last week's statement projected a substantial tightening cycle beginning around April next year and proceeding at a pace equivalent to one OCR hike per quarter. By the early 2016 cut-off for the published forecasts, the 90-day rate is projected to be at 4.7% (and rising) – a full 50 basis points higher than what was projected in June.

The RBNZ is sounding increasingly confident that the New Zealand economy has entered a sustained upswing, aided by a construction boom and further propelled by rising house prices. It estimates that activity has now by and large returned to its non-inflationary 'potential' level, and will rise above this point in coming years, putting more upward pressure on wages and prices.

But that picture hasn't changed dramatically in the last few months. Rather, what seems to have prompted the RBNZ to signal a greater series of OCR hikes is that some of its long-held assumptions are coming under threat. The RBNZ had taken the view that rising house prices would not provoke much extra consumer spending, and that the Canterbury rebuild would prove less inflationary than past construction booms. In contrast, we've long been saying that the inflationary effects of this cycle would be no different to past cycles. The recent evidence has been more in favour of our view, and by the July OCR review the RBNZ was acknowledging that too.

The RBNZ's new forecasts took into account the possible future impact on the housing market of the recent spike in fixed mortgage rates and the new restrictions on high loan-to-value (LVR) mortgage lending, which were announced in August. The RBNZ's

Shine a light

continued

forecasts assumed that the LVR restrictions will reduce the rate of house price inflation by 2.5 percentage points over the next year, making the tightening effect of the restrictions equivalent to 30 basis points' worth of OCR hikes. That seems reasonable to us. But the RBNZ must have decided that underlying pressures in the housing market had intensified appreciably, because the house price forecast in the September *MPS* was similar to that articulated back in June.

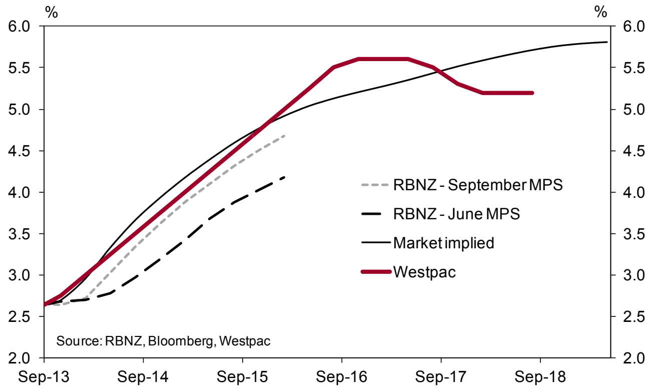
The RBNZ's new stance is similar to financial market pricing. And both now roughly agree with Westpac's long-held view. We have long argued that rising house prices and a construction boom would eventually provoke inflation pressures and would require a substantial OCR hiking cycle, similar to the experience of past decades. It is right for the central bank to warn markets and the public that a period of higher interest rates is coming. Indeed, moving early in this manner may limit the eventual extent of OCR hikes that are required – the anticipation of future OCR hikes has caused markets to push fixed mortgage rates up, which will slow the housing market earlier than OCR hikes on their own could have.

Given where market pricing has gotten to, we no longer feel that 'fixing' is better value than 'floating' for borrowers. In our view, long-dated interested rates are now a fair reflection of the upcoming cycle in short-term rates. If anything, there may be a few reasons to be wary of a near-term pull-back in interest rates.

First and foremost, if the Federal Reserve's much-vaunted 'tapering' announcement this week is a disappointment to markets, the New Zealand dollar will rise and the RBNZ will become less inclined to lift interest rates.

Secondly, we do suspect that the LVR restrictions and the sharp lift in fixed mortgage rates will produce a few months of weak housing market data, starting around October.

90-day rate expectations



And finally, this week's GDP data could be very weak. Until a few weeks ago it looked as if June quarter GDP growth would be 0.4%. But after a run of shocking partial indicators, we have revised our forecast to -0.1%. It seems the summer drought had a shorter and sharper impact on GDP than previously anticipated. March GDP was boosted by drought-stricken farmers slaughtering animals early, and in June we'll see payback for that. And we estimate that milk production fell 11% in June, contributing to an 8% fall in total agricultural production.

There are also a couple of non-agricultural factors that will compound the weakness in June quarter GDP. The Census work that featured in the March quarter was complete by June. And construction activity was surprisingly weak in the June quarter. (We suspect this simply reflects normal volatility in the survey of building work completed.)

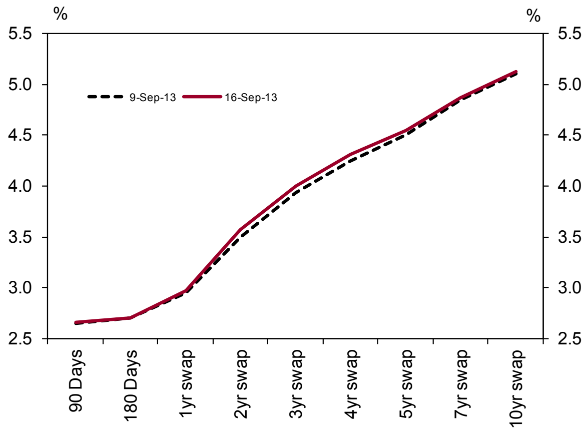
Such a weak GDP print could spook markets on the day. But a single quarter of weak GDP would do little to change our overall impression of the economy, given the veritable plethora of other evidence showing that the economy is clearly on a broad trajectory of improvement. Indeed, we have already revised our forecast of September GDP up from 0.8% to 0.9%, with an eye to taking it even higher depending on how this week's releases pan out.

Fixed vs Floating for mortgages

We are now indifferent between fixing and floating.

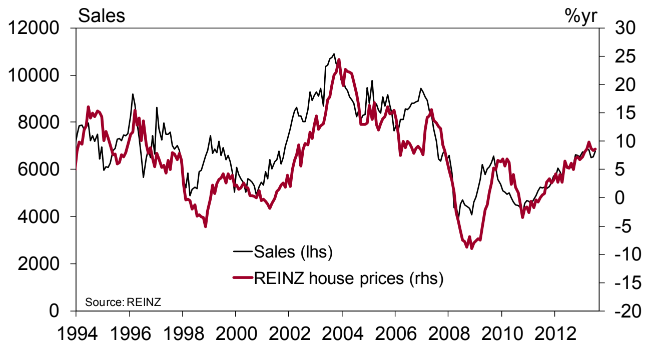
In our view, interest rate markets are now "fairly priced". We expect short-term rates to rise substantially over the next three years. The level of long-term fixed rates, which are higher than short-term rates, is in tune with that expectation. This means we can discern no obvious interest rate advantage in any particular term. The choice really comes down to individual circumstances and preferences.

NZ interest rates

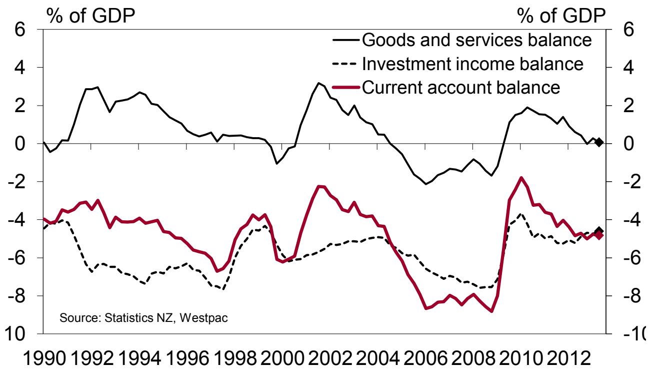


The week ahead

REINZ house prices and sales



NZ annual current account balance



NZ Aug REINZ house prices and sales

Sep 16, Sales last: 3.8%, Prices last: 8.6%yr

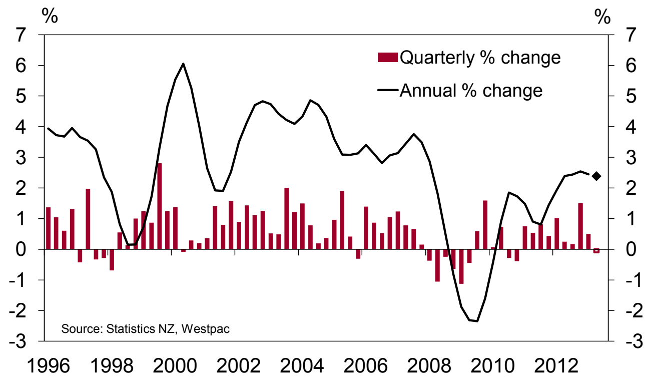
- House prices rose 0.5% in seasonally adjusted terms in July, lifting the annual growth rate slightly to 8.6%. Annual house price inflation has been around the 8-9% mark for the last six months.
- While sales ticked up in July, they appear to have stalled since the start of the year. Supply may be the constraining factor, with the stock of unsold homes falling to fresh record lows on a monthly basis. However, there are recent signs that higher prices are helping to induce more new listings.
- As of July, there was little evidence that housing demand was cooling of its own accord. That picture could well change in coming months: the RBNZ's new restrictions on high loan-to-value ratio home loans is likely to have some disruptive effect at least in the short term, but the substantial rise in fixed-term mortgage rates in the last few months might actually prove to be the more potent force.

NZ Q2 current account balance

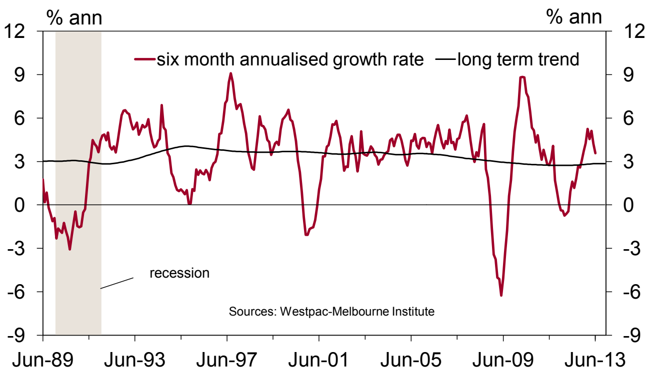
Sep 18, Last: -4.8%, WBC f/c: -4.8%, Mkt: -4.8%

- We expect the current account deficit to hold at 4.8% of GDP for the year to June. The goods balance deteriorated as export values fell on the back of the drought, while import values continued their steady increase. Both meat and dairy export volumes took the biggest hit, only partly offset by higher world dairy prices.
- The investment income deficit is expected to have widened relative to the March quarter (though with little change in the annual balance), as profits for overseas-owned firms in New Zealand strengthened in line with the rest of the economy.
- As with the GDP figures, the impact of the drought has been short and sharp. A recovery in volumes of primary exports, along with continued high dairy prices, will bolster the trade balance over the next year.

Production based GDP



Westpac-MI Leading Index



NZ Q2 GDP

Sep 19, Last: 0.3%, WBC f/c: -0.1%, Mkt: 0.2%

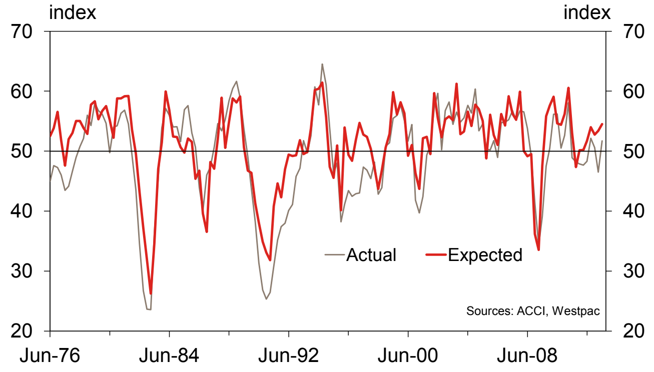
- We expect a 0.1% drop in June quarter GDP, with the direct impact of the drought knocking around 0.6 percentage points off the growth rate. While the drought had well and truly broken by June, the timing of its effects mean that the greatest hit to the level of production fell in this quarter.
- Stripping out the drought effect leaves underlying growth of around 0.5% – not spectacular, although it looks to have been more widespread compared to the March quarter, which was heavily skewed towards construction-related activities.
- Our forecast is towards the lower end of the range of market forecasts, although three of the four main trading banks are expecting a negative outturn. The impact of the drought on GDP has been more abrupt than expected; the flipside of this is that there is now more upside risk to our forecasts for the second half of this year.

Aus Jul Westpac–MI Leading Index

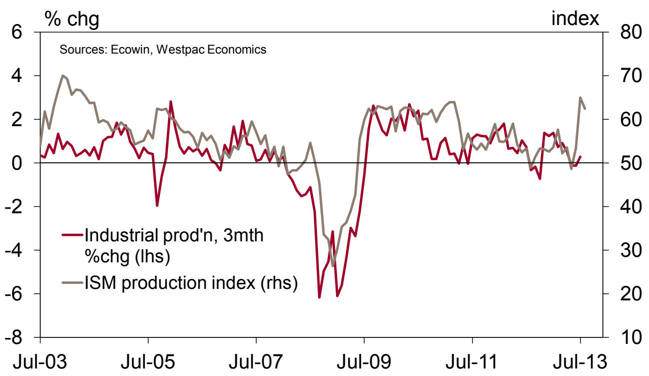
Sep 18, Last: 3.6% annualised

- The growth rate in the Leading Index has slowed over the last few months from 5.3% to 3.6%. That is the slowest annualised growth rate since November 2012 but still comfortably above the long term trend of 2.9%.
- The July reading will draw on a fairly mixed bag of indicators. It will incorporate updated monthly component data on: equities (ASX +5.4% vs –2.8% in Jun); money supply (+0.5% vs 0+.4% in Jun); dwelling approvals (+10.8%mth vs –6.9%mth in Jun) and US IP (flat vs +0.2%mth in Jun). It will also included updated quarterly data on: overtime worked (+17 vs –11 in Q1); manufacturing materials prices (–1.4% vs –0.7% in Q1); and national accounts based measures of productivity and corporate profits, both of which were weaker in Q2 vs Q1.

Westpac-ACCI composite indexesActual & expected, sa



US industrial sector



Aus Q3 Westpac-ACCI Survey of Industrial Trends

Sep 19, Last: 51.7

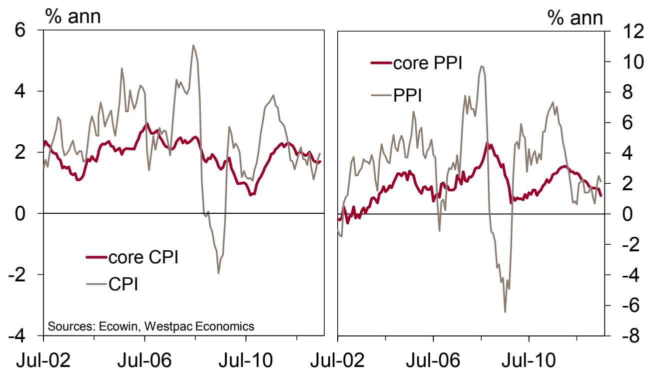
- The September quarter 2013 ACCI–Westpac Survey of Industrial Trends - the 208th report of this long running survey - will provide a timely update on current economic conditions and prospects. It was in the field from 8 Aug to 6 Sep.
- In the June quarter, the Westpac–ACCI Actual Composite rose from 46.5 to 51.7. The Expected Composite also rose to 54.5, from 53.4. The activity gain in the quarter only partly offset the decline seen in the three months prior. The depreciation of the AUD during the quarter arguably boosted expectations.
- Key for the September quarter release will be manufacturers' labour market and investment intentions. Growth in the Australian economy is decidedly sub-trend; with the mining investment boom cresting, there is a real need for momentum in other sectors of the economy.

US Aug industrial production

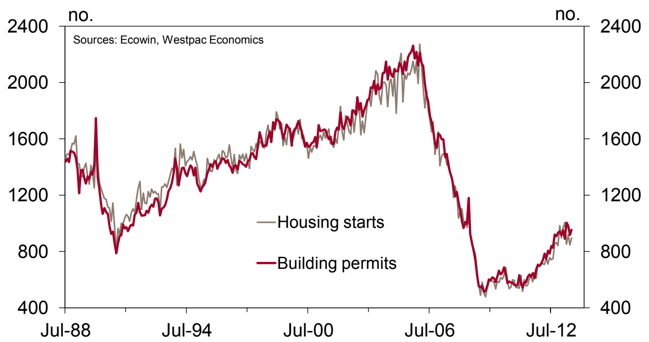
Sep 16, Last: 0.0%, WBC f/c: 0.6%

- US industrial production was flat in July with a fall in auto manufacturing pulling factory output down 0.1%, the utilities down 2.1% but higher weighted mining rising 2.1%. The sluggish industrial picture this year contrasts with the recent surging ISM factory survey
- Hours worked in factories rose 0.5% in Aug, so there should be some sort of bounce in Aug output, especially with ISM production component running above 60 in July-Aug, up from sub 50 in May.
- Less encouraging, core capital goods orders fell 3.3% in July, machinery orders were flat, and auto orders slowed. Mining is likely on an uptrend though.
- These factors point to a moderate Aug rise in IP for a change; our 0.6% forecast would be the strongest since Feb.

US price inflation



US housing starts & permits



US Aug CPI

Sep 17, CPI: Last: 0.2%, WBC f/c: 0.1%

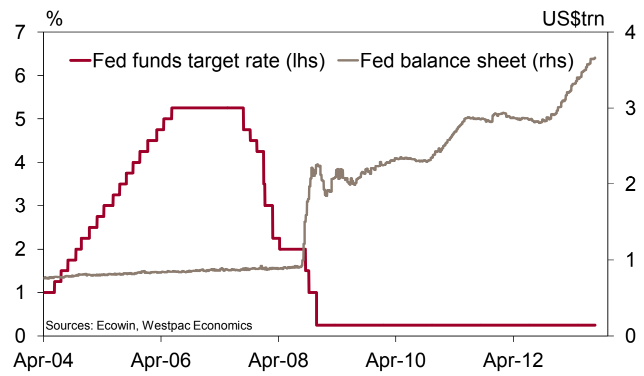
- The CPI posted a 0.2% rise in Jul. Energy prices rose 0.2% (gasoline 1.0%), food was up 0.1% and the core rate rose 0.2%. This is benign but not weak, with falls in auto and apparel and flat drug prices in the July PPI, not showing up in the CPI yet. Indeed apparel rose 0.6% on top of gains in May-June. The annual pace of gain for the headline accelerated to 2.0%, while the core rated edged up to 1.7% yr.
- Gasoline prices were little changed in Aug, perhaps slightly lower on average. Food prices should remain subdued. Clothing should correct lower. Elsewhere pressures are mild, unless the housing/rent component throws up a surprise.
- We expect a subdued 0.1% gain in both headline and core CPI, which should pull the headline annual CPI down to 1.6% yr.

US Aug housing starts/permits/existing sales

Sep 18, Housing starts: Last: 5.9%, WBC f/c: 0.0%
Sep 18, Housing permits: Last: 3.9%, WBC f/c: 0.0%
Sep 19, Existing home sales: Last: 6.5%, WBC f/c 0.0%

- Starts jumped 5.9% in July, and permits were up 3.9%, with a 26% jump in multiple starts and a 13% rise in multiples permits key factors at play. Despite the solid headlines, single family starts fell 2.2% in July, and permits were down 2.6%, suggestive of renewed fragility in the US housing recovery story.
- Meanwhile, existing home sales jumped 6.5% in July, their steepest rise since 2010, to a 5.39mn annualised sales pace. Year to date sales closures have risen 10%, in line with pending home sales which were up 9.5% ytd. The National Association of Realtors noted that rising mortgage rates had "panicked some buyers" into action. More recently, pending home sales have slipped.
- Our forecasts reflect a softer housing vibe in H2 2013.

Fed funds target rate and balance sheet



US FOMC decision - the taper question

Sep 18

- On the basis of the various tests laid out by Fed officials in recent months, the case for slowing the pace of asset sales has not been made. Payrolls jobs growth in the 3 months to Aug was the slowest since QE3 was commenced a year ago; core PCE inflation at 1.2% annualised in May-Jul is below the 1.4% pace in Q3 last year. GDP growth of 1.6% yr in Q2 was barely half the 3.1% yr pace the economy was running in that quarter. Chair Bernanke will announce downgraded forecasts for the economy, having said tapering would begin if the economy was on track to meet Fed forecasts.
- For some Fed officials, that is evidence that asset purchases should continue or be expanded further; for others, it's evidence QE doesn't work and isn't worth the possible risks. Maybe the best compromise is a token taper of $5bn offset by more dovish forward guidance so Bernanke can argue the overall policy stance has not been tightened.

Data calendar

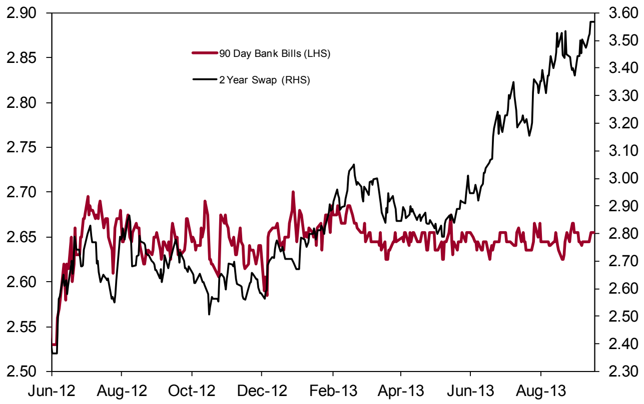
		Last	Market median	Westpac forecast	Risk/Comment
Mon 16					
NZ	Q3 Westpac-MM consumer confidence	116.6	-	-	Confidence has strengthened significantly since late 2012.
	Aug REINZ house sales	3.80%	-	-	A recent upturn in new listings could translate to higher turnover...
	Aug REINZ house price index %yr	8.60%	-	-	...while helping to ease the upward squeeze on prices.
	Aug Performance of Services Index	58.1	-	-	Consistently strong over the last six months.
Eur	Q2 labour costs %yr	1.60%	–	–	In downtrend since 2011.
	Aug CPI final %yr	1.6% a	–	–	Core rate was 1.1% yr in flash report.
UK	Sep house prices, %yr	5.50%	–	–	Rightmove index of asking prices - BoE/Treasury FFL scheme boost.
US	Sep Empire manufacturing survey	8.2	9	5	Orders and shipments detail were weak in Aug.
	Aug industrial production	0.00%	0.40%	0.60%	ISM survey strong, hours worked in factories up 0.5%.
Can	Aug existing home sales	0.20%	–	–	Little history to this series.
Tue 17					
Aus	RBA meeting minutes	–	–	–	Important elaboration given another brief Gov's statement in Sep.
	Aug new motor vehicle sales	–3.5%	–	1.80%	Impact from announced FBT changes has been minor to date.
Eur	Jul trade balance, €bn	14.9	–	–	Current account data out too.
Ger	Sep ZEW survey of analyst expectations	42	–	39	Recent weak partial data and Buba commentary cautious.
UK	Aug PPI %yr	1.10%	1.10%	1.00%	Core output measure.
	Aug CPI %yr	2.80%	2.70%	2.60%	Core inflation sitting on 2% target currently
	Jul ONS house prices	3.10%	–	–	Dated relative to private measures, but accelerating.
US	Sep NAHB housing index	59	59	57	Momentum in housing market looks to be slowing.
	Aug CPI	0.20%	0.20%	0.10%	Gasoline prices little changed; core pressures benign with occasional
	Aug CPI core	0.20%	0.10%	0.10%	component spikes (eg apparel) quickly reversed. See text box.
	Jul TIC data $bn	–66	–	–	Net long term flows, outflows recently (since Feb).
Can	Jul manufacturing sales	–0.5%	0.50%	–	Down 3 in last 4 months.
Wed 18					
NZ	GlobalDairyTrade auction	-1.10%	-	-	Prices expected to ease 10% by year-end as global supply picks up.
	Q2 current account % of GDP	-4.80%	-4.80%	-4.80%	Primary export volumes hit hard by drought.
Aus	Jul Westpac-MI Leading Index	3.60%	–	–	Slowed in H1 but stayed above trend rate of 2.9%.
Chn	Aug new property prices %net bal	85.70%	–	–	Surprisingly resilient this far out from the March iteration of controls.
Eur	Jul construction output, %yr	–3.0%	–	–	Lack of credit supply a big concern for sector, amongst many others.
UK	Bank of England minutes	–	–	–	Has recent upswing in UK data altered risks around Aug forecasts?
US	Aug housing starts	5.90%	2.40%	0.00%	Single family starts have been sluggish, at their low for the year in Jul
	Aug building permits	3.90%	–0.4%	0.00%	but multiples distort the headline picture. See text box
US	FOMC decision APP per mth $bn	85	75	80	Token $5bn tapering offset by dovish guidance. See text box.
Thu 19					
NZ	Q2 GDP	0.30%	0.20%	-0.10%	The toll of the drought fell most heavily in Q2.
Aus	Q3 RBA Bulletin	–	–	–	A treasure trove of economic analysis.
	Q3 Westpac-ACCI Survey	51.7	–	–	Timely update on Q3 conditions. Index avg'd 50 over past yr. See textbox.
UK	Aug retail sales incl. fuel	1.10%	0.00%	0.20%	Weather and royal baby boost to Jul less supportive in Aug
	Sep CBI industrial trends survey	0	–	–	Total orders series; selling price series also on 0 in Aug.
US	Initial jobless claims w/e 13/9	292k	–	350k	Claims bounce risk following systems upgrade distortion in prior wk.
	Q2 current account deficit $bn	106.1	96.8	–	Sharply lower monthly trade deficit in Q2.
	Sep Philadelphia Fed index	9.3	10	6	Orders, shipments and jobs detail all weaker in Aug.
	Aug existing home sales	6.50%	–2.4%	0.00%	Pending sales down 2 months running, mortgage rates higher.
	Aug leading indicators	0.60%	0.60%	–	Modest underlying macro trend apparent, despite hype.
Can	Jul wholesale trade	–2.8%	1.50%	–	June saw broadbased drop from record sales level.
Fri 20					
NZ	Net immigration, August (s.a.)	1980	-	1900	Positive net immigration is now contributing to NZ's economic upswing.
Eur	Sep consumer confidence	–15.6	–	–15.0	Consumers have found something to be optimistic about.
UK	Aug PSNCR, £bn	–19.6		–	Public sector net credit requirement. PSNB ex intv'ns £0.1bn in Apr.
	Fedspeak	–	–	–	Bullard, George and Kocherlakota.
Can	Aug CPI %yr	1.30%	1.10%	–	BoC core rate 1.4% yr in Jul.

New Zealand forecasts

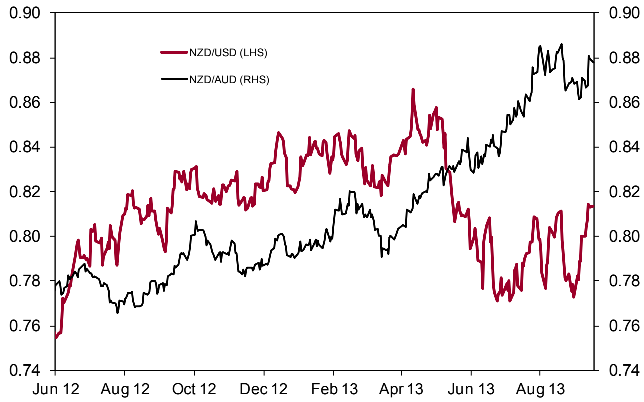
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.5	2.4	3.8	1.4	2.7	2.3	3.7
Employment	1.0	0.4	2.3	2.8	1.5	-1.4	3.5	2.9
Unemployment Rate % s.a.	6.8	6.2	5.7	4.8	6.3	6.8	5.9	4.9
CPI	1.6	0.9	1.6	2.5	1.8	0.9	1.5	2.3
Current Account Balance % of GDP	-4.4	-4.8	-5.2	-6.0	-4.0	-5.0	-4.9	-6.0

Financial Forecasts	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Cash	2.50	2.75	3.00	3.25	3.50	3.75
90 Day bill	2.75	3.00	3.25	3.50	3.75	4.00
2 Year Swap	3.40	3.50	3.60	3.80	4.00	4.20
5 Year Swap	4.20	4.20	4.30	4.40	4.50	4.70
10 Year Bond	4.30	4.30	4.40	4.50	4.60	4.70
NZD/USD	0.82	0.83	0.81	0.78	0.76	0.76
NZD/AUD	0.89	0.90	0.90	0.90	0.89	0.89
NZD/JPY	80.4	80.5	77.8	74.9	72.2	71.3
NZD/EUR	0.62	0.62	0.62	0.62	0.62	0.62
NZD/GBP	0.51	0.51	0.50	0.50	0.48	0.47
TWI	77.0	77.7	76.6	75.2	74.0	73.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 16 Sep 2013

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.64%	2.64%	2.63%
60 Days	2.65%	2.65%	2.64%
90 Days	2.66%	2.66%	2.64%
2 Year Swap	3.57%	3.42%	3.47%
5 Year Swap	4.55%	4.36%	4.35%

NZ foreign currency mid-rates as at Monday 16 Sep 2013

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8134	0.7765	0.8104
NZD/EUR	0.6114	0.5879	0.6080
NZD/GBP	0.5122	0.5003	0.5191
NZD/JPY	80.79	76.42	79.10
NZD/AUD	0.8778	0.8689	0.8827
TWI	76.45	73.66	76.09

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012	2013f	2014f
Australia						
Real GDP % yr	1.4	2.5	2.4	3.6	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.2	2.5
Unemployment %	5.6	5.2	5.2	5.4	6.2	6.4
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.4	-2.3
United States						
Real GDP %yr	-3.1	2.4	1.8	2.8	1.4	1.5
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.4	1.6
Unemployment Rate %	9.3	9.6	8.9	8.1	7.7	7.6
Current Account %GDP	-2.7	-3.0	-3.0	-2.8	-3.0	-3.1
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.7	2.2
Consumer Prices %yr	-1.3	-0.7	-0.3	0.0	-0.2	0.1
Unemployment Rate %	5.2	5.1	4.5	4.3	4.3	4.3
Current Account %GDP	2.8	3.6	2.0	2.1	2.0	2.0
Euroland						
Real GDP %yr	-4.3	1.9	1.5	-0.5	-1.0	-0.6
Consumer Prices %yr	0.3	1.7	2.7	2.2	1.4	1.2
Unemployment Rate %	9.5	10.0	10.1	11.7	12.4	13.0
Current Account %GDP	-0.2	-0.1	0.0	0.9	1.0	1.0
United Kingdom						
Real GDP %yr	-4.0	1.8	0.9	0.2	1.1	0.9
Consumer Prices %yr	2.2	3.2	4.0	2.8	2.3	1.8
Unemployment Rate %	7.6	7.8	8.4	8.0	8.5	8.5
Current Account %GDP	-1.3	-2.5	-1.9	-3.8	-2.5	-1.5
Forecasts finalised 9 August 2013						

Interest Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
Australia						
Cash	2.50	2.25	2.00	2.00	2.00	2.00
90 Day Bill	2.58	2.30	2.10	2.10	2.10	2.10
10 Year Bond	4.09	3.70	3.40	3.40	3.50	3.70
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.93	2.70	2.50	2.60	2.75	2.80
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
AUD/USD	0.9250	0.92	0.92	0.90	0.87	0.85
USD/JPY	99.80	98	97	96	95	94
EUR/USD	1.3280	1.31	1.31	1.28	1.23	1.20
AUD/NZD	1.1390	1.12	1.11	1.11	1.12	1.12

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