23 September 2013

Weekly Commentary

Spring Lupines, Lake Tekapo

In this issue

On course

The US Fed's decision to delay 'tapering' has sent the NZ dollar back into the stratosphere. While that in itself will make the RBNZ less keen to raise interest rates, the exchange rate is not the only thing in its reaction function. We believe domestic economic momentum continues to argue for a steady series of OCR increases starting in March next year.

It goes without saying that the number one event of the past week for financial markets was the US Federal Reserve's announcement that the US economy was not yet ready for an end to its programme of quantitative easing. That decision not to 'taper' sent the New Zealand dollar soaring back above US 83 cents, roughly where it was back in May, and we wouldn't be surprised to see it go higher.

Other developments last week also pointed in the direction of a higher exchange rate, though the market reaction was less pronounced. The June quarter GDP figures were stronger than expected. The current account deficit over the year to June was surprisingly small, at 4.3% of GDP, partly thanks to data revisions showing that New Zealanders' income from offshore investments is higher than previously thought. And global dairy prices continued to defy gravity in Fonterra's latest online auction.

Where does this leave the New Zealand interest rate outlook? In the near term, the Fed's decision to hold fire will almost certainly make the RBNZ less keen to signal interest rate hikes, and we could see an according shift in tone at the next OCR Review. The Reserve Bank's forecasts are very sensitive to 'portfolio' movements in the NZ dollar (changes in the exchange rate for reasons unrelated to New Zealand economic conditions). On a trade-weighted basis the exchange rate is now a full 4% above what the Reserve Bank was forecasting for the end of the year in its latest Monetary Policy Statement.

But monetary policy is not just about the exchange rate. We have long expected that the current economic upswing would be more pronounced, and generate more inflation pressure, than the RBNZ has so far considered likely. Indeed, our view has been that

On course continued

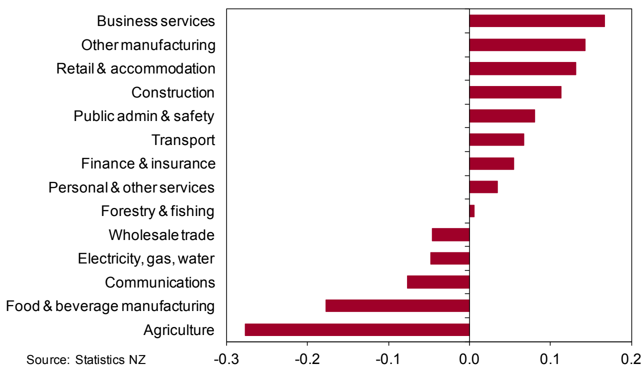
substantial interest rises from early next year would be required even if Fed 'tapering' was delayed. Put another way, our forecasts assumed no tapering and an exchange rate at 83 US cents by year-end, and so there is no reason for them to change as a result of the Fed announcement. If anything, this week's other developments – which generally suggest a stronger New Zealand economy – have made us more confident in our call.

Certainly, our forecast for annual GDP growth to accelerate to the high 3's next year looks more easily achievable after last week's GDP release. While the headline figure was a very soft 0.2% (not quite as soft as we had feared), that was due to the summer drought taking a serious bite out of food-related production. Other parts of the release painted a picture of considerable underlying economic strength.

Details are in last Thursday's bulletin,[1] but we'd draw special attention to the whopping 1.5% increase in private consumption spending. Combined with upward revisions to the last two quarters, the year-on-year rate of consumption growth is now 3.9%. Some of this could be pegged on the strong New Zealand dollar, which has depressed import prices and given consumers more bang for their buck – there was a 4% jump in spending on durable goods. But that won't explain the growth in spending on services – up 1.4% for the quarter and 4% on a year ago, the fastest annual growth since 2006.

These numbers should settle a debate that raged between us and the Reserve Bank earlier in the year: would a rising housing market stimulate consumption, much along the lines of past history, or would consumers (as the Reserve Bank believed) prove more conservative in the post-GFC era, thereby making the housing boom less relevant for inflation? The Reserve Bank began to abandon the latter view around June, and in our opinion the latest numbers lay any residual doubt to rest.

Percentage point contribution to Q2 GDP growth



If interest rates do rise from early next year as we expect, one important implication is that this will itself take some of the wind out of the sails of the housing market and consumer spending. Over the past year, we have consistently drawn close links between mortgage rates, housing market dynamics, and households' spending appetites. While mortgage rates were at record lows, that argued for ongoing house price inflation and accelerating consumption growth. But this is not a one-way street. We also warned that if interest rates were to rise, the housing market would cool.

Recall that our monetary policy outlook was effectively encapsulated in the recent sharp rises in fixed-term mortgage rates. This level of mortgage rates isn't high enough to presage an actual fall in house prices as in 2008, but combined with the Reserve Bank's upcoming mortgage restrictions it's sufficiently high to cause house price inflation to slow – perhaps closer to mid-single digits. The first symptoms of a slowdown would be a small reduction in turnover, a lengthening of the average time to sell, and an increase in the number of properties available on the market. We'd expect those symptoms to emerge around November this year.

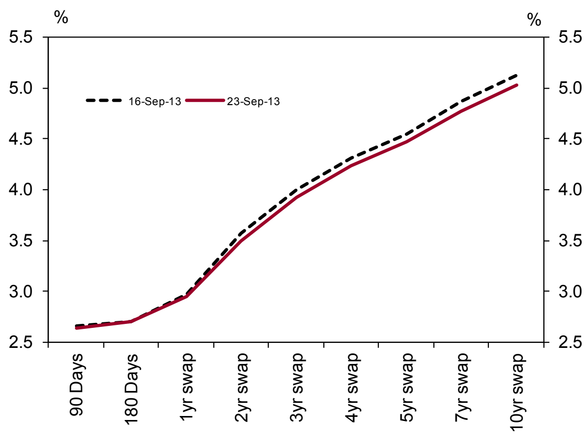
1 See 'On the march – NZ GDP review, Q2 2013', at http://www.westpac.co.nz/wib/economic-updates/economic-research-and-strategy/.

Fixed vs Floating for mortgages

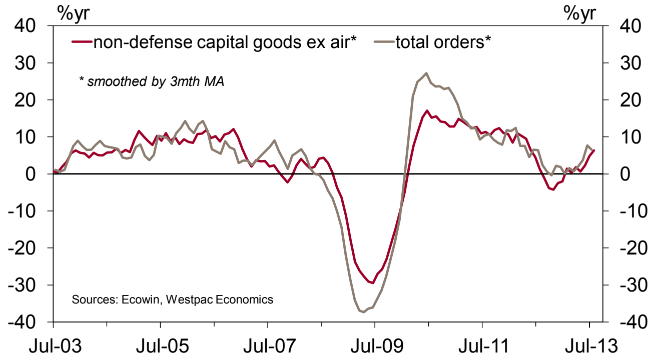
We are now indifferent between fixing and floating.

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.

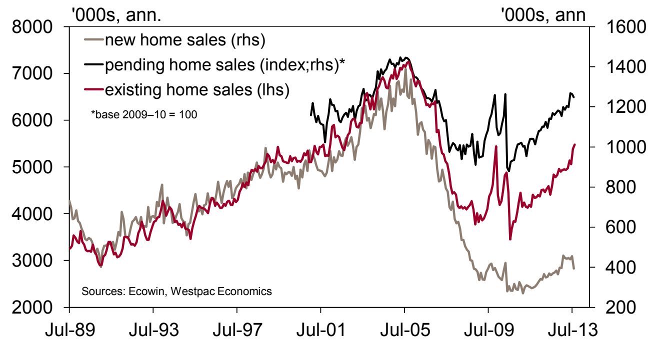
NZ interest rates



US durable goods orders



US housing sales



US Aug durable goods orders

Sep 25, Last: –7.4%, WBC f/c: 0.5%

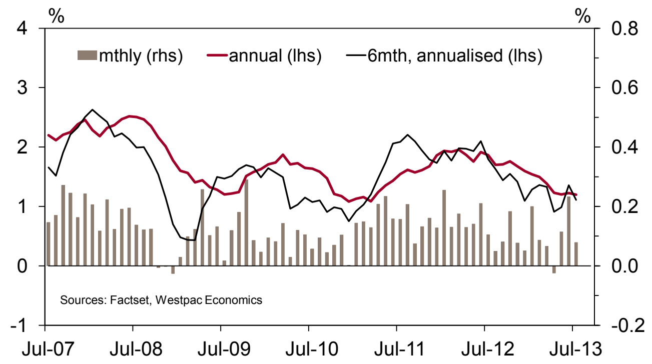
- Durable goods fell 7.3% in July, the steepest fall in almost two years. Once again volatile aircraft orders were a driving factor (down 52%) after a successful Paris air show for Boeing saw orders rise temporarily mid-year. Auto orders rose a modest 0.5% but defence posted a 22% fall after a cumulative gain of 80% through the June qtr. Core capital goods orders ex defence/aircraft fell 3.3% in July, the first fall in 5 months, but shipments of same fell for a second month, down 1.5%.
- ISM factory orders have risen from 49 to 63 since May, but regional Fed factory surveys revealed mixed/weaker orders. Boeing took just 16 orders in Aug from 90 in July but auto sales rose 2% and production was up 5%; business equipment output recovered July's 0.9% loss in Aug. These offsetting signals point to a modest headline gain at best. Core orders we expect to be flat or weaker, and shipments probably fell for a third month. Higher long term rates may be a factor at play.

US Aug new/pending home sales

Sep 25, New: Last: –13.4%, WBC f/c: 5.0%
Sep 26, Pending: Last: –1.3%, WBC f/c: –1.0%

- New home sales plunged 13.4% in July, and sales in prior months were revised down sharply. The July sales pace of 394k annualised is the weakest for the year so far. The slump in sales, despite an apparent shortage of established dwellings on the market, could be a further sign that higher mortgage rates are nipping the nascent housing recovery in the bud. Weekly mortgage applications are now at a five year low.
- Pending home sales fell 1.3% in July, so whatever hit the new market so hard (rising mortgage rates?) is yet to have the same impact on the established market (also new sales data are volatile are revised sharply). Pending sales are up 8.6% yr, existing sales are up 17.2% yr whereas new home sales after July's fall are up just 6.7% yr (all compared to July last year). New home sales may bounce in Aug but we see a weaker housing trend more generally into year end.

US core PCE deflator



US Aug PCE deflator, personal income & spending

Sep 27, Core PCE deflator: Last: 0.1%, WBC f/c: 0.1%
Sep 27, Personal income: Last: 0.1%, WBC f/c: 0.5%
Sep 27, Personal spending: Last 0.1%, WBC f/c: 0.2%

- Personal income and spending both grew just 0.1% in July, constrained by falling hours worked and earnings, and previous savings rundown. Meanwhile, the core PCE deflator rose by less than 0.1% in July although its three month annualised pace rose to 1.2% from 0.8% in May and June.
- A 0.2% rise in retail sales, despite a recovery in hours worked/earnings in Aug, suggests savings were built up last month. So personal spending won't have matched income growth.
- The core CPI rose 0.1% in Aug after 0.2% gains in each of May-Jun-Jul. With different weights, the core PCE has tended to track lower but 0.1% is likely again in Aug.

Data calendar

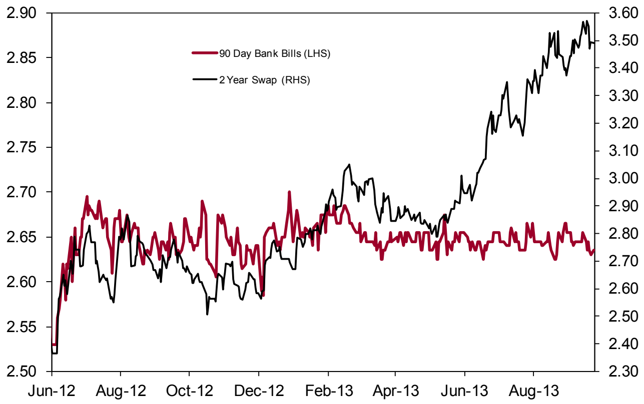
		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
Eur	Sep PMI factory adv	51.4	51.6	51	Recent hard data on orders, IP, exports has been less upbeat from
	Sep PMI services adv	50.7	50.9	50.5	Germany and France remains in contractionary PMI territory. We see
	Sep PMI composite advance	51.5	51.6	51.1	downside risks ahead for Eurozone growth.
US	Aug Chicago Fed national activity index	–0.15	–	–	Based on 80 or so data inputs, not a business survey.
	Fedspeak	–	–	–	Lockhart and Dudley.
Tue 24					
Ger	Sep Ifo business climate index	107.5	108	107.5	German economy just growing marginally on most indicators.
	Aug import prices %yr	–2.6%	–3.7%	–	Helping to constrain inflation.
UK	Aug mortgages no.	37.2k	38.0k	–	BBA data covering about 70% of the market.
US	Jul house prices %yr	12.10%	12.50%	–	S&P-Case Shiller 20 city index.
	Sep Conf Board consumer confidence	81.5	80.3	79	Uni of Michigan survey was weaker in Sep.
	Sep Richmond Fed factory index	14	–	8	Aug was highest since early 2011.
	Jul house prices	0.70%	0.90%	–	FHFA index.
	Fedspeak	–	–	–	Pianalto.
Can	Jul retail sales	–0.6%	0.50%	–	Flooding in Alberta impacted June retail sales.
Wed 25					
NZ	Aug merchandise trade $m	-774	-693	-600	The spike in world dairy prices peaked in August.
Aus	RBA Financial Stability Review	–	–	–	Half yearly update. Minutes of Sep Board meeting included commentary.
Ger	Oct GfK consumer confidence	6.9	7	–	Surveyed early Sep but labelled Oct. Aug was highest since 2007.
UK	Sep CBI retail survey	27	24	–	Reported sales index surged in Aug due hot weather, Royal Baby.
US	Aug durable goods orders	–7.4%	–0.1%	0.50%	Recent swings due aircraft; underlying story soft again; see text box.
	Aug new home sales	–13.4%	7.90%	5.00%	Recent upswing reversed and revised away. See text box.
Thu 26					
Eur	Aug money supply M3 %yr	2.20%	2.30%	–	Slowed from 3.9% yr peak in Oct 2012, LTRO paybacks a factor.
UK	Q2 GDP final	0.7% a	0.70%	0.70%	More detail on solid rebound in growth.
	Q2 current account £bn	–14.5	–10.0	–	Deficit data volatile and often revised.
US	Q2 GDP final	2.5% a	2.70%	2.60%	Q2 growth pace 1.6% yr half 3.1% pace when QE3 began in Q2 last yr
	Initial jobless claims w/e Sep 20	309k	–	–	Claims at pre-recession lows but hiring still not impressing.
	Sep Kansas City Fed factory index	8	–	4	Jul-Aug first back to back non-neg readings since Q3 last year.
	Aug pending home sales	–1.3%	–1.0%	–1.0%	House sales impacted by constrained supply, higher mortgage rates.
	Fedspeak	–	–	–	Kockerlakota
Fri 27					
Chn	Aug industrial profits %ytd	11.10%	–	–	Profit data - this series plus surveys - led the recent bounce in activity.
Eur	Sep business climate indicator	–0.21	–	–0.10	Business surveys remained upbeat despite weaker hard data, but
	Sep economic confidence	95.2	95.9	95.5	we question sustainability of upswing.
Ger	Sep CPI prelim %yr	1.50%	1.50%	–	1.5% is midpoint of recent April-July spike from 1.2% yr to 1.9% yr.
UK	Sep house prices %yr	3.50%	4.50%	–	Tentative date for Nationwide index due 27/9-10/2
US	Aug core PCE deflator	0.10%	0.10%	0.10%	Core CPI was 0.1% in Aug and core PCE likely to round down to 0.1%.
	Aug personal income	0.10%	0.40%	0.50%	Hourly earnings and hours worked recovered in Aug after July falls
	Aug personal spending	0.10%	0.30%	0.20%	Retail sales up 0.2% suggest some savings rebuild in Aug.
	Jun UoM consumer sentiment final	76.8 a	78	77.5	Latest equity upswing helpful.
	Fedspeak	–	–	–	George, Rosengren, Dudley. Also Evans in Oslo.
Can	Jul average weekly earnings	2.60%	–	–	Uptrend since late 2011 now stabilised.

New Zealand forecasts

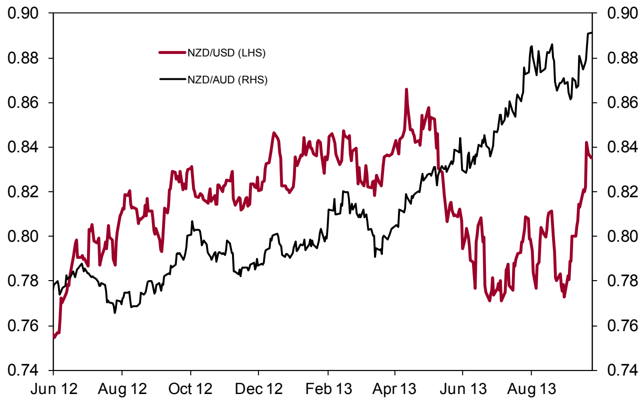
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.7	2.9	3.8	1.4	2.7	2.7	3.7
Employment	1.0	0.4	2.3	2.8	1.5	-1.4	3.5	2.9
Unemployment Rate % s.a.	6.8	6.2	5.7	4.8	6.3	6.8	5.9	4.9
CPI	1.6	0.9	1.6	2.3	1.8	0.9	1.5	2.1
Current Account Balance % of GDP	-3.8	-4.5	-4.4	-5.4	-3.6	-4.7	-4.2	-5.4

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	74.1	71.4	70.8
NZD/EUR	0.63	0.63	0.63	0.63	0.63	0.63
NZD/GBP	0.52	0.52	0.51	0.51	0.49	0.48
TWI	77.3	78.1	76.9	75.5	74.3	73.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 23 Sep 2013

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.63%	2.64%	2.62%
60 Days	2.63%	2.64%	2.63%
90 Days	2.64%	2.65%	2.65%
2 Year Swap	3.49%	3.48%	3.44%
5 Year Swap	4.47%	4.48%	4.40%

NZ foreign currency mid-rates as at Monday 23 Sep 2013

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8350	0.8007	0.7804
NZD/EUR	0.6161	0.6082	0.5831
NZD/GBP	0.5217	0.5123	0.5012
NZD/JPY	82.79	79.81	76.94
NZD/AUD	0.8914	0.8696	0.8636
TWI	77.80	75.64	73.62

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012	2013f	2014f
Australia						
Real GDP % yr	1.4	2.5	2.4	3.7	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.2	2.7
Unemployment %	5.6	5.2	5.2	5.4	6.0	6.5
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.6	-3.0
United States						
Real GDP %yr	-3.1	2.4	1.8	2.8	1.5	1.7
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	7.6	7.5
Current Account %GDP	-2.7	-3.0	-2.9	-2.7	-2.7	-2.9
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.9	2.4
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	-4.4	1.9	1.6	-0.6	-0.5	-0.4
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 September 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	2.55	2.30	2.10	2.10	2.10	2.10
10 Year Bond	3.95	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	2.70	2.50	2.60	2.75	2.80	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	0.9450	0.92	0.92	0.90	0.87	0.85
USD/JPY	99.30	98	97	96	95	94
EUR/USD	1.3540	1.31	1.31	1.28	1.23	1.20
AUD/NZD	1.1280	1.12	1.11	1.11	1.12	1.12

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