15 September 2014

Weekly Commentary

Castle Hill, Canterbury.

In this issue

A change of mood

The persistence of low inflation, despite an obvious acceleration in the pace of economic activity in New Zealand, has been a puzzle for forecasters and policymakers over the past couple of years.

Last week's *Monetary Policy Statement* revealed that the Reserve Bank has made some significant new judgements about the extent of inflation pressures in the economy, concluding that interest rates won't need to rise as quickly in order to keep future inflation in check.

We had already been contemplating the case for a slower pace of interest rate hikes, and in our latest *Economic Overview* we spent some time reviewing the factors behind low inflation in recent times and whether they would persist. But the sharp change in tone from the RBNZ made a change of call inevitable. These kinds of judgements are always difficult to anticipate, but now that the RBNZ has adopted them, they are likely to stay in place for some time. Consequently, we now think the RBNZ won't be prompted into raising the OCR again until June next year.

Significantly, it wasn't as change in the economic environment that motivated the RBNZ's shift – indeed, our expectation that the RBNZ would take a fairly balanced view of economic developments over the last three months turned out to be correct. Export prices and house price inflation have fallen, but only slightly more than the RBNZ had assumed in the June *Monetary Policy Statement.* Domestic activity has carried on much as expected, with the upturn becoming increasingly broad-based. And net immigration, which the RBNZ made quite a song and dance about in June, has been much stronger than previously forecast. If anything, the RBNZ has become more confident about the state of the domestic economy, judging by the upgrade to its GDP growth forecasts over the next year or so.

Instead, the RBNZ has taken a second look at some of the key links in its economic forecasts, in light of the subdued inflation outcomes to date. The economy is growing strongly, and the RBNZ remains of the view that GDP is now running more than 1% above its non-inflationary potential level. An output gap of that size would imply a

A change of mood continued

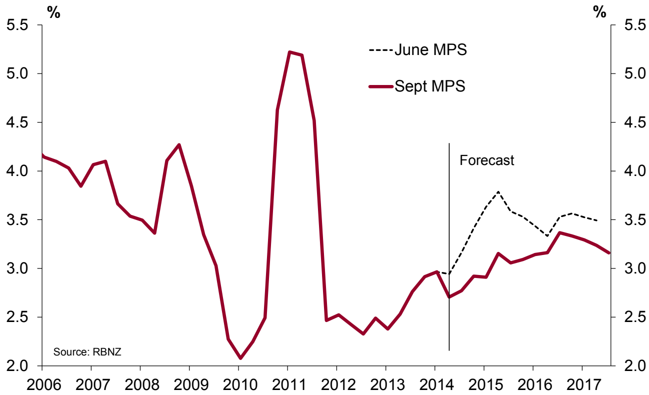
noticeable degree of inflation pressure, particularly in non-tradable goods and services. Yet non-tradables inflation has been persistently lower than expected. As a result, the RBNZ has substantially lowered its forecasts for non-tradables inflation, despite making little change to its assessment of the output gap.

In contrast, the lack of inflation in tradable goods in recent years has perhaps been more of a surprise but less of a mystery: low global inflation, the rise of internet retailing, and most importantly the persistent strength of the New Zealand dollar can plausibly account for this. The RBNZ hasn't changed its thinking on that front, and has actually lowered its exchange rate projections and consequently lifted its forecast of tradables inflation since June.

Another instance of the RBNZ's change of mood is in the housing market. Having strenuously argued the case for a strong link between net immigration and house price inflation earlier this year, the RBNZ is now taking the view that "net immigration is having a more muted and more lagged effect on house prices than in past cycles". Our own analysis agrees with this to some extent: we have long argued that the mid-2000s housing boom was mainly about low interest rates, tax changes, and rising inflation, rather than an imbalance between physical supply and demand. Consequently, we have argued that booming net migration will have only a relatively small effect on house prices this year. Nevertheless, we were very surprised to see the RBNZ alter its judgement so suddenly.

The bottom line of the RBNZ's forecasts remains that interest rates will need to rise from here in order to keep inflation near the 2% target over the medium term. But those rate hikes are now likely to be later and more gradual than previously thought. That message was reinforced in the accompanying media release, where the "period of assessment before interest rates adjust further" in the July OCR review became "a period of monitoring and assessment before considering further policy adjustment". In other words, the burden of proof for further rate hikes is now greater, and will take longer to accumulate.

RBNZ non-tradables inflation forecasts



The economic data over the last week is probably best described as being more of what the RBNZ had in mind when it made its latest judgements: robust activity but subdued price pressures. House sales ticked up slightly for a third straight month in August, while prices continued to rise gradually but at a much slower pace than last year. Electronic cards spending and the manufacturing PMI pointed to ongoing momentum in domestic demand. And food prices remained subdued, up 0.3% for the month but just 0.7% on a year ago.

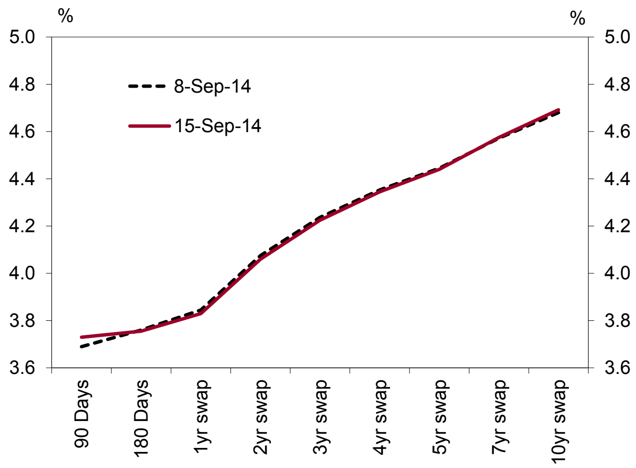
This week the focus will largely be on the June quarter national accounts. After three straight quarters of significantly above-trend growth, we expect the GDP figures on Thursday to show a slowdown to something closer to trend. The current account in Wednesday is expected to narrow slightly, with exports weakening over the June quarter this year as commodity prices fell, but still faring better than they did during last year's drought. The latest GlobalDairyTrade auction will also be of immense interest, given the continued slide in world dairy prices in the previous auction.

Fixed vs Floating for mortgages

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.

Among the standard fixed rates, the best deals for borrowers with a deposit of 20% or more are clustered around the two-year term, and these offer substantial value relative to where we expect shorter-term rates to go over the next two years. There is little point in fixing for just one year, given that these rates are higher than the two-year rate in most cases. Opting for three- or four-year terms would require higher payments up front, but could help to insulate the borrower if the Reserve Bank follows through with an extensive OCR hiking cycle.

NZ interest rates

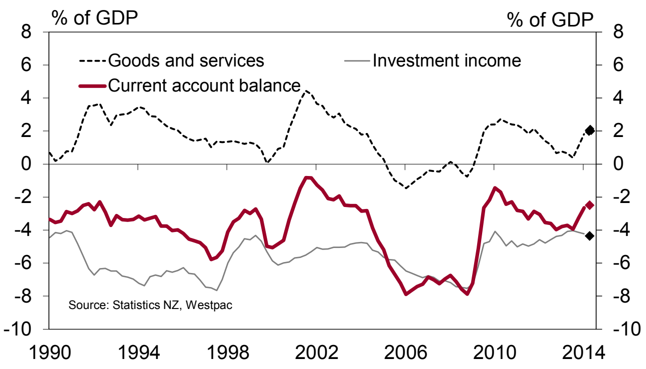


NZ Q2 current account % of GDP

Sep 17, Last: -2.8%, Westpac f/c: -2.5%, Mkt f/c: -2.5%

- We expect the current account deficit to narrow to 2.5% of GDP for the year to June, which would be the lowest since 2010. The improvement in the annual balance reflects the fact that, while conditions were getting tougher for exporters in Q2 this year, they were still better than the same time last year, when dairy export prices were high but volumes were devastated by drought.
- The Q2 release will incorporate a shift to the BPM6 international reporting standards and a range of other data improvements. Statistics NZ has indicated that new data on investment income earned overseas will have the effect of narrowing the current account deficit by 0.1-0.2% of GDP over the last two years.

Annual current account balance

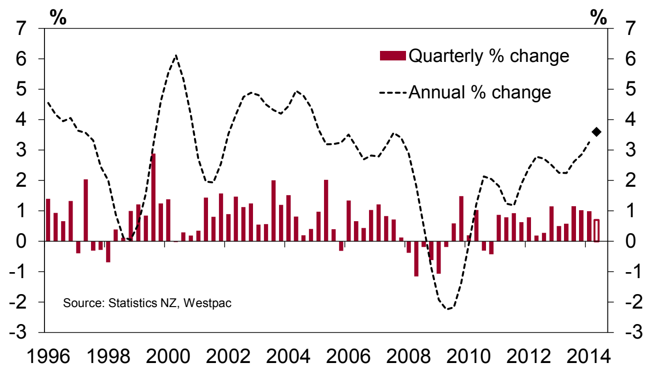


NZ Q2 GDP

Sep 18, Last: 1.0%, Westpac f/c: 0.7%, Mkt f/c: 0.6%

- We expect GDP growth to slow to 0.7% for the June quarter, after three straight quarters of growth of 1% or more. High-level economic indicators such as business confidence have softened since the start of the year, but only to levels that are more consistent with trend growth.
- Our estimate of the breakdown of growth suggests that the softening has largely been in the export-oriented primary sectors, with falling dairy and log prices prompting a drop in production.
- In contrast, growth in the domestically-oriented sectors remained robust. Construction won't feature as a driver of growth this quarter, but it is coming off a 12% rise last quarter.

Production based GDP

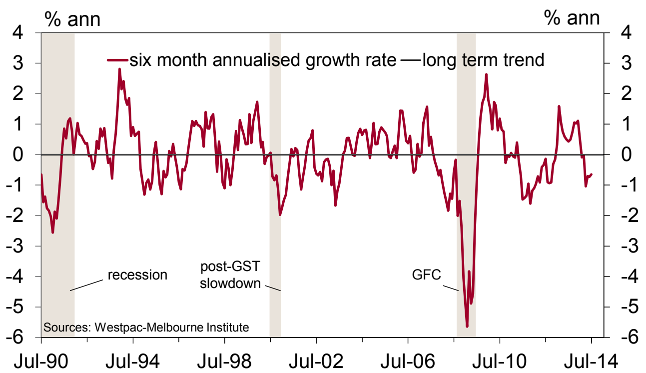


Aus Aug Westpac–MI Leading Index

Sep 17, Last: –0.65%

- The six month annualised growth rate of the Index has been growing below trend since Feb, indicating that growth in the Australian economy is likely to remain below trend over the remainder of 2014 with limited momentum into 2015. Notably recent readings have seen the main drag on momentum shift from the consumer to commodity prices and the yield spread.
- Components were again mixed in Aug: the ASX was flat after a strong 4.5% rise in July; the CSI Expectations Index fell 5.7%, consumers' unemployment expectations deteriorated (+2.1% indicating more consumers expect unemployment to rise), and the yield gap showed a further slight narrowing. Against this, dwelling approvals rose 4.2%; commodity prices were up 1.5% in AUD terms in Aug (but have fallen sharply so far in Sep); and hours worked were flat, a surprisingly subdued outcome in what was otherwise a wild Aug labour report.

Westpac-MI Leading Index

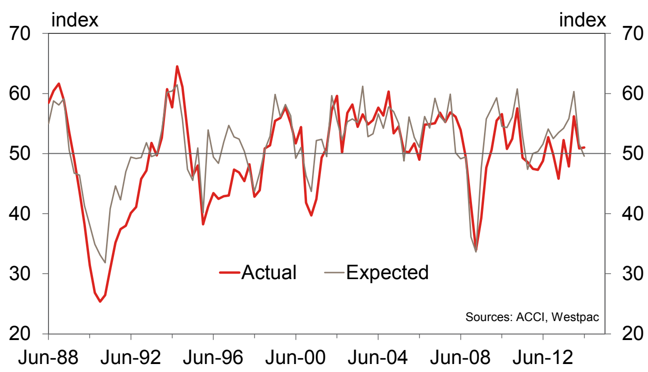


Aus Q3 Westpac-ACCI Survey of Industrial Trends

Sep 18, Last: 51.0

- The September quarter 2014 ACCI–Westpac Survey of Industrial Trends will provide a timely update on the manufacturing sector and insights into economy wide trends. The survey was in the field from August 12 to September 5.
- In the June quarter, the Westpac–ACCI Actual Composite held firm at 51.0. That was the third consecutive reading above 50, the first run of expansionary readings since 2011. The manufacturing sector is benefitting from a strengthening of household demand, including a strong bust of home building.
- New orders increased in Q2, with a net 4% reporting a rise and output edged higher, with a net +1% result.
- In the September survey, a key focus will be around the momentum of the current upswing. Record low interest rates are providing a tailwind but headwinds persist.

Westpac-ACCI composite indexes. Actual & expected, sa

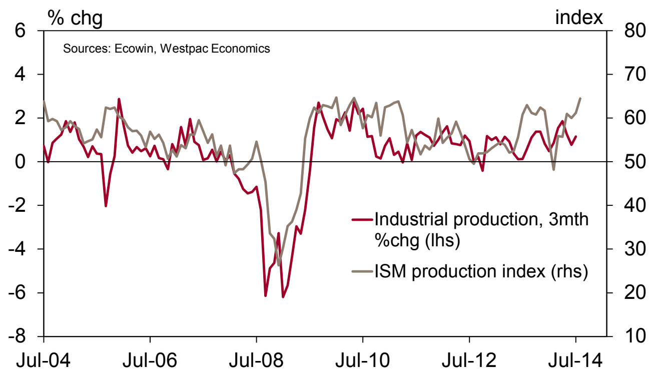


US Aug industrial production

Sep 15, Last: 0.4%, WBC f/c: 0.2%

- US industrial production rose 0.4% in July. Manufacturing was up 1.0%, its fastest rise since February, due to an outsized 10.1% jump in auto production which was related to shorter than usual summer plant shutdowns for retooling. With automakers looking to keep production at full tilt to meet demand, the July jump should not be fully reversed in August. Utilities fell 3.4% in July with cooler than usual weather reducing the need for aircon. Utilities have not posted a rise since the bitter winter in January but should rebound in August.
- Hours worked in factories were flat in Aug, and down for durables (autos) but ex auto manufacturing should hold July's 0.4% pace with ISM production component at new high in the month and core capital goods orders sharply higher at the start of Q3. These factors point to a modest Aug rise in IP but manufacturing risks a small fall due to autos.

US industrial sector

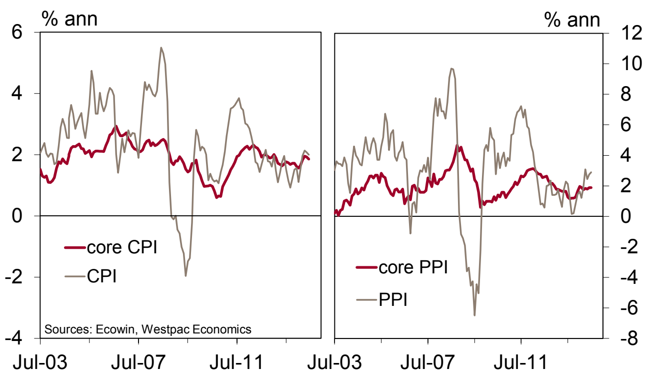


US Aug CPI

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

- The CPI is expected to post the first fall in over a year in Aug. We expect a small fall of 0.1% in the headline. Another subdued core CPI is likely, up 0.1%, with risks biased towards a 0.2%.
- The CPI rose 0.1% in July with a 0.4% rise in food prices (14% weight) mostly offset by a 0.3% fall in energy (10% weight). The annual CPI of 2.0% yr compared to 1.9% yr for the core, whose second consecutive 0.1% gain reflected modest yet above trend gains in rent (0.3%), clothing (0.2%) and new auto prices (0.3%), on trend medical care (0.2%) and a 0.3% fall in tobacco.
- Gasoline prices were down sharply in Aug. Food prices should soon turn. Further sub 0.2% core outcomes usually require one of more of autos, clothing, tobacco, rents and medical care printing declines or below trend outcomes.

US price inflation

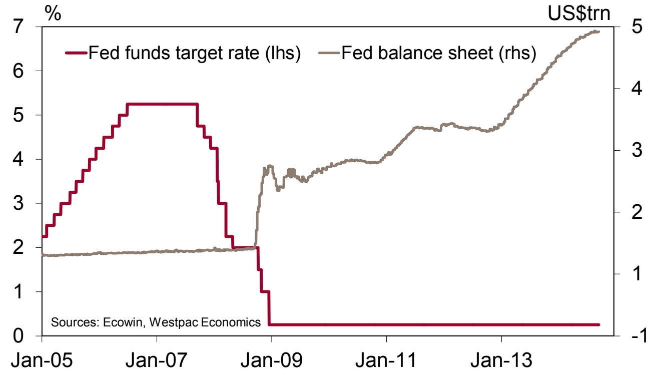


US FOMC to debate forward guidance tweaks

Sep 17

- This FOMC meeting is likely to agree the final round of asset purchases at a reduced $15bn pace, on the understanding that the program will be wound up at the October meeting.
- With Fed chair Yellen holding a press conference and presenting the new participants' forecasts, some on the committee will be anxious to rework the forward guidance which currently has the Fed funds rate unchanged "for a considerable time " after the purchases cease.
- Unchanged forward guidance would not reflect the progress the economy has made, they have argued. But others would be reluctant to send a signal that rate rises might be imminent, so would insist that any future decision to begin retightening would be data dependent, with the case not yet made.

Fed funds target rate and balance sheet

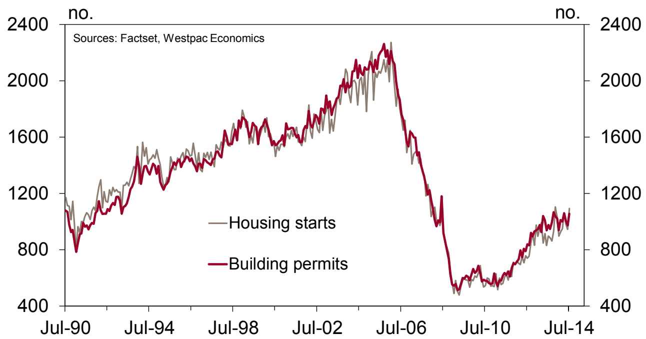


US Aug housing starts & permits

Sep 18, Housing starts: Last: 15.7%, WBC f/c: –7.0%
Sep 18, Housing permits: Last: 8.6%, WBC f/c: 1.0%

- Housing starts jumped 15.7% in July, reflecting a 29% jump in multiples (first rise in 3 months) and an 8.3% rise in single family starts.
- Housing permits rose 8.6% after falling 8.1% in May-June; multiples were the driver with a 28% July rise after a two month drop of 28%.
- Single family permits fell 0.5%, their third gain on the trot, for an annualised pace of 631k, lower than starts on 656k so possibly a constraining factor on starts later in Q3. New home sales fell in June and July, another constraining factor, but were 12.3%yr higher compared to July a year ago; single family permits were 3.9%yr higher, vs starts on 10.2%yr.

US housing starts & permits

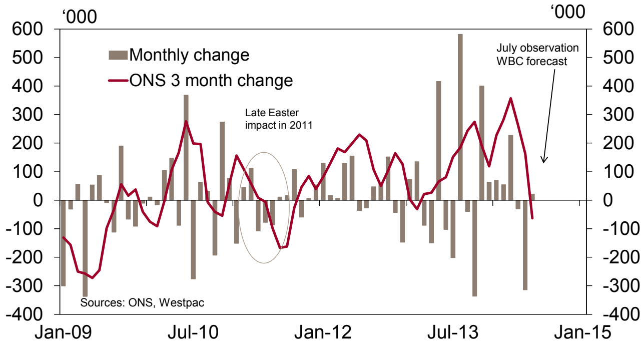


UK Jul employment

Sep 17, Employment 3m/3m: Last: 167k, WBC f/c: –65k

- To be representative of the population, the ONS publishes rolling 3 month avgs of monthly jobs estimates, each based on a third of the sample, so subject to higher variability on their own.
- Because Easter fell in late April this year, seasonal employment that typically terminates then boosted April to a 227k seasonally adjusted jobs gain after Q1's average 63k per month; May and June corrected with a cumulative 345k fall. But with April still in the latest quarter, ONS reported positive jobs growth in May (254k) and June (167k). In the July calculations, April shifts into the previous trimester making a July jobs fall, (the first since March 2013), very likely.
- We expect at best a 122k monthly rise, which the ONS would report as a –30k decline in the three months to July; and at worse, a 78k fall for an ONS print of almost –100k. We will be in the consensus surveys as –65k.

UK jobs to correct for Easter boost in July



Data calendar

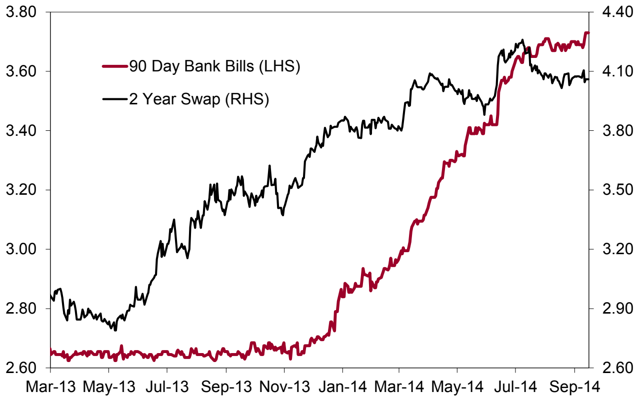
		Last	Market median	Westpac forecast	Risk/Comment
Mon 15					
NZ	Aug Performance of Services Index	58.4	–	–	Rebounded very strongly in July, but it is a volatile survey.
Aus	Aug new vehicle sales	–1.3%	–	–	In trend terms, sales edged 0.5% higher in July, to be –0.8%yr.
Eur	Jul trade balance, €bn	13.8	–	–	Persistent surpluses were a factor behind EUR gains but no longer.
UK	Sep house prices, %yr	5.3%	–	–	Rightmove index of asking prices; looking fragile?
US	Sep Empire manufacturing survey	14.7	16.0	10.0	Correcting for excessive mid-year strength.
	Aug industrial production	0.4%	0.3%	0.2%	ISM survey strong, factory hours flat (durables lower). Autos pullback
Can	Aug existing home sales	0.8%	–	–	Little history to this series.
Tue 16					
Aus	RBA Assist. Governor Economic	–	–	–	Chris Kent speaking at Bloomberg Economic Summit, Sydney 10am.
	RBA minutes of Board meeting	–	–	–	Additional colour around RBA thinking on economy, housing, AUD etc.
Eur	Q2 labour costs %yr	0.9%	–	–	In downtrend since 2011.
Ger	Sep ZEW survey of analyst expectations	8.6	–	0.0	Sentix fell to recessionary levels in Sep, ZEW hot on its heals.
UK	Aug PPI %yr	0.9%	0.9%	–	Core output measure.
	Aug CPI %yr	1.6%	1.5%	1.4%	Discounting, price wars, previous sterling appreciation.
	Jul ONS house prices	10.2%	–	–	Dated relative to private measures, but may have peaked in May.
US	Aug PPI final demand	0.1%	0.1%	0.2%	Relatively benign apart from occasional spikes in services costs.
	Jul TIC data $bn	–19	–	–	Net long term flows, outflows recently (since Feb).
Can	Jul manufacturing sales	0.6%	1.0%	–	Down 3 in last 4 months.
Wed 17					
NZ	GlobalDairyTrade auction	–6.0%	–	–	Dairy prices remain weak, little sign of a change in sentiment.
	Q2 current account % of GDP	–2.8%	–2.5%	–2.5%	An improved annual balance relative to last year's drought.
Aus	Aug Westpac–MI Leading Index	–0.65%	–	–	Stuck below trend for 6mths now, commodity price falls a bigger drag.
Chn	Sep MNI business indicator	59.0	–	–	Waxes and wanes as an effective lead on the flash PMI.
Eur	Aug CPI final %yr	0.3% a	0.3%	–	Core rate was 0.9% yr in flash report.
	Jul construction output, %yr	–2.3%	–	–	Mild weather earlier in year distorting seasonal patterns of activity.
UK	Bank of England minutes	–	–	–	Two dissenters for immediate hike in August; no backdown yet?
	Jul employment change 3mma	167k	113k	–65k	Late Easter effect jobs boost rolls back into prior period.
	Aug jobless claims	–34k	–	–20k	Slower jobs growth impact.
US	Sep NAHB housing index	55	56	57	Housing market still struggling to regain steady upward traction.
	Aug CPI	0.1%	0.0%	–0.1%	Gasoline prices sharply lower; core pressures benign with occasional
	Aug CPI core	0.1%	0.2%	0.1%	component spikes (eg apparel) quickly reversed.
	Q2 current account deficit $bn	111.2	114.5	–	Monthly trade deficit widened modestly in Q2.
	FOMC decision APP per mth $bn	25	15	15	Likely last decision to keep buying assets.
Thu 18					
NZ	Q2 GDP	1.0%	0.6%	0.7%	Softer primary production but domestic growth remained robust.
Aus	Q3 RBA Bulletin	–	–	–	Quarterly bulletin includes research articles.
	Q3 Westpac–ACCI Survey of Ind. Trends	51.0	–	–	A timely update on Q3. In Q2, Actual Composite was steady at 51.0.
Chn	Aug 70 city house prices NEW %net	–88.6%	–	–	Previous cycle low was –75.7%, surpassed in July.
	Aug 70 city house prices 2'ndary %net	–91.4%	–	–	Secondary market hampered by discounting of new/off-plan.
UK	Aug retail sales incl. fuel	0.1%	0.4%	0.2%	Volumes may have picked up with extended discounts.
	Sep CBI industrial trends survey	11	10	–	Total orders series; selling price series also on –1 in Aug.
	Scottish independence referendum	–	–	–	Yes vote late surge in polls makes this one a nail-biter.
US	Initial jobless claims w/e 13/9	315k	–	298k	Labor Day holiday may have distorted claims higher at start of month.
	Aug housing starts	15.7%	–5.3%	–7.0%	Single family starts up over 8%, multiples boost too.
	Aug building permits	8.6%	–2.1%	1.0%	Single family permits have less upward momentum.
	Sep Philadelphia Fed index	28.0	22.5	15.0	Orders, shipments and jobs detail all weaker in Aug.
	Mar payrolls benchmark revision prelim	–	–	–	Estimate of payrolls under/overshoot based on March universe count.
Fri 19					
NZ	Aug net migration	4,540	–	4,300	Strong monthly flows to continue, boosted by a pickup in arrivals.
Eur	Jul current account balance, €bn	13.1	–	–	Persistent surpluses were a factor behind EUR gains but no longer.
Ger	Aug PPI %yr	–0.8%	–	–	Euro depreciation may limit downside from here.
US	Aug leading indicators	0.9%	0.4%	–	May to July strongest triple month reading since late 2009.
Can	Jul wholesale trade	0.6%	–	–	Building materials and farm supplies boost.
Sat 20					
NZ	General Election	–	–	–	Polls leaning towards a National-led government.

New Zealand forecasts

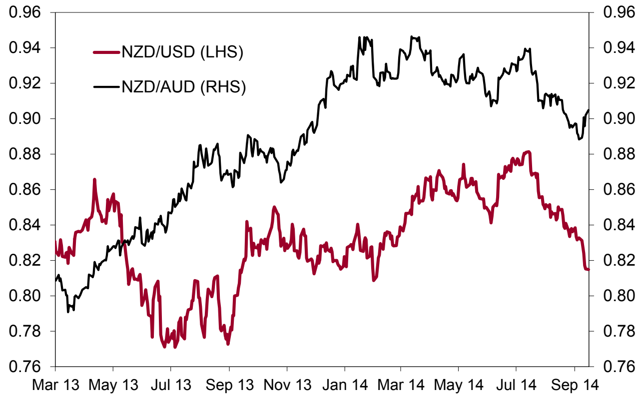
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2012	2013	2014f	2015f
GDP (Production) ann avg	2.3	3.3	3.4	3.2	2.5	2.9	3.6	3.2
Employment	0.4	3.8	2.8	2.6	0.4	2.9	3.0	2.9
Unemployment Rate % s.a.	6.2	5.9	5.3	4.7	6.8	6.0	5.4	4.7
CPI	0.9	1.5	1.7	2.1	0.9	1.6	1.4	2.0
Current Account Balance % of GDP	-3.9	-2.8	-5.0	-5.0	-4.1	-3.4	-3.8	-5.3

Financial Forecasts	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Cash	3.50	3.50	3.75	4.00	4.25	4.50
90 Day bill	3.70	3.70	3.90	4.20	4.40	4.60
2 Year Swap	4.20	4.40	4.60	4.80	5.00	5.10
5 Year Swap	4.60	4.80	5.00	5.10	5.20	5.30
10 Year Bond	4.40	4.70	4.80	4.90	5.00	5.10
NZD/USD	0.83	0.84	0.84	0.84	0.84	0.84
NZD/AUD	0.92	0.93	0.91	0.90	0.89	0.88
NZD/JPY	85.5	87.4	88.2	89.0	89.9	90.7
NZD/EUR	0.65	0.66	0.66	0.66	0.65	0.65
NZD/GBP	0.53	0.52	0.50	0.49	0.47	0.46
TWI	79.8	80.8	80.1	79.9	79.6	79.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 15 September 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.66%	3.66%	3.65%
60 Days	3.67%	3.69%	3.67%
90 Days	3.73%	3.71%	3.69%
2 Year Swap	4.06%	4.08%	4.05%
5 Year Swap	4.44%	4.36%	4.38%

NZ foreign currency mid-rates as at Monday 15 September 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8149	0.8353	0.8491
NZD/EUR	0.6280	0.6362	0.6341
NZD/GBP	0.5008	0.5034	0.5073
NZD/JPY	87.36	87.04	86.87
NZD/AUD	0.9049	0.8959	0.9115
TWI	78.19	78.92	79.59

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013	2014f	2015f
Australia						
Real GDP % yr	2.3	2.6	3.6	2.3	3.2	3.2
CPI inflation % annual	2.8	3.0	2.2	2.7	2.3	2.8
Unemployment %	5.2	5.2	5.3	5.8	6.4	6.1
Current Account % GDP	-3.5	-2.8	-4.4	-3.3	-3.0	-2.0
United States						
Real GDP %yr	2.5	1.8	2.3	2.2	2.0	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.9	1.9
Unemployment Rate %	9.6	8.9	8.1	7.4	6.3	5.7
Current Account %GDP	-3.0	-2.9	-2.9	-2.4	-2.5	-2.4
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.6	1.6	1.4
Euroland						
Real GDP %yr	1.9	1.6	-0.6	-0.4	0.7	1.0
United Kingdom						
Real GDP %yr	1.7	1.1	0.3	1.8	2.6	2.1
China						
Real GDP %yr	10.4	9.3	7.7	7.7	7.4	7.5
East Asia ex China						
Real GDP %yr	7.8	4.4	4.0	4.0	3.9	5.0
World						
Real GDP %yr	5.2	3.9	3.2	3.0	3.1	3.7
Forecasts finalised 5 September 2014						

Interest Rate Forecasts	Latest	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.75	3.00
90 Day Bill	2.65	2.55	2.55	2.65	3.00	3.25
10 Year Bond	3.62	3.60	3.80	4.20	4.50	4.70
International						
Fed Funds	0.125	0.125	0.125	0.125	0.250	0.500
US 10 Year Bond	2.55	2.70	2.70	2.80	3.20	3.20
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
AUD/USD	0.9060	0.90	0.90	0.92	0.93	0.94
USD/JPY	107.30	103	104	105	106	107
EUR/USD	1.2920	1.27	1.27	1.28	1.28	1.29
AUD/NZD	1.1090	1.08	1.07	1.10	1.11	1.12

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