22 September 2014

Weekly Commentary

Castle Hill, Canterbury.

In this issue

More of the same

The weekend's general election returned an increased majority to the ruling coalition of National, ACT, United Future and Maori.

In theory National could govern alone with its 61 seats, but we doubt that this fact is particularly significant for the trajectory of policy or the economy. While we are yet to hear exactly what the coalition deal will be, at this stage it looks as though the election result spells "more of the same" for the economy.

Of course, some market prices will change as the risk of a change of government is priced out. The most obvious example will be the share price of electricity companies, which could have been affected by a change in regulation had Labour and Greens taken power. Similarly, removing the possibility of capital gains tax (for the next three years at least) will provide a modest boost to the markets for houses and farmland. Correspondingly, we expect to see the New Zealand dollar and interest rates rise slightly when markets open this morning.

There was nothing in the election result that requires us to change our economic forecasts, which were always predicated on a return of the National-led coalition. Quite separately, we have lowered our dairy payout, exchange rate, and GDP forecasts this week, in response to weak global dairy prices and economic data suggesting that the Chinese economy may remain subdued for longer than previously anticipated. We now expect the New Zealand dollar to average 81 cents against the US dollar in the December 2014 and March 2015 quarters. We still expect the exchange rate to rally back to 84 cents over the June quarter of 2015 as OCR hikes resume and dairy prices recover.

With the election over, attention will return to local economic data. Last week's GDP release showed that the New Zealand economy grew 0.7% in the June quarter – a step down from the 1% or more per quarter we had been experiencing over the preceding nine months, and bang in line with our forecast.

The pace of GDP growth in June was close to New Zealand's current potential growth rate, meaning inflation pressures were neither inflamed nor hosed down in the quarter. Of course, the economy had been growing faster than its non-inflationary speed limit

More of the same continued

across much of 2013 and early-2014, creating the environment of steadily rising non-tradable inflation that we observe today.

Beneath the headline, the June quarter GDP figures showed a clear parting of ways between slowing export sectors and booming domestic demand.

The domestically-focused service industries that make up around 70% of GDP had a particularly strong run, growing by a combined 1.4% – the biggest quarterly increase since December 2006. Business services made the strongest contribution, but there were also sizeable gains in wholesaling, retail trade, transport and personal and social services.

The construction sector grew by 2.2%, after 12.5% growth last quarter. Construction activity has now registered 52% growth since March 2011. The construction boom was originally confined to the earthquake-affected Canterbury region, but lately Auckland construction activity has ramped up, and construction activity across many other parts of New Zealand is showing signs of life.

The main points of weakness in the GDP figures were in export-oriented sectors. Dairy production fell by 5% in seasonally adjusted terms due to weather conditions. Production levels were very strong in the March quarter thanks to unusually favourable weather conditions, and normalised in the June quarter. There was a commensurate 1.1% fall in food and beverage manufacturing. Forestry production fell by 3.5% as lower log prices reduced the incentive to harvest, and mining production fell.

Some might have been surprised to see GDP growth holding up so well in the face of the sharp drop in dairy and forestry export prices we experienced in the June quarter. Actually, the ups and downs of export prices have only a small bearing on the volume of goods and services produced in New Zealand, which is what GDP measures.

The impact of falling export prices shows up more obviously in incomes. Over year to June 2014, Gross National Disposable Income (GNDI) rose 7.8%, the biggest annual increase since records began in 1987. This reflected the huge surge in export prices over 2013 and early 2014. But in line with the sharp reversal in export prices that began a few months ago, GNDI actually fell by 0.5% in the June quarter. And of course, we expect GNDI to fall hard over the year ahead as incomes in the dairy sector drop away.

On that note, last week we adjusted our forecast of Fonterra's farmgate milk price for the current season, to $5.30 per kilogram of milk solids. This is well below Fonterra's most recent forecast of $6.00 per kg, and is probably below operating costs for some dairy farmers. Note that Fonterra's own forecast will probably be revised down later this week.

This drop in dairy income will undoubtedly be important to New Zealand. However, we expect the construction and population booms, combined with very strong performances in other export industries such as meat and tourism, will conspire to maintain GDP at an above-trend pace of around 3.1% annual growth for 2015.

The juxtaposition between falling dairy incomes and strong domestic demand will eventually cause the current account deficit to widen. Domestic expenditure on imports will continue apace, and foreign-owned firms operating in New Zealand will remain profitable. Both count as debits on the current account balance. But current account credits will drop away as export incomes fall. This week's figures showed that the annual current account deficit for June 2014 was 2.5% of GDP, but we expect that to widen to 5% over the year ahead.

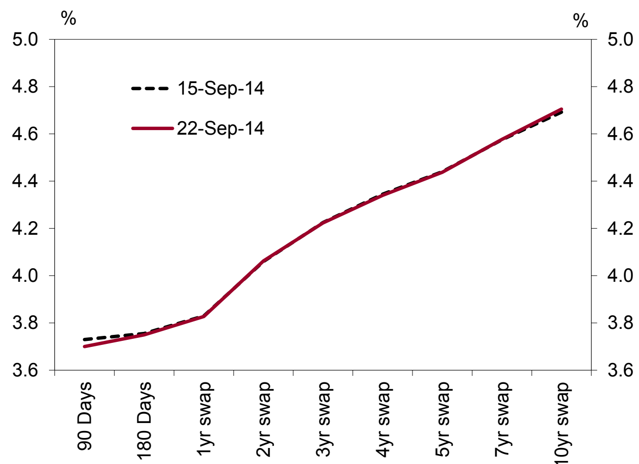
Finally, last week's net immigration data hit a new all-time high in annual terms, on the back of the second-biggest monthly net inflow of migrants on record. Net immigration has contributed 43,483 people to New Zealand's population over the past year. Our forecast for net immigration of 50,000 people by March 2015 was controversial just a few months ago, but now looks a touch light. Net immigration has in the past exacerbated cycles in economic growth, and this time will be no exception. In its latest Monetary Policy Statement, the Reserve Bank mused that net immigration might be having a more muted impact on inflation than normal, because the early stages of the net immigration boom was mainly about fewer New Zealanders leaving rather than foreigners arriving. But that situation has reversed. The stunning surprise in net immigration over the past four months has been due to a surge of foreign arrivals.

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

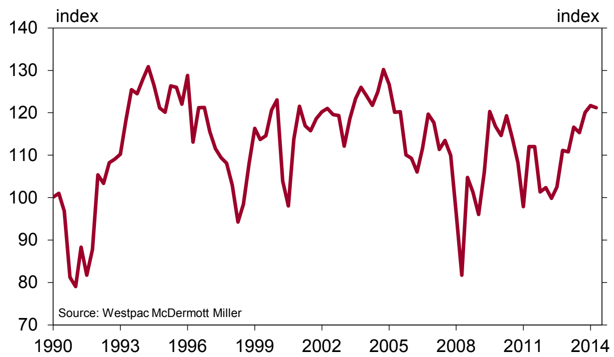


NZ Q3 Westpac-MM Consumer Confidence

Sep 22, Last 121.2

- Consumer confidence remained relatively unbowed in the June quarter, easing just a touch as key indicators of the economy started to come off the boil.
- While economic optimism has eased, survey results to date suggest there has been relatively little impact from rising interest rates.
- The September survey was conducted over 1-12 September, as the country geared up for the general election on September 20.

Westpac-McDermott Miller consumer confidence

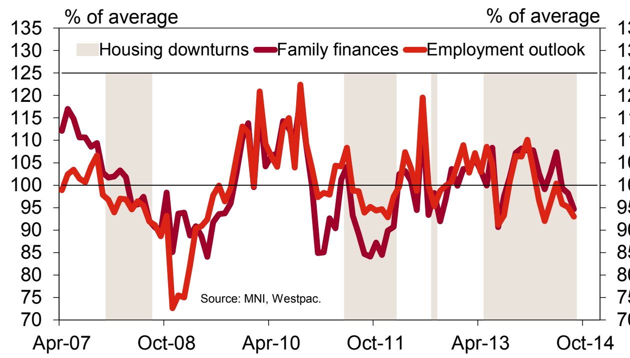


China Sep Westpac-MNI Consumer Sentiment

Sep 24 Last: 113.3

- The headline index fell to 113.3 in August from 114.8 in July, a –1.3% change over the month and –2.4% over the year. The August outcome was 6.8% below the long run average.
- We noted at the time of both the August and July releases that households were less impressed with the state of the economy than the two PMIs. Given the much softer than expected official data over the last two months, it seems that the instinctive scepticism of the consumer was closer to the mark.
- We will be looking for the following in September: 1) Is the survey still consistent with a pick-up in consumption in Q4, or does that need to be pushed back? 2) What consumers are now saying about the labour market, coming off bad June-Aug readings; 3) The evolving attitude of consumers towards the ongoing housing correction, in the context of easier policy; and 4) What all the above has done to savings attitudes (avenues and motivations) over the month.

Westpac MNI China CSI & housing downturns

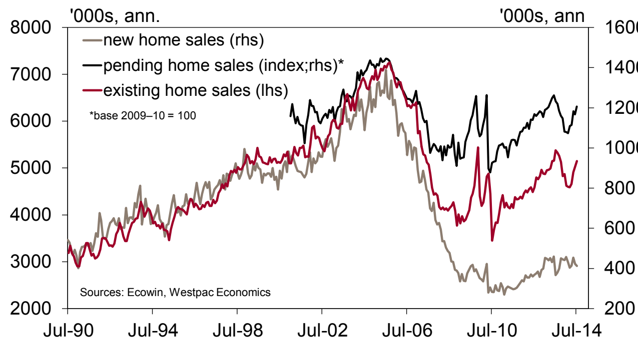


US Aug existing/new home sales

Sep 22, Existing: Last: 2.6%, WBC f/c: flat
Sep 24, New: Last: –2.4%, WBC f/c: 8.0%

- Existing home sales rose 2.6% in July, building upon their Q2 rises such that just over two thirds of the 15% decline in sales between last July and March had been recovered. That is more of a bounce than hinted at by pending home sales which fell 15.4% peak to trough (May 2013 to February 2014) and had recovered around 11ppts of that fall by July. So existing home sales should be constrained in August.
- New home sales fell a cumulative 9.4% in June-July, to an annualised sales pace of 412k, about 10% lower than in mid 2013, when sales peaked for that year at 459k in June. In recent months, homebuilder sentiment has soared, so the next big surprise outcome/major revision should be to the upside. We expect to see a 445k sales pace in August, implying there would be an 8% sales gain prior to any revisions, which are usually substantial.

US housing sales

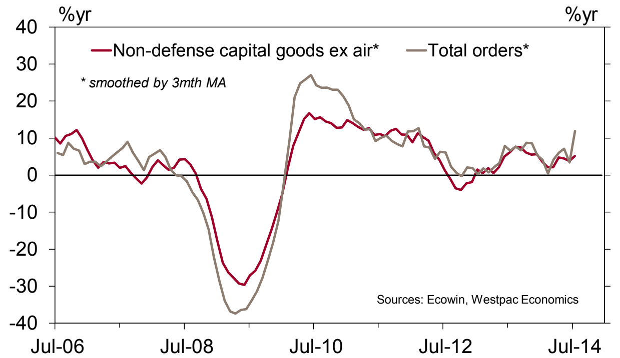


US Aug durable goods orders

Sep 25, Last: 22.6%, WBC f/c: –18.0%

- US durable goods orders surged 22.6% in July, lifted by a 74% jump in transport orders, which reflected a 318% takeoff in civil aircraft and a 10.2% acceleration in auto orders. The strength in auto orders was a factor behind the shorter summer shutdown in the auto industry this year, and the associated surge in auto production. Leaving aside wings and wheels, and a 15.3% fall in defence orders, core capital good orders fell 0.5% in July but this followed a June rise of 5.4%.
- The ISM factory orders index has risen from 51 to 67 since the start of this year but some of the regional Fed factory surveys revealed weaker orders (Phily, NY). Boeing took just 107 orders in Aug, down from 324 in July and auto production reversed most of the July spike in August. Business equipment output was flat in the month. All but one of these signals point to a steep headline orders fall. Core orders might post a modest bounce but a June-sized gain is less likely.

US durable goods orders



Data calendar

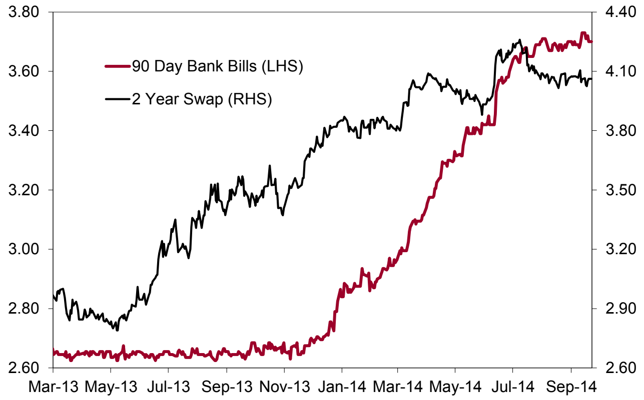
		Last	Market median	Westpac forecast	Risk/Comment
Mon 22					
NZ	Q3 Westpac-MM consumer confidence	121.2	–	–	Confidence was little changed in June, remaining elevated.
Eur	Sep consumer confidence adv	–10	–9.8	–11	Peaked at –7.1 in May.
US	Aug Chicago Fed national activity index	0.39	–	–	Based on 80 or so data inputs, not a separate business survey.
	Aug existing home sales	2.4%	1.0%	0.0%	Pending sales' 3% rise in July may have completed same month.
	Fedspeak	–	–	–	Dudley.
Tue 23					
Chn	Sep HSBC manufacturing PMI - flash	50.2	50.1	–	Submitted to gravity in Aug after over-optimistic readings in June-July.
Eur	Sep PMI factory adv	50.7	50.6	51.0	Recent stronger data on orders, IP, exports from Germany validates the ...
	Sep PMI services adv	53.1	53.1	52.5	... contrasting German-French PMI pictures but other survey evidence ...
	Sep PMI composite advance	52.5	–	52.2	... suggests the Euroland aggregate weakened.
UK	Aug PSNB, £bn	–1.1	10.5	–	Public sector net borrowing. PSNB ex interventions £0.2bn in Jul.
	Aug mortgages no.	42.8k	–	–	BBA data covering about 70% of the market.
US	Sep Richmond Fed factory index	12	10	8	Aug was highest in over 3 years, validating higher Phily/NY readings?
	Jul house prices	0.4%	0.5%	–	FHFA index.
	Fedspeak	–	–	–	Bullard, George.
Can	Jul retail sales	1.1%	0.5%	–	Ex auto sales jumped 1.5% in June.
Wed 24					
NZ	Aug merchandise trade $m	–692	–1,125	–900	Falling dairy prices likely to continue to dominate trade data.
Aus	Sep RBA Financial Stability Review	–	–	–	Half yearly update of more interest after Sep RBA meeting minutes.
Chn	Sep Westpac MNI consumer sentiment	113.3	–	–	Predicted current soft patch, some light now at the end of the tunnel?
Ger	Sep Ifo business climate index	106.3	105.7	106.0	Sanctions, ECB policies, but some recent decent industrial news.
	Aug import prices %yr	–1.7%	–	–	Tentative date. Has been constraining inflation, less so as euro falls.
US	Aug new home sales	–2.4%	4.4%	8.0%	July sales 10% below 2013 peak in June, 12% above 2013 trough in July!
	Fedspeak	–	–	–	Mester, George, Evans.
	President Obama speaking	–	–	–	At UN 69th General Assembly.
Thu 25					
Aus	RBA Governor Stevens speaking	–	–	–	Remarks to the Melbourne Economic Forum, 12.30 pm AEST.
Eur	Aug money supply M3 %yr	1.8%	1.8%	–	Some acceleration as ECB's June measures kick in.
UK	Sep CBI retail survey	37	–	–	Reported sales index surged in Aug after sluggish start to summer.
	Sep house prices %yr	11.0%	–	–	Tentative date for Nationwide index due 25/9-30/9.
US	Aug durable goods orders	22.6%	–17.0%	–18.0%	Recent swings due to aircraft; underlying story might be softening again.
	Initial jobless claims w/e Sep 20	280k	–	–	Claims likely to sustain sub 300k levels from now on.
	Sep Kansas City Fed factory index	3	–	4	Aug reading lowest year to date.
	Fedspeak	–	–	–	Lockhart.
Can	Jul average weekly earnings	3.3%	–	–	Uptrend since late 2011 now stabilised.
Fri 26					
Ger	Oct GfK consumer confidence	8.6	8.5	–	Sep saw first fall since start of last year.
UK	Sep house prices %yr	5.5%	–	–	Hometrack index, like most others, has decelerated a little lately.
US	Q2 GDP final	4.2% a	4.6%	4.4%	Q2 growth pace unlikely to be matched in H2 2014.
	Jun UoM consumer sentiment final	84.6 a	85.0	85.5	Sentiment close to multi-year highs.
Sat 27					
Chn	Aug industrial profits %ytd	11.7%	–	–	Weaker activity, disinflation will hinder profitability in August.

New Zealand forecasts

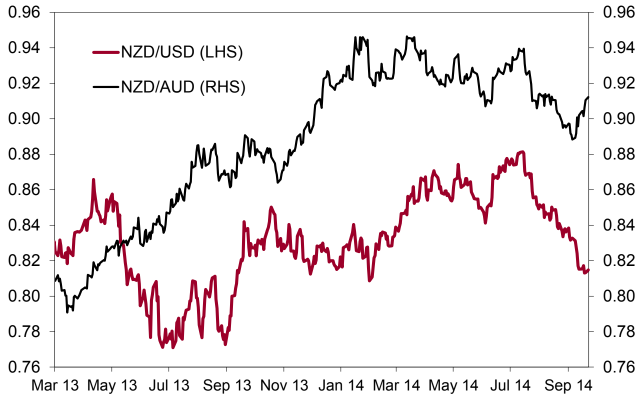
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2012	2013	2014f	2015f
GDP (Production) ann avg	2.3	3.2	3.4	3.1	2.5	2.8	3.6	3.1
Employment	0.4	3.8	2.8	2.6	0.4	2.9	3.0	2.9
Unemployment Rate % s.a.	6.2	5.9	5.3	4.7	6.8	6.0	5.4	4.7
CPI	0.9	1.5	1.7	2.1	0.9	1.6	1.4	2.0
Current Account Balance % of GDP	-3.8	-2.7	-4.9	-4.8	-4.1	-3.3	-3.8	-5.2

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	0.81	0.81	0.84	0.83	0.82	0.81
NZD/AUD	0.90	0.90	0.91	0.89	0.87	0.85
NZD/JPY	83.4	84.2	88.2	88.0	87.7	87.5
NZD/EUR	0.64	0.64	0.66	0.65	0.64	0.62
NZD/GBP	0.51	0.50	0.50	0.48	0.46	0.45
TWI	77.9	77.9	80.1	79.0	77.7	76.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 22 September 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.68%	3.66%	3.64%
60 Days	3.70%	3.67%	3.67%
90 Days	3.70%	3.69%	3.67%
2 Year Swap	4.06%	4.08%	4.09%
5 Year Swap	4.44%	4.45%	4.42%

NZ foreign currency mid-rates as at Monday 22 September 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8148	0.8313	0.8398
NZD/EUR	0.6350	0.6415	0.6364
NZD/GBP	0.5001	0.5136	0.5075
NZD/JPY	88.88	87.30	87.56
NZD/AUD	0.9122	0.8877	0.9021
TWI	78.75	78.95	79.30

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	3.72	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	2.64	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	0.8953	0.90	0.90	0.92	0.93	0.94
USD/JPY	109.23	103	104	105	106	107
EUR/USD	1.2920	1.27	1.27	1.28	1.28	1.29
AUD/NZD	1.1009	1.11	1.11	1.10	1.12	1.15

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