16 March 2015

Weekly Commentary

Hobbiton, Matamata

In this issue

Keep it simple

Last week's *Monetary Policy Statement (MPS)* was more focused than usual on delivering a simple, unambiguous message to financial markets. However, the simplicity of that message belies the fact that the Reserve Bank is grappling with a growing number of complex, often conflicting, considerations for monetary policy.

As expected, the RBNZ left the cash rate unchanged at 3.50% and reiterated the neutral stance that it adopted in its January OCR review. The RBNZ sees "a period of stability in the OCR" as the most likely outcome, with any interest rate moves in the foreseeable future – whether up or down – being reliant on new information.

The notable part was how the RBNZ incorporated this message formally into its forecasts. The 90-day interest rate projection in the *MPS* was not only dead flat at current levels, it was deliberately cut off a year earlier than the other economic forecasts, ending at March 2017. Given the RBNZ's forecasts of strong economic growth and rising home-grown inflation pressures over that time, it's not hard to conclude that the additional year on the projections would have included an uptick in interest rates.

The reason for this truncated interest rate track seems to have been an unusually high level of discomfort about the outlook for the economy over that horizon. Given the risk that financial markets might make a meal out of a small and highly conditional rise in interest rates projected three years from now, the RBNZ avoided the issue by emphasising the bit it feels most strongly about – that the OCR is expected to remain unchanged over the next two years.

Despite the effort to deliver a simple 'bottom line' to the market, the *MPS* reveals that the RBNZ is grappling with a number of complex issues. That was reflected in the increased length of the document itself, including a whole new chapter on the effects of lower oil prices on the economy. On that front at least, the RBNZ is in no doubt about what this means for interest rates:

Keep it simple continued

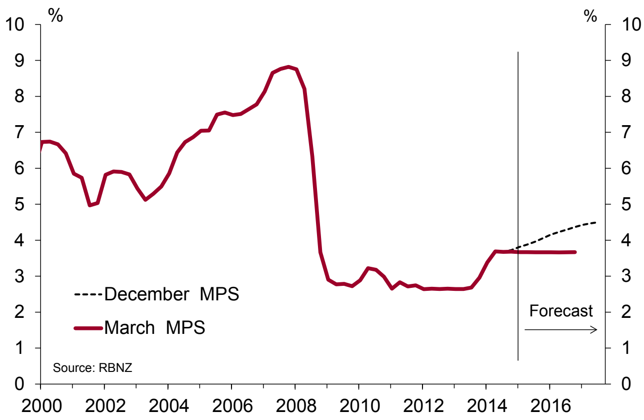
"Monetary policy is not responding to the direct, near-term effects on inflation of the fall in the oil price level of the past six months, nor will it respond to the direct effects of the rise in oil prices assumed in the projection for 2017. This is because monetary policy affects inflation with a lag and cannot offset these effects – trying to do so would result in unnecessary instability in output, interest rates and the exchange rate."

The more troubling concerns for the RBNZ are around inflation expectations. Inflation has turned out persistently lower than expected over the last couple of years, and another year of very low headline inflation due to the one-off plunge in oil prices might end up having a sustained impact on people's wage and price expectations. The *MPS* detailed an alternative scenario in which surveyed inflation expectations fall further to around 1% and then hold at those levels. In this case, the RBNZ would be prepared to cut the OCR in order to guide inflation expectations back towards the 2% midpoint of the inflation target.

The RBNZ is still uncomfortable with the strength of the exchange rate – while the NZ dollar has fallen quite a bit against the US dollar, it remains at a very high level in trade-weighted terms. If anything, the language in last week's statement escalated those concerns: the January statement noted that a further significant depreciation was "expected", while the March statement said that it was "needed" in order to rebalance New Zealand's external accounts.

On that note, the RBNZ is unlikely to have been pleased by the jump in the NZ dollar after the release of the *MPS.* While the RBNZ appears to have crafted its statement for the purpose of dissuading the market from pricing in OCR hikes, it may have underestimated the strength of feeling among traders that the next move will be a cut. That view seems to have been expressed more through the exchange rate, whereas interest rates were little changed after the statement.

RBNZ 90-day interest rate forecasts



There was no direct mention of macroprudential policy, or the recent consultation on increased bank capital requirements for investor property loans. That's not surprising, as the RBNZ tends to avoid conflating these issues with monetary policy. Indeed, there was no mention at all of housing as a complication for monetary policy, though the RBNZ has recognised the market's recent resurgence and expects house price inflation to accelerate to 7.4% this year (much the same as our forecast).

Our view remains that the next move in the OCR will be up. However, as we've said before, any further interest rate hikes are such a distant prospect at the moment that debating the timing is something of a red herring. The overarching issue is that persistently low inflation, despite a strong domestic economy, has muddied the waters for monetary policy. Until we get some clarity on the medium-term outlook for inflation, we agree with the RBNZ that there's no case for moving the OCR one way or another.

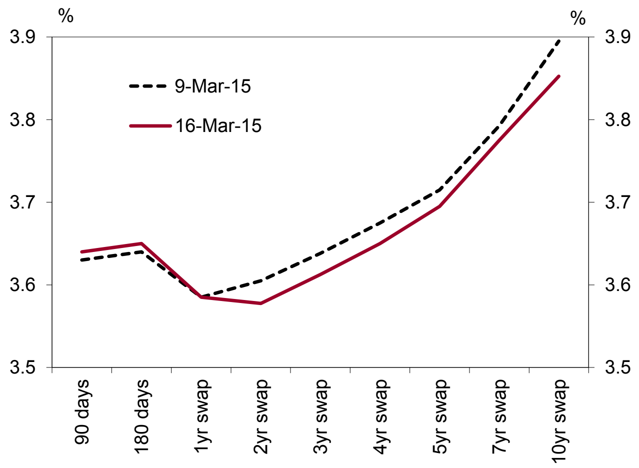
Fixed vs Floating for mortgages

Among the current standard fixed rates, the best value for borrowers with a deposit of 20% or more probably lies in the two-year and three-year terms. However, there is a possibility that fixed mortgage rates will fall even further over the weeks ahead. Waiting a while before fixing might offer even better value.

Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the coming four or five years, though the gap has narrowed in recent weeks, and these longer-term rates do offer the benefit of stability.

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.

NZ interest rates



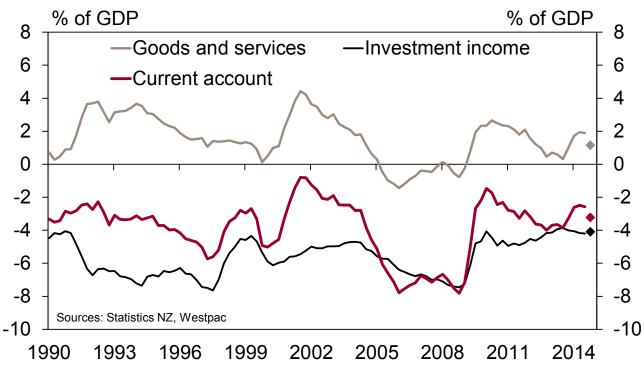
The week ahead

NZ Q4 current account % of GDP

Mar 18, Last: -2.6%, Westpac f/c: -3.2%, Mkt f/c: -3.3%

- The widening of the current account deficit in the December quarter reflects a well-known quantity. The record prices for dairy exports received in late 2013 are now dropping out of the calculation, to be replaced by the sharp plunge in dairy prices over 2014.
- What's more, dairy prices tend to be set three months ahead of shipment, so we can reasonably expect a further deterioration in the March quarter trade figures, despite the recent rebound in world prices.
- Elsewhere we expect a modest improvement in the services balance, led by strong tourist spending; and a modest narrowing of the investment income deficit, with overseas-owned banks reporting lower profits, compared to the September quarter.

Annual current account balance

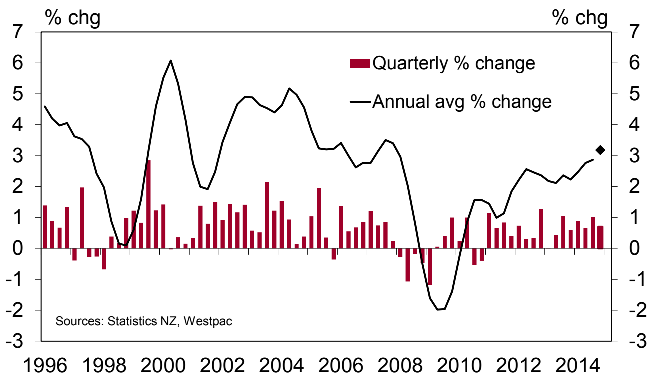


NZ Q4 GDP

Mar 19, Last: 1.0%, Westpac f/c: 0.7%, Mkt f/c: 0.8%

- While the 1% rise in September quarter GDP was stronger than we expected, there were some facets that looked overdone, or were unlikely to be repeated. The 9% jump in milk production is likely to have been a seasonal quirk, and an 8% rise in mining output was driven by a temporary burst of oil exploration.
- The indicators for Q4 GDP point to something closer to trend growth. Strong retail spending and the post-election resurgence in the housing market were highlights, while manufacturing, construction and agriculture were fairly flat.
- Our forecast is slightly below the median market forecast, and we feel the risks are skewed to the downside.

Production based GDP

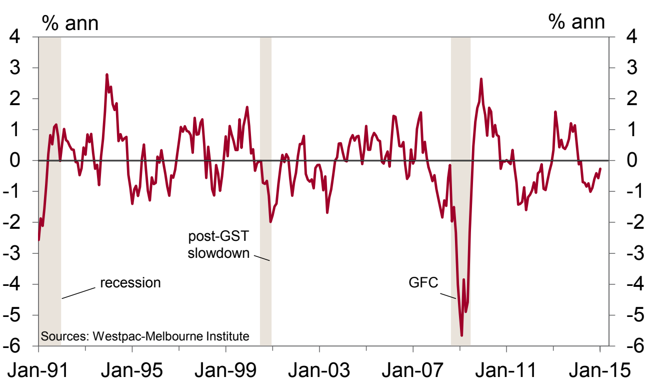


Aus Feb Westpac–MI Leading Index

Mar 18, Last: –0.27%

- The 6mth annualised growth rate of the Index, which indicates the likely pace of economic growth 3 to 9mths into the future, lifted from –0.57% in Dec to –0.27% in Jan. Despite the improvement, Jan marked the 12th consecutive negative (i.e. sub-trend) reading.
- The Feb update will include mostly positive updates. While the Westpac-MI Consumer Sentiment Index dipped 0.3% in Mar after a 10.3% surge, the Westpac-MI Unemployment Expectations Index posted a further modest 2.5% improvement. Also, the ASX surged 6.2%; total hours worked rose 0.8%; and dwelling approvals surged 7.9%. Even commodity prices managed to edge up slightly in AUD terms, up 0.2% despite a 3.6% fall in USD terms. The yield gap widened marginally. The mix could see the first above-trend reading on the Index's growth rate in over a year.

Westpac-MI Leading Index

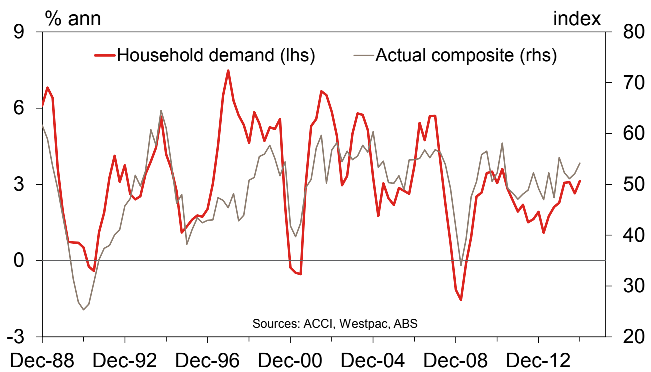


Aus Q1 ACCI-Westpac survey

Mar 19, Last: 54.2

- The ACCI-Westpac survey of the manufacturing sector provides a timely update on conditions, with insights into economy-wide trends. The Westpac-ACCI Actual Composite tracks movements in household demand, highlighting the key linkages between the consumer, home building and manufacturing.
- In Q4, the Actual Composite strengthened, up 2.1pts to 54.2, boosted by a lift in new orders and in output, as well as overtime, but not employment.
- Manufacturing is benefitting from the strong upswing in home building activity, as well as some improvement in service sector investment. In early 2015, dwelling approvals have hit fresh record highs and the RBA lowered rates in February.
- However, the cycle remains relatively modest. Consumer spending is sub-trend, mining investment is falling and global fragilities persist.

Westpac-ACCI composite & household demand

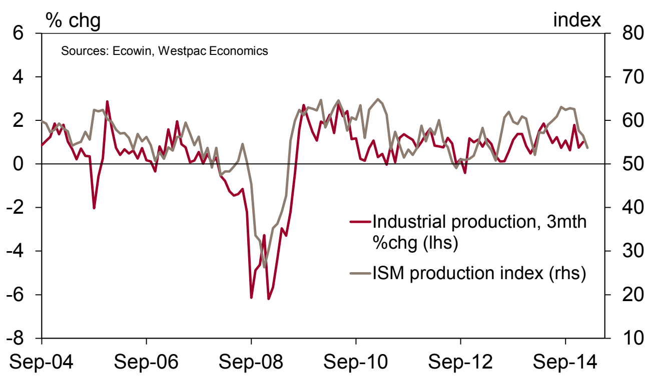


US Feb industrial production

Mar 16, Last: 0.2%, WBC f/c 0.0%

- Industrial production rose 0.2% in Jan, with a 0.2% gain in manufacturing and an accompanying rise in utility output offsetting a fall in mining output. Autos saw a further 0.6% drop in production, and defence output was down a sharp 1.1%; however, business equipment bounced.
- The ISM factory production index fell to its second lowest reading in almost two years and factory hours worked were down 0.2% in February. Utility output might fall after the cold snap boosted Jan; and mining may struggle to bounce with uneconomic oil production being shut down. Auto sales slipped for the third month running in Feb, likely constraining any auto production bounce. All up, we expect a subdued IP report, with manufacturing posting (at best) a modest rise, and the risk of a flat total IP outcome.

US industrial sector momentum stable

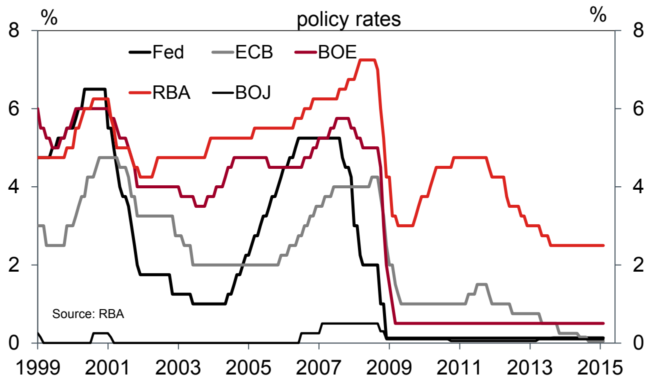


US FOMC meeting

Mar 18, Fed funds target Last: 0-0.25%, WBC f/c 0-0.25%

- Recent weeks have seen tension over the outlook for US monetary policy build amidst mixed signals. Equities are fully priced; volatility is low; and the labour market has a decidedly positive hue. Elsewhere there is reason for concern: retail sales have not (yet) received a boost from falling gasoline prices; business investment and housing partials are soft; and inflation expectations have declined.
- In its written communications, the FOMC (and Chairman Yellen in February testimony) has chosen not to provide specific guidance, instead preferring to keep all options open, on both the timing of the first hike and the path that normalisation will take from there. That said, Yellen hinted that “patient” will be removed from the March 18 statement, meaning subsequent meetings should be live, albeit data dependent. The best characterisation of the policy outlook is “arguably soon, but not quite yet”. September remains our expectation.

Developed world policy interest rates



Data calendar

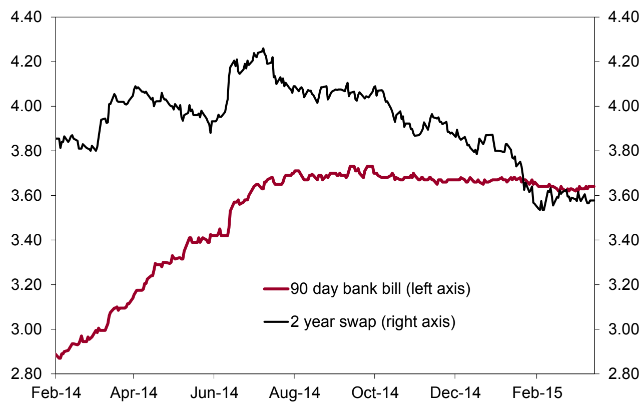
		Last	Market median	Westpac forecast	Risk/Comment
Mon 16					
NZ	Feb Performance of Services Index	58.4	–	–	Generally strong for the last couple of years, but can be volatile.
Aus	Feb new vehicle sales	–1.5%	–	1.5%	Industry data points to 10% jump in SUV sales.
	RBA Assist. Governor Debelle	–	–	–	Speaking at KangaNews DCM Summit, Sydney.
UK	Mar house prices %yr	6.6%	–	–	Rightmove index of asking prices.
US	Mar NAHB housing market index	55	57	54	Homebuilder sentiment stalled since mid 2013.
	Mar NY Fed factory survey	7.8	8.0	0.0	Some regional surveys way down from 2014 peak. Weather impact too.
	Jan TIC data, $bn	35.4	–	–	Net long-term TIC flows.
	Feb industrial production	0.2%	0.3%	0.0%	Lower factory hours and weaker ISM factory index in Feb.
Tue 17					
Aus	RBA minutes	–	–	–	Easing bias clear in statement; further detail in minutes.
Eur	Feb CPI %yr final	–0.3% a	–0.3%	–0.3%	Still in deflationary territory, but may have bottomed for now.
Ger	Mar ZEW analysts' expectations	53.0	58.0	53.0	Expectations have recovered most of their 2014 slump since Nov 14.
US	Feb housing starts	–2.0%	–2.4%	–3.0%	Jan weakness (especially in single-family starts) may be due to the cold
	Feb housing permits	0.0%	0.5%	–1.0%	snap, but permits were lower too, suggesting some underlying softness.
Can	Jan factory sales	1.7%	–1.2%	–	Dec sales rise led by machinery, autos.
Wed 18					
NZ	GlobalDairyTrade auction	1.1%	–	–	Drought concerns have softened a little.
	Q4 current account % of GDP	–2.6%	–3.3%	–3.2%	Last year's dairy price plunge continues to operate with a lag.
Aus	Feb Westpac–MI Leading Index	–0.27%	–	–	Latest monthly updates of components were mostly positive.
Chn	Feb new property prices %net bal	–88.6%	–	–	Developer asking prices need to fall further to lower stock ex tier one.
	Feb 2'ndary property prices %net bal	–78.6%	–	–	Tier one stabilising, tier four haemorrhaging.
Eur	Jan trade balance €bn	23.3	21.5	–	Exports fell 1.1% in Dec.
	Jan construction output	–0.8%	–	–	Construction's weather boost a year ago dropping out of annual calc.
UK	Mar BoE minutes	–	–	–	Dissent in favour of an immediate hike may be building again.
	Feb unemployment ch'	–39k	–31k	–	Benefit claimant count.
	2015 Budget	–	–	–	Chancellor to present pre-election budget having met fiscal targets.
US	FOMC policy decision	0-0.25%	0-0.25%	0-0.25%	It's finely balanced, but September remains our 'first hike' expectation.
Can	Jan wholesale sales	2.5%	–	–	Sales grew at fastest pace in 4 years in Dec on autos, consumer goods.
Thu 19					
NZ	Q4 GDP	1.0%	0.8%	0.7%	Growing at trend with some positive one-offs from Q3 dropping out.
Aus	Q1 ACCI-Westpac survey	54.2	–	–	Actual composite up 2.1pts in Q4, orders rose on strong home building.
	Q1 RBA Bulletin	–	–	–	Collection of short research articles from RBA staff.
Eur	Q4 labour costs	1.3%	–	–	Up from cyclical (record?) low pace of 0.6%yr in Q1.
UK	Mar CBI industrial trends	10	–	–	Total orders index.
US	Q4 current account deficit $bn	100.3	102.0	–	Stronger dollar yet to materially impact on deficit level in net terms.
	Initial jobless claims w/e 14/3	289k	–	294k	Recent rises likely due to snow disruption delaying claim filing.
	Feb leading indicators	0.2%	0.3%	0.2%	Subdued by weather rather than underlying slowdown?
	Mar Philadelphia Fed factory survey	5.2	8.0	2.5	Weather impact compounding slowdown from excessive 2014 highs.
Fri 20					
NZ	Feb net migration	5,540	–	5,300	Migration boom shows no signs of easing.
	Mar ANZ consumer confidence	124.0	–	–	No obvious boost from lower fuel prices in Jan/Feb.
Aus	RBA Governor Stevens	–	–	–	AMCHAM lunch in Melbourne; topic TBA.
Chn	Mar MNI business indicator	52.8	–	–	Survey of listed firms, manuf and services. Occasionally predicts flash PMI.
Eur	Jan current account €bn	17.8	–	–	In surplus since 2011.
Ger	Feb producer prices %yr	–2.2%	–1.9%	–	PPI has been deflating for almost two years; at steepest pace in Jan.
UK	Feb PSNCR £bn	–18.9	–	–	Public sector net credit requirement. Public finances in better shape.
US	Fedspeak	–	–	–	Lockhart and Evans.
Can	Feb CPI %yr	1.0%	0.9%	–	Fuel prices down but BoC core rate was much higher at 2.2%yr in Dec.
	Jan retail sales	–2.0%	–0.5%	–	Gasoline sales led broad-based sales declines in Dec.

New Zealand forecasts

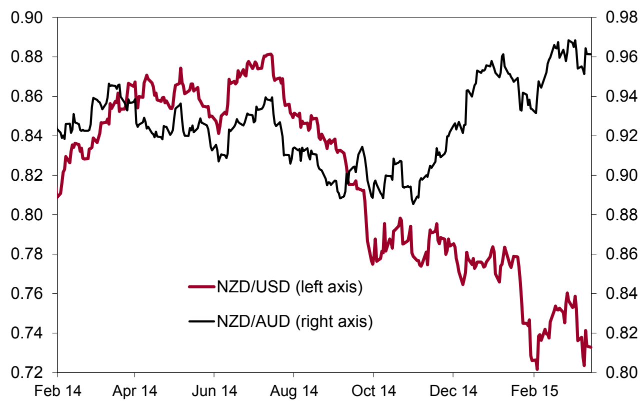
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2013	2014f	2015f	2016f
GDP (Production) ann avg	2.2	2.5	3.1	2.8	2.2	3.2	2.7	3.6
Employment	0.4	3.8	2.9	3.0	2.9	3.5	2.6	2.5
Unemployment Rate % s.a.	6.2	6.0	5.5	4.7	6.0	5.7	4.8	4.3
CPI	0.9	1.5	0.3	1.7	1.6	0.8	0.8	2.4
Current Account Balance % of GDP	-3.7	-2.6	-4.1	-4.7	-3.3	-3.2	-4.8	-4.2

Financial Forecasts	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16
Cash	3.50	3.50	3.50	3.50	3.75	4.00
90 Day bill	3.70	3.70	3.70	3.75	4.00	4.25
2 Year Swap	3.60	3.70	3.80	4.00	4.20	4.50
5 Year Swap	3.70	3.80	3.90	4.10	4.40	4.60
10 Year Bond	3.40	3.50	3.70	3.90	4.20	4.30
NZD/USD	0.73	0.73	0.74	0.76	0.78	0.78
NZD/AUD	0.97	0.97	0.97	0.97	0.98	0.96
NZD/JPY	89.1	90.5	93.2	95.8	99.1	99.8
NZD/EUR	0.68	0.68	0.69	0.70	0.71	0.70
NZD/GBP	0.49	0.49	0.49	0.49	0.49	0.49
TWI	78.5	78.7	79.7	81.0	82.2	81.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 16 March 2015

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.62%	3.63%	3.61%
60 Days	3.63%	3.63%	3.63%
90 Days	3.64%	3.63%	3.64%
2 Year Swap	3.58%	3.59%	3.57%
5 Year Swap	3.70%	3.71%	3.64%

NZ foreign currency mid-rates as at Monday 16 March 2015

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7328	0.7571	0.7463
NZD/EUR	0.7004	0.6770	0.6538
NZD/GBP	0.4971	0.4906	0.4836
NZD/JPY	88.98	90.64	88.34
NZD/AUD	0.9613	0.9683	0.9593
TWI	77.69	78.60	77.28

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2011	2012	2013	2014e	2015f	2016f
Australia						
Real GDP % yr	2.7	3.6	2.1	2.7	2.4	3.0
CPI inflation % annual	3.0	2.2	2.7	1.7	2.1	3.0
Unemployment %	5.2	5.3	5.8	6.2	6.7	6.4
Current Account % GDP	-2.8	-4.4	-3.3	-2.8	-2.5	-1.7
United States						
Real GDP %yr	1.6	2.3	2.2	2.4	2.8	3.2
Consumer Prices %yr	3.1	2.1	1.5	1.6	1.0	2.1
Unemployment Rate %	8.9	8.1	7.4	6.2	5.2	4.9
Current Account %GDP	-2.9	-2.9	-2.4	-2.4	-2.5	-2.5
Japan						
Real GDP %yr	-0.4	1.7	1.6	-0.1	1.0	1.7
Euroland						
Real GDP %yr	1.6	-0.6	-0.4	0.8	1.0	1.0
United Kingdom						
Real GDP %yr	1.1	0.3	1.7	2.6	2.5	2.7
China						
Real GDP %yr	9.3	7.7	7.7	7.4	7.3	7.5
East Asia ex China						
Real GDP %yr	4.5	4.5	4.3	4.1	4.8	5.3
World						
Real GDP %yr	4.1	3.4	3.3	3.3	3.5	4.1
Forecasts finalised 9 March 2015						

Interest Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
Australia						
Cash	2.25	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.36	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.69	2.50	2.90	3.00	3.10	3.40
International						
Fed Funds	0.125	0.125	0.375	0.625	0.875	1.125
US 10 Year Bond	2.20	2.10	2.50	2.70	2.90	3.20
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16
AUD/USD	0.7675	0.75	0.75	0.76	0.78	0.80
USD/JPY	121.42	122	124	126	126	127
EUR/USD	1.0834	1.07	1.07	1.07	1.08	1.10
AUD/NZD	1.0409	1.03	1.03	1.03	1.03	1.03

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