



Weekly Commentary

9 February 2016



Waiting is the hardest part

We've been forecasting the need for the OCR to fall below 2.5% for some time, and persistent softness in inflation has reinforced this case. However, while it's clear the OCR will need to go lower, the timing of cuts is less certain. Following a week of big developments, including an update on the RBNZ's thinking on the economy, we have shifted back to expecting cuts in June and August.

Back in July 2015, we argued that the OCR would need to drop to a record low of 2%. That reflected our assessment that inflation wasn't on track to meet the RBNZ's medium term target. Events over the past few weeks, particular the ongoing weakness in inflation and signs of continuing softness in the global economy, have really rammed home why such cuts are necessary.

But while the need for OCR cuts is abundantly clear, the timing of when those cuts will occur has always been much less certain.

Just last week we tentatively suggested that cuts might begin in March. That followed the softer than expected December quarter CPI result, and the RBNZ's January policy statement which saw them adopting an explicit easing bias.

However, more recent events have delivered a number of surprises. As a result, while we still expect the OCR to fall to 2% later this year, we have pushed the expected timing of rate cuts back out to June and August.

Three key events have prompted us to expect a slightly later resumption of OCR cuts. First was RBNZ Governor Wheeler's annual speech to the Canterbury Employers' Chamber of Commerce. This speech was actually very encouraging in regards to OCR reductions over the coming year, with the Governor talking almost exclusively of downside risks and reiterating the RBNZ's easing bias. However, the speech

downplayed the idea that an OCR reduction could occur as soon as March. In addition, the Governor sounded a little less dovish than at the time of the January OCR Review. Whereas the January OCR Review included a straightforward suggestion that the OCR may fall over the year ahead, the speech introduced some conditionality: *"If concerns deepen around the prospects for the global economy and its impact on New Zealand, some further policy easing may be needed over the coming year..."*

The Governor's speech also stressed the RBNZ's flexible, medium-term approach to inflation targeting, and counselled against focussing on the current rate of headline inflation when assessing what might happen to the OCR. Instead, the Governor emphasised the importance of the underlying trends in prices which tend to be more enduring. That fits very well with our own thinking. Our forecast that the OCR will fall to 2.0% is based on our assessment inflation would remain stubbornly low over the coming years.

The next key update over the past week was the December quarter labour market data. This revealed a picture of ongoing improvement. Employment was up a solid 0.9% over the quarter, and the unemployment rate dropped sharply from 6.0% to 5.3% - the lowest rate in seven years! Because the HLFs data can be volatile from quarter to quarter, we are a little cautious about reading too much

Waiting is the hardest part continued

into the extent of the recent decline in unemployment. Nevertheless, looking at a broad suite of indicators (including the surveys of businesses and employers) still leaves us with a picture of a labour market that is continuing to gradually strengthen. This is likely to make the RBNZ feel more comfortable about holding fire for now, even though wage inflation remained very low over the past year.

Lastly, the past week saw a few straws in the wind suggesting that the Auckland housing market may be picking up after a sharp slowdown late last year. Data from Barfoot and Thompson showed a 20% lift in seasonally adjusted Auckland house sales for January. In addition, listings data point to tightness in Auckland and beyond. These are important developments, but not conclusive. We will be looking to the upcoming REINZ data to get a more comprehensive read on where the Auckland housing market is heading.

In contrast to the above developments were the results of the latest GlobalDairyTrade auction, in which prices tumbled 7.4%. This has introduced some downside risk to our \$4.20 farm gate milk price forecast for this year. Perhaps even more importantly, it implies that achieving our \$5.20 milk price forecast for 2016/17 season might be a tough ask, especially given the ongoing strong growth in milk production globally. We could now be looking at three consecutive years of sub-\$5 payouts in the dairy sector. This is an important risk to the outlook for GDP growth, and does lean in the direction of earlier OCR reductions.

Unemployment rate



However, it's not enough to outweigh the three points above.

Putting it all together, it's looking most likely that the cutting cycle will resume in June. However, this will be dependent on the flow of data, and March and April are certainly live decisions. Continued downside surprises in terms of inflation, inflation expectations, or a weakening in the global economy could force the RBNZ's hand earlier.

Thus next week, we will release our latest Quarterly Economic Overview. This report, which will be available for download from our website, provides a detailed look at factors shaping the New Zealand economy and how expect policy makers will respond.

Fixed vs Floating for mortgages

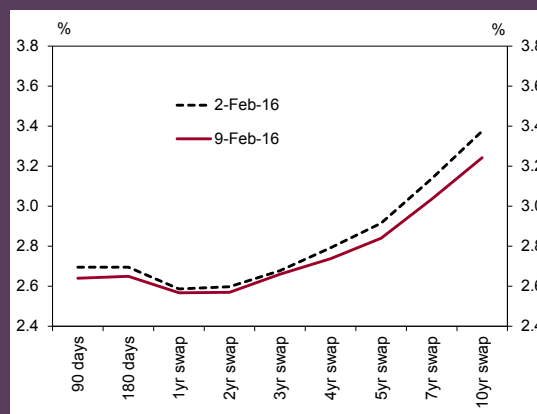
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

Longer-term fixed rates do offer the benefit of stability, but even those looking to fix may want to wait a while longer.

For borrowers with a deposit of 20% or more, the best value probably continues to lie in the two-year ahead and three-year ahead terms. Four- and five-year rates still seem high relative to where we think shorter-term rates are going to go over the next four or five years.

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



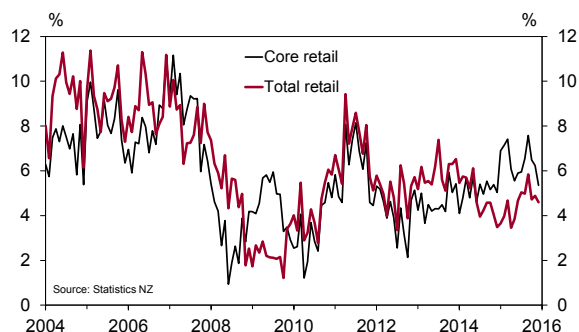
The week ahead

NZ Jan retail card spending

Feb 10, last -0.2%, WBC f/c +0.7%

- The monthly pace of household spending moderated a little in the final month of 2015, with a notable pull back in durables spending. Spending on durables has been falling since October when changes to lending restrictions and the taxation of capital gains on investor housing were introduced. However, it's not clear whether these changes, or the continued softness in prices, has driven falls in the level of durables spending.
- We expect to see firm growth in retail card spending of 0.7% in January, supported by low interest rates, strong population growth, and strong tourist inflows (the latter being a key pillar of support for spending on hospitality and related services). Falls in petrol prices over the month will also have put a bit more money back in households' pockets, which should see a solid 0.9% gain in core spending (which excludes spending on fuel and motor vehicles).

Card transactions, annual % change



Aus Feb Westpac-MI Consumer Sentiment

Feb 10 Last: 97.3

- The **Westpac-Melbourne Institute Consumer Sentiment Index** fell 3.5% in Jan, slipping below the 100 level indicating pessimists outnumber optimists, albeit only marginally. Global financial market jitters were the main negative factor in Jan.
- The Feb survey is in the field over the week ended Feb 7. Financial markets have again been unsettled, although both the ASX and S&P500 are unchanged since the Jan survey, with the AUD firming a touch. Locally, the RBA left rates unchanged at its Feb meeting with economic news tending to be downbeat – falling commodity prices putting more pressure on exports and a reported decline in house prices. More positively, sharp falls in oil prices are starting to have more of an impact on local petrol prices – average pump prices down 9¢ since the Jan survey. On the political front, prospective changes to the GST were again prominent in the media.

Consumer Sentiment Index

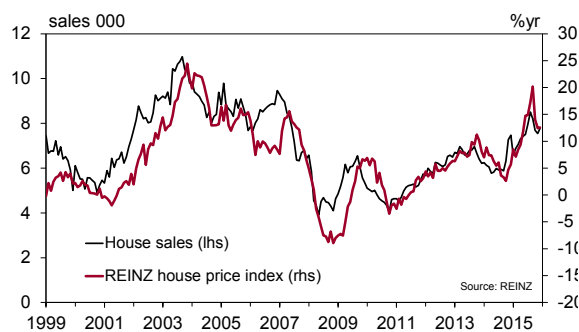


NZ Jan REINZ house prices and sales

Feb 10 (tbc), Sales last: 3.0%, Prices last: 12.6%/yr

- Housing turnover slowed sharply in October as new tax and foreign buyer regulations came into force. This was at least partly due to purchases being brought forward, and there are indications of activity picking up again in December and January.
- The upward trend in prices does seem to have slowed, particularly in Auckland where the regulations were expected to have their greatest impact. A continued moderation in house price inflation would leave the RBNZ more comfortable about further interest rate cuts this year.
- The release date for this report is unconfirmed; due to public holidays it may be delayed until the following week.

REINZ house prices and sales



Aus Dec housing finance (no.)

Feb 12, Last: 1.8%, WBC f/c: 1.5% Mkt f/c: 2.8%/%,

Range: -0.5% to 4.8%

- The number of owner occupier finance approvals rose 1.8% in Nov. Notably, the value of new investor loans and the broader total value of new loans measure (covering both investors and owner occupiers) were both up in Nov as well (+0.7%/mth and +1.3%/mth respectively). For investor loans, that follows a 19% drop over the previous 6mths as regulatory measures impacted, with an associated 'spillover' boost for owner occupier loans (+11% in value terms). The Nov update suggests this effect has now largely run its course.
- Industry figures suggest owner-occupier approvals posted a similar gain in Dec – we expect 1.5% rise. With housing markets showing a clear slowdown late last year, that suggests we may see more weakness in the value of investor loans, notwithstanding the apparent stabilisation in Nov.

New finance approvals: total



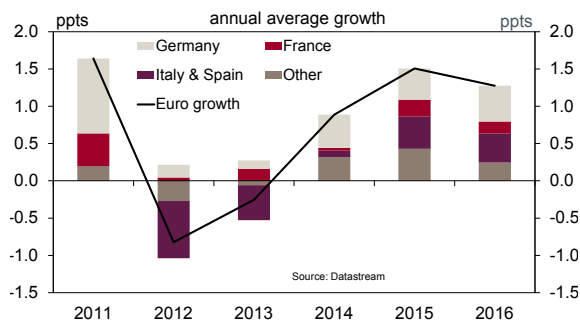
The week ahead

Eur Q4 Euro Area GDP

Feb 12, Last: 0.3% , WBC f/c: 0.3%

- Euro Area GDP surprised to the upside through the year to September 2015, and Q4 is expected to see another healthy gain.
- Known detail includes another strong result for Spain, +0.8%, but a much less impressive rise for France, +0.2%. The former continues to benefit from an investment upswing; job gains; and much easier credit conditions. The latter is being hampered by one of the weakest labour markets in the region and political indecision.
- Elsewhere, momentum remains modest. A solid but not spectacular outcome is expected for Germany, +0.4%; while Italy should eke out another small positive.
- All told, a 0.3% gain for the region is most probable, maintaining annual growth around 1.6%/yr.

Contribution to Euro area annual growth

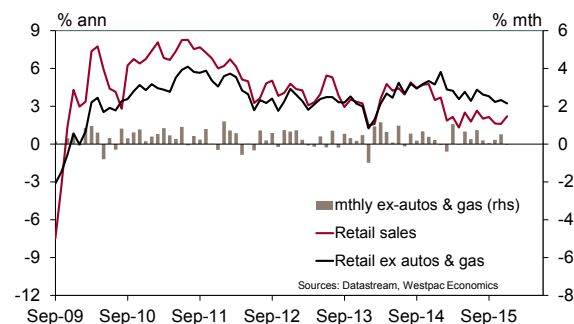


US Jan retail sales

Feb 12, Last: -0.1% , WBC f/c: 0.2%

- Retail sales continue to disappoint in the US, with the average monthly gain over the seven months to December just 0.1%.
- Even omitting the impact of weak energy prices (as well as auto sales), core retail sales have only risen 0.3% per month over the same period – remember these are nominal figures.
- The apparent weakness in retail sales comes at an odd time, given continued strong employment gains; near full employment; and rising real wages.
- One suspects that weak global growth; uncertainty over US interest rates; a potential skewed allocation of wage gains; and rising costs for life's essentials (housing; health; and education) are all impacting discretionary spending. All of the above are unlikely to be resolved in the near term.

US retail sales, momentum remains absent



Data calendar

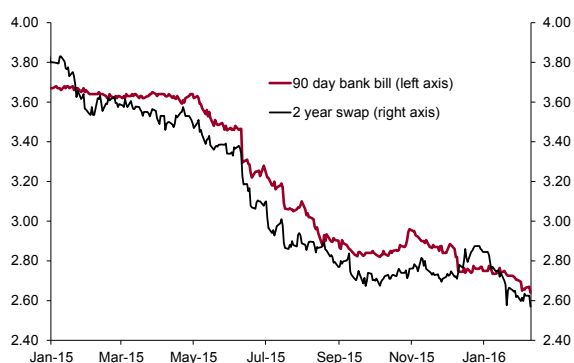
		Last	Market median	Westpac forecast	Risk/Comment
Mon 8					
NZ	Waitangi Day observed	–	–	–	Public holiday, markets closed.
–	Lunar New Year	–	–	–	Year of the (Fire) Monkey; ambitious & adventurous but irritable.
Aus	Jan ANZ job ads	–0.1%	–	–	Up 10% in the year but the pace of improvement has clearly slowed.
Chn	Jan foreign direct investment	–5.8%	–2.0%	–	Tentative date, 8–12/2.
Eur	Sentix investor confidence	9.6	–	–	ECB willing; FOMC angst; China?
US	Jan Fed labour market conditions index	2.9	–	–	FOMC's aggregate measure of the US labour market.
Tue 9					
Aus	Jan NAB business survey	7	–	–	In Dec, conditions index above avg but fell 3pts to +7.
UK	Dec Trade balance, £b	–3.2	–2.7	–	Drags from soft external demand and strength in GBP.
US	Jan NFIB small business optimism	95.2	94.5	–	Conditions remain favourable overall, though momentum has ebbed.
	Dec wholesale inventories	–0.3%	–0.1%	–	Potential for revisions to already weak Q4 GDP.
Wed 10					
NZ	Jan retail card spending	–0.2%	0.4%	0.7%	Population growth and tourist inflows are boosting retail spending.
	Jan REINZ house sales	3.0%	–	–	Signs of turnover picking up again after post-regulation drop.
	Jan REINZ house prices, %yr	12.6%	–	–	Price trend should continue to moderate.
Aus	Feb Westpac-MI Consumer Sentiment	97.3	–	–	Financial markets' shakey start to 2016 weighed on sentiment in Jan.
	Feb Westpac-MI unemployment exp'ns	0.7%	–	–	Risen 6% in 3mths but still down 5%yr as labour market strengthened.
Chn	Jan aggregate financing, CNYbn	1820	2200	–	Tentative date, 10–15/2.
	Jan new Yuan loans, CNYbn	598	1830	–	Tentative date, 10–15/2.
	Jan M2 money supply	13.3%	13.5%	–	Tentative date, 10–15/2.
UK	Dec industrial production	–0.7%	0.0%	–	Soft external demand is weighing on manufacturing.
US	Jan Federal Monthly budget, \$bn	–14.0	10.1	–	Small surplus to follow Dec's small deficit.
	FOMC Chair Yellen	–	–	–	Appears before Financial Services Committee.
	Fedspeak	–	–	–	Williams on health and the economy.
Thu 11					
NZ	Jan BusinessNZ PSI	58.9	–	–	Service sector conditions have remained firm.
Aus	Feb MI inflation expectations	3.6%	–	–	Exhibiting a very modest rising trend, from 3.4% in Jun to 3.7% in Jan.
UK	Jan RICS house price balance	50%	–	–	Demand firm, rush to beat stamp duty increase boosting sales.
US	Initial jobless claims	285k	–	–	Jobless claims have picked up but remain low.
	FOMC Chair Yellen	–	–	–	Follow-up appearance before Senate Banking Committee.
Can	Dec new house price index	0.6%	–	–	House price inflation has remained subdued.
Fri 12					
NZ	Jan food price index	–0.8%	–	1.2%	Seasonal uptick but annual change to remain negative.
Aus	RBA Governor Stevens speaking	–	–	–	Parliamentary testimony, half yearly, 11:30am.
	Dec housing finance	1.8%	2.8%	1.5%	Industry data suggests firm result for owner-occupier approvals.
Eur	Dec industrial production	–0.7%	0.3%	–	Global demand remains a clear concern for manufacturers.
	Q4 GDP	0.3%	0.3%	0.3%	Growth rolls on, albeit in a mixed fashion across the continent.
US	Jan retail sales	–0.1%	0.1%	0.2%	Persistently weak trend.
	Dec business inventories	–0.2%	0.2%	–	Potential for revisions to already weak Q4 GDP.
	Feb consumer sentiment, prelim	92.0	92.5	–	Uni of Mich measure.
	Fedspeak	–	–	–	Dudley answers questions at press briefing in New York.
Can	Jan house prices	–0.1%	–	–	Teranet/ National Bank measure; price inflation subdued.

New Zealand forecasts

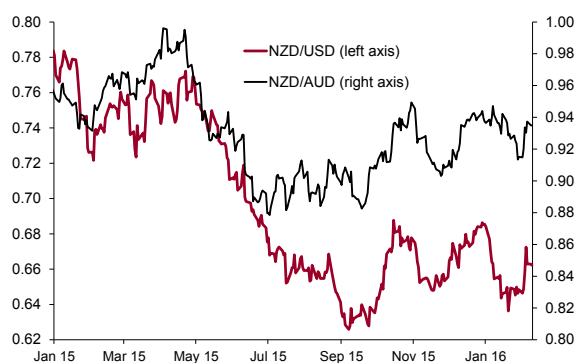
Economic Growth Forecasts	March years				Calendar years			
% change	2014	2015	2016f	2017f	2014	2015e	2016f	2017f
GDP (Production) ann avg	2.7	3.6	2.2	2.2	3.7	2.4	2.0	2.9
Employment	3.8	3.2	1.1	2.4	3.6	1.2	2.1	2.1
Unemployment Rate % s.a.	6.0	5.8	5.8	5.2	5.7	5.3	5.3	5.3
CPI	1.5	0.3	0.3	1.3	0.8	0.1	0.8	2.1
Current Account Balance % of GDP	-2.5	-3.4	-3.3	-2.7	-3.1	-3.3	-2.9	-3.0

Financial Forecasts	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Cash	2.50	2.25	2.00	2.00	2.00	2.00
90 Day bill	2.60	2.30	2.10	2.10	2.10	2.10
2 Year Swap	2.60	2.40	2.20	2.20	2.20	2.20
5 Year Swap	2.90	2.90	3.00	3.00	3.10	3.10
10 Year Bond	3.10	3.30	3.50	3.70	3.70	3.70
NZD/USD	0.65	0.63	0.61	0.61	0.62	0.62
NZD/AUD	0.93	0.93	0.92	0.91	0.90	0.89
NZD/JPY	79.5	77.7	75.9	76.5	75.9	75.9
NZD/EUR	0.61	0.61	0.59	0.58	0.57	0.57
NZD/GBP	0.44	0.44	0.43	0.42	0.41	0.40
TWI	71.1	70.1	68.4	68.0	67.7	67.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Tuesday 9 February 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.59%	2.60%	2.64%
60 Days	2.65%	2.67%	2.70%
90 Days	2.70%	2.74%	2.77%
2 Year Swap	2.60%	2.71%	2.80%
5 Year Swap	2.92%	3.05%	3.18%

NZ foreign currency mid-rates as at Tuesday 9 February 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6523	0.6422	0.6739
NZD/EUR	0.5988	0.5873	0.6201
NZD/GBP	0.4518	0.4505	0.4518
NZD/JPY	78.98	74.98	81.65
NZD/AUD	0.9187	0.9397	0.9390
TWI	71.69	71.39	73.59

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.3	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	2.2	2.2
Unemployment %	5.3	5.8	6.2	6.0	6.1	6.1
Current Account % GDP	-4.4	-3.4	-3.0	-4.3	-5.5	-5.5
United States						
Real GDP %yr	2.2	1.5	2.4	2.5	2.8	2.0
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.7	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.8	4.8
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.6	-0.1	0.6	1.4	1.8
Euroland						
Real GDP %yr	-0.8	-0.3	0.9	1.4	1.1	1.3
United Kingdom						
Real GDP %yr	0.7	1.7	3.0	2.5	2.5	2.0
China						
Real GDP %yr	7.7	7.7	7.3	7.0	6.6	6.4
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.6	3.8	4.6
World						
Real GDP %yr	3.4	3.3	3.4	3.1	3.5	3.7
Forecasts finalised 8 Dec 2015						

Interest Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.29	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.55	2.50	2.70	2.90	3.30	3.55
International						
Fed Funds	0.375	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	1.84	1.80	2.20	2.60	3.00	3.25
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17
AUD/USD	0.7190	0.70	0.68	0.66	0.67	0.69
USD/JPY	116.70	122	123	124	125	122
EUR/USD	1.1195	1.07	1.04	1.02	1.03	1.06
AUD/NZD	1.0740	1.08	1.08	1.08	1.10	1.11

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