

Weekly Commentary

2 May 2016



Softly softly

All eyes were firmly on the RBNZ's OCR review last week. In the lead up, markets had upped the odds of both an April rate cut and an OCR below 2%, as the NZ dollar rose above 70c against the US dollar and, more recently, weak Australian CPI data introduced the risk of rate cuts across the Tasman.

In the end, the RBNZ left the OCR unchanged at 2.25%, as we had expected. And they retained their easing bias, saying "*further policy easing may be required*". However, contrary to our expectations, they were no more emphatic about the need to cut rates than they were back in the March MPS. That came as a surprise to the market which reacted by sending the NZ dollar and interest rates significantly higher.

The lack of stern language on the exchange rate was a little surprising given that the NZ dollar was around 3% higher than the RBNZ's projections. Meanwhile commentary on the incomplete pass-through from the last OCR cut to mortgage rates was conspicuously absent. Instead, the RBNZ's focus was on the modestly inflation positive developments on the domestic front. Strong inward migration, construction activity and the tourism sector all got a nod.

House prices rated a mention too. The RBNZ sounded like it was treating the recent pickup in house price inflation in Auckland with some caution (although recent developments would probably give them more confidence in their bullish March forecasts). It also noted further pressures building in house prices in other parts of the country. Clearly, the RBNZ remains stuck between a rock and a hard place when it comes to the housing market. On one hand, it is relying on interest rate cuts to work through usual transmission channels, boosting asset

prices (including house prices) and supporting consumer spending. But on the other hand, it continues to have financial stability concerns about the rapid acceleration in house prices.

Little surprise then that the RBNZ reiterated its view that additional housing supply is needed. Lower house price inflation via more house building (and an associated lift in construction activity) would probably help the RBNZ square the circle at least a little bit.

The other factor which seems to be giving the RBNZ a degree of comfort is the outlook for inflation. The risk of further large falls in inflation expectations is likely to abate as headline inflation heads higher on the back of rising oil prices and gradually building inflation pressures. That said, inflation expectations data between now and the June *Monetary Policy Statement* will be well worth watching.

For our part, we continue to expect the RBNZ to deliver one more rate cut, most likely in June this year. The outlook for global growth remains underwhelming, the stresses and strains of plunging incomes in the dairy sector are starting to impact further afield, and the high NZ dollar is keeping the handbrake on non-tradables inflation. Headline inflation is set to rise from here, but only gradually, meaning inflation expectations are likely to only lift slowly. Add uncertainty about the transmission between OCR cuts and mortgage rates, and the case for a further rate cut remains convincing.

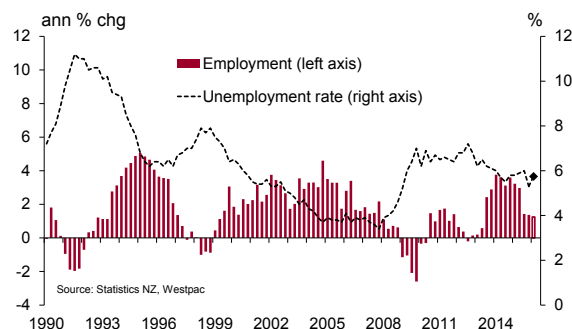
Softly softly continued

Other data out last week underscored the mixed outlook for New Zealand economic activity over the next year. Building consent issuance pulled back in March, falling 9.8%, after surging 10% in February. However, consent issuance in Auckland continues to grow strongly (up 20% in the year). It's also worth noting that the early Easter this year may not be fully accounted for in the seasonal adjustment (meaning reported March figures might be lower than we would expect). We continue to expect strong construction activity, especially in Auckland, to underpin GDP growth this year.

Meanwhile business confidence nudged a bit higher in April, but remains low. Firms continue to be more upbeat about their own prospects than the economy. However, the divergence across sectors remains stark. Sentiment is very weak in the agricultural sector, and is also low in the manufacturing and retail sectors. In contrast, businesses in the construction and service sectors are more upbeat.

Looking ahead, this week's focus for markets will be Wednesday's release of New Zealand labour market data. There's probably even more uncertainty than usual ahead of this volatile data because of the surprisingly big fall in the unemployment rate back in the December quarter. A partial unwind in the March quarter is likely and we're picking the

Household Labour Force Survey



unemployment rate to lift from 5.3% to 5.7%. That said, we're wary of potential for more big surprises this quarter.

Looking through the quarter to quarter volatility, indications are that the labour market started the year in good health. Surveys of employment conditions remain positive and GDP growth is pretty reasonable. The firm labour market, along with strong house price growth and low interest rates, has supported consumer spending to date – a dynamic expected to remain in place for much of this year.

Fixed vs Floating for mortgages

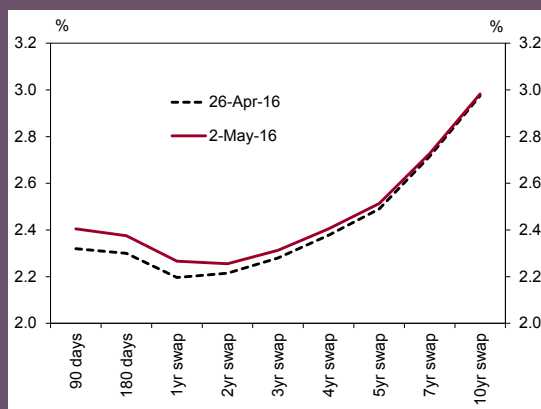
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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 Q1 Household Labour Force Survey

May 4, Employment, last: 0.9%, WBC f/c: 0.6%, Mkt f/c: +0.7%
 Unemployment, last: 5.3%, WBC: 5.7%, Mkt f/c: 5.5%

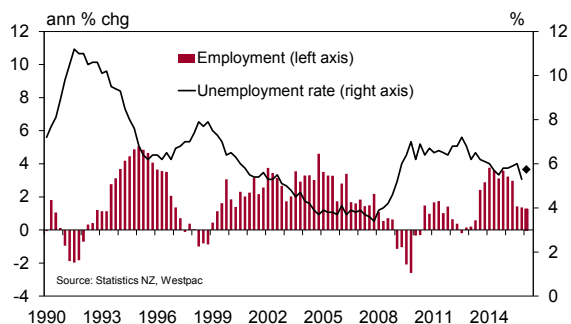
- Employment is expected to grow strongly for a second consecutive quarter in March. We're forecasting a 0.6% gain. However, that would still leave annual growth at a modest 1.2%.
- After a surprisingly sharp drop in the participation rate in the December quarter, we are expecting a partial rebound in March. A lift in the participation rate back to 68.6% would bring the rate back to the level we saw prior to the run-up over late 2014-early 2015.
- Consequently, we are forecasting the unemployment rate to tick up to 5.7%. That said, after such a sharp fall in the December quarter, we are wary of the potential for further volatility next week.

NZ Q1 Labour Cost Index

May 4, Private sector (incl. overtime), last: 0.4%, WBC f/c: 0.4%,
 Mkt f/c: 0.3%

- Strong growth in the labour force and a subdued inflation backdrop is likely to translate into ongoing softness in wage growth. We are forecasting a 0.4% lift in the private sector LCI, which would leave annual wage inflation at 1.7% on this measure.
- Wage growth is an important signal of the degree of spare capacity in the domestic economy. In this regard, developments will be important for the RBNZ's thinking around the degree of slack in the labour market and consequently, the outlook for non-tradable inflation.

Household Labour Force Survey



LCI and QES wages



Aus Mar dwelling approvals

May 3 Last: 3.1%, WBC f/c: -2.0%
 Mkt f/c: -2.0%, Range: -5.0% to 2.0%

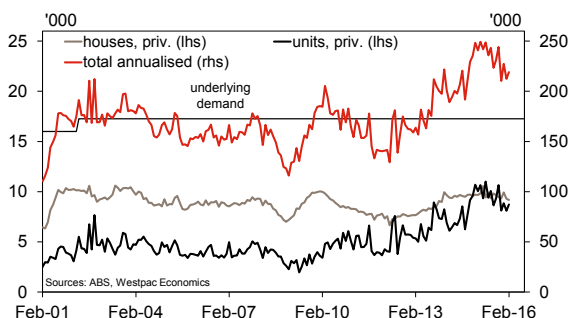
- Dwelling approvals rose 3.1% in Feb, posting a partial recovery from a 6.6% fall in Jan. The detail was mixed with upward revisions to previous estimates but a monthly mix showing the slowdown since early 2015 may be starting to spread beyond the 'high rise' segment. Total dwelling approvals are down 9%yr.
- The Mar update is expected to confirm an underlying downtrend. A 2% decline would put have that trend running at a slightly weaker 10% annualised pace of contraction. The component and state mix will again be of interest. Although already down significantly on a year ago (-33%), 'high rise' approvals remain elevated by historical standards and could still generate monthly 'noise' given the 'lumpiness' of the segment reflecting large individual projects. The early timing of Easter this year could also cause some disruption.

Aus RBA policy decision

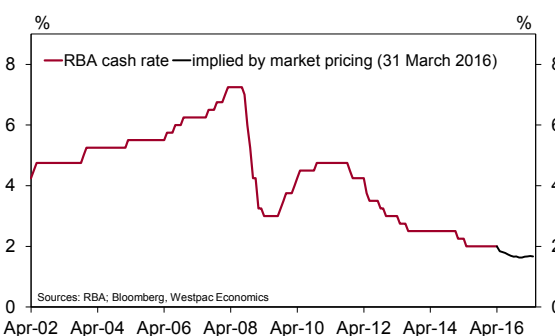
May 3, Last: 2.00%, WBC f/c: 2.00%
 Mkt f/c: 2.00%, Range: 1.75% to 2.00%

- The RBA has kept the cash rate steady at 2% since May last year, maintaining a 'mild' conditional easing bias since Nov, reiterated in April as: "low inflation would provide scope for easier policy, should that be appropriate to lend support to demand".
- A surprisingly weak Q1 CPI points to an even lower trajectory for inflation, with core measures likely to remain below the RBA's 2-3% target range near term. The question is whether this will trigger the Board to act on its easing bias. We expect the framework for the decision will be around the Bank's 2017 forecasts. On balance we expect its growth forecasts to be unchanged at 3% for 2016 and 2017 with a lower track for inflation that still leaves its 2017 forecast at 2.4% - a mix that would see no policy change. The Bank releases updated forecasts in its **Statement on Monetary Policy** on Friday.

Dwelling approvals



RBA cash rate & market pricing



The week ahead

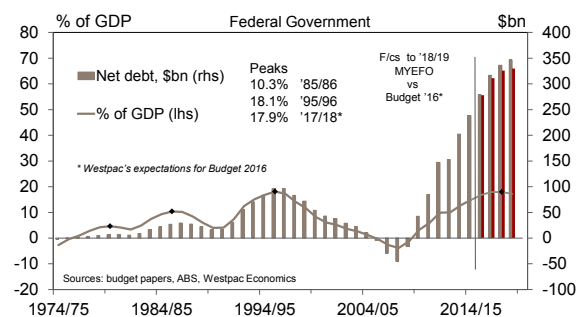
Aus 2016 Federal Budget, AUDbn

May 3, Last: -36.4, WBC f/c: -29.0

Mkt f/c: -35.0, Range: -38.0 to -25.0

- For 2015/16, we expect the budget deficit to be \$36.4bn, \$1bn less than forecast by the Government in the December mid-year update (MYEFO). Expenses are lower than anticipated outweighing some disappointment on revenue.
- For 2016/17, we expect the Government's budget deficit forecast to be \$29bn (1.7% of GDP), a \$5bn improvement on MYEFO. The economic backdrop has improved a little, notably commodity prices have unexpectedly bounced off historic lows. New policy measures are expected to be budget neutral in 2016/17 and to make a modest contribution thereafter.
- Net debt peaks at 17.9% of GDP in 2017/18, marked lower from 18.5% in MYEFO.
- For more detail see our bulletin previewing the budget.

Australia: public net debt



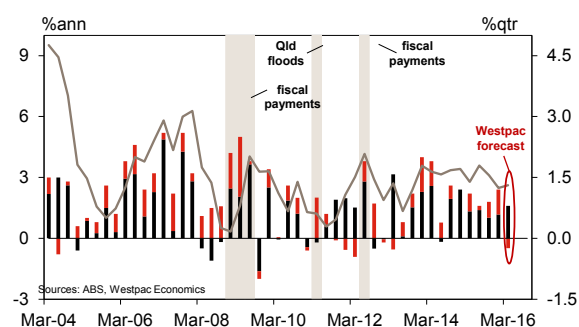
Aus Q1 real retail sales

May 5, Last: 0.6%, WBC f/c: 0.8%

Mkt f/c: 0.7%, Range: 0.3% to 0.9%

- Real retail sales rose 0.6% in Q3, following a 0.5% rise in Q3 and gains of 0.7% in Q2 and Q1. Notably, whereas the broader measure of total consumer spending in the national accounts recorded a significant pick up over the second half of last year, retail sales growth remained steady at a solid but unspectacular 2½-3% annual pace.
- The picture for Q1 is somewhat better. Nominal sales have been more subdued, set to come in with a 0.6% gain for the quarter vs 1.2% in Q4. However, the detail from the Q1 CPI points to a significant decline in retail prices over the quarter – of around -0.2% vs a 0.7% rise in Q4. That points to a decidedly perkier 0.8%qtr gain in real retail sales, the strongest quarterly result since 2014 but still leaving annual growth at a subdued 2.6%yr.

Quarterly retail volumes and prices

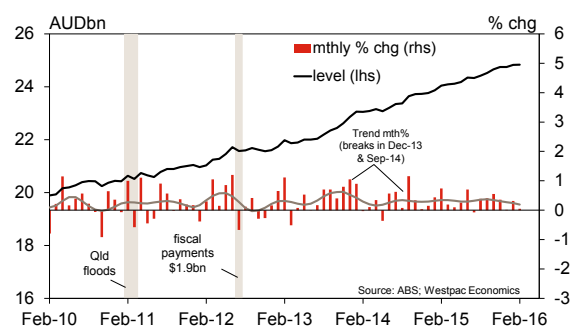


Aus Mar retail trade

May 5, Last: flat, WBC f/c: 0.3% Mkt f/c: 0.3%, Range: 0.1% to 0.6%

- Retail sales stalled flat in Feb following a lacklustre 0.3% gain in Jan. Annual sales growth dropped to 3.3%yr, well below the 20yr average of 5%yr. The softening is despite a lift in consumer sentiment through Nov-Feb. The Q1 CPI suggests much of the weakness is due to falling prices.
- Consumer sentiment softened a little in March, weakening further into 'cautiously pessimistic' territory in April. Private sector business surveys also suggest demand cooled in early 2016 although these ran well ahead of retail sales in the second half of 2015. On balance we expect March retail sales to show an improvement but with a still lacklustre 0.3% gain. The early timing of Easter this year may give some boost although the ABS attempts to adjust for this and an unusually warm Autumn may be a negative for some segments.

Monthly retail sales



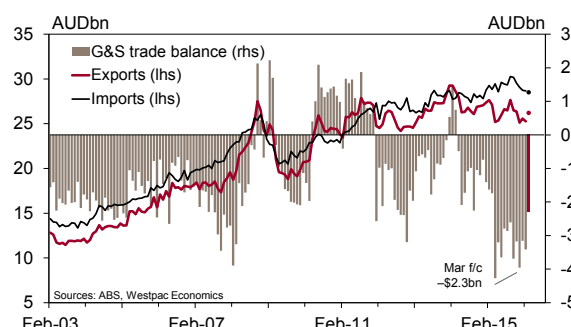
Aus Mar trade balance, AUDbn

May 5, Last: -3.4, WBC f/c: -2.3

Mkt f/c: -2.9, Range: -4.3 to -2.3

- Australia's trade balance will be in deficit for 24 consecutive months in March. That's the bad news. The good news, the deficit narrowed materially in March, we suspect. We expect a \$2.3bn deficit for the month, a \$1.1bn improvement on February.
- Exporters will see some relief, with earnings recovering by a forecast 3.7%, +\$0.9bn. The iron ore spot price was on the move, jumping 20% to US\$56/t from US\$47/t. In addition, coal and LNG shipments advanced.
- The import bill is forecast to shrink by 0.6%, down \$0.2bn. Prices weakened on a stronger Australian dollar, up 5% vs the US dollar, to 74.8¢, and up 4% on a TWI basis. However, partially offsetting this, fuel imports became more expensive with the oil price surging, up 20% in US dollar terms.

Australia's trade position



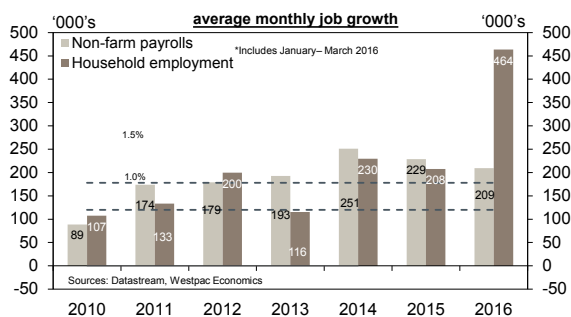
The week ahead

April US nonfarm payrolls

May 6, Last: 215k, WBC 210k

- Nonfarm payrolls rose by 215k in March, leaving 3-month average job growth at 209k. Annual growth continues to run at an impressive 2.0%/yr. Unusually the household sector survey lined up with payrolls in March, seeing annual growth of 2.0%/yr. The strength of this result is most evident when it is set against growth in the population, just 1.1%/yr in March.
- Had it not been for a rise in participation, the unemployment rate would have remained below 5.0%. The participation rate is now 0.6ppts off its September 2015 low.
- In April we expect the pace of job creation to remain strong, with a payrolls gain of 210k forecast. After such a rapid rise, a pullback in the participation rate seems likely. Together these two factors should see the unemployment rate edge back below 5.0%. Risks to jobs are again to the upside.

US job creation remains strong



Data calendar

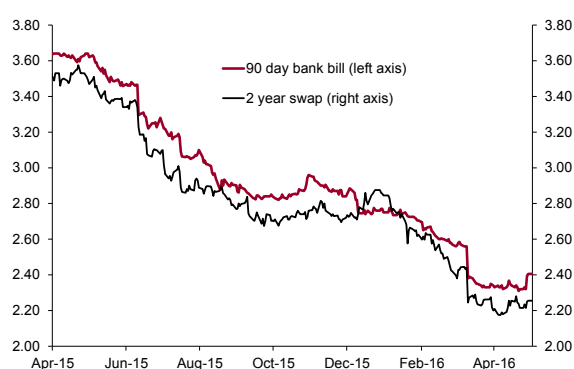
		Last	Market median	Westpac forecast	Risk/Comment
Mon 02					
Aus	Apr AiG PMI	58.1	-	-	Manufact'g index jumped 4.6pts in Mar to 6yr high - risk of pull-back.
	Apr CoreLogic RP Data home value index	0.2%	-	1.5%	Big variations by city - 6mth ann'd pace stabilising in 0-5% range.
	Apr MI inflation gauge, %yr	1.7%	-	-	Big miss in Q1 following 2yrs of significantly improved performance.
	Apr NAB business survey	12	-	-	Conditions index well above trend, up 4pts to +12 in March.
Eur	Apr Markit manufacturing PMI, final	51.5	51.5	-	Flash points to slightly slower momentum at beginning of Q2.
Ger	Apr Markit manufacturing PMI	51.9	51.9	-	External demand a major headwind.
US	Fedspeak	-	-	-	Lockhart Makes Introductory Remarks in Florida.
	Apr ISM manufacturing	51.8	51.5	51.3	Momentum hard to come by for US manufacturing.
	Mar construction spending	-0.5%	0.5%	-	Non-residential activity weak; residential peaking?
Tue 03					
Aus	Mar dwelling approvals	3.1%	-2.0%	-2.0%	Downtrend broadening to non high-rise segments.
	RBA policy decision	2.00%	2.00%	2.00%	Decision framed by RBA's 2017 growth and inflation forecasts.
	2016/17 Federal Budget, \$bn	-36.4	-35	-29	Deficit to narrow in 2016/17, as commodity prices bounce.
Chn	Apr Caixin China PMI	49.7	49.8	-	External sector a heavier burden for Caixin measure.
UK	Apr Markit manufacturing PMI	51.0	51.2	-	Manufacturing remain subdued; external conditions are a drag.
US	Fedspeak	-	-	-	Williams in LA; Mester moderates Panel on Financial Markets.
Wed 04					
NZ	GlobalDairyTrade auction results	3.8%	-	-	Futures market suggesting a 5% rise in whole milk powder prices.
	Q1 unemployment rate	5.3%	5.5%	5.7%	Fell sharply in Q4 due to a steep fall in the participation rate ...
	Q1 employment growth	0.9%	0.6%	0.6%	... which seemed at odds with the solid trend in employment growth.
	Q1 LCI private wages (incl. overtime)	0.4%	0.3%	0.4%	Persistently low inflation has depressed nominal wage growth.
	Apr QVNZ house prices (% yr)	11.4%	-	-	Auckland market has regained momentum since February.
Eur	Apr Markit services PMI, final	53.2	53.2	-	Flash points to slightly slower momentum at beginning of Q2.
Ger	Apr Markit services PMI, final	54.6	54.6	-	Benefitting from low unemployment; could be much stronger.
US	Fedspeak	-	-	-	Lockhart Speaks to World Affairs Council Jacksonville.
	Apr ADP employment change	200k	198k	205k	Momentum set to continue; firing at multi-decade low.
	Mar trade balance US\$bn	-47.1	-46.0	-	Net exports to remain a drag on growth in 2016.
	Apr ISM non-manufacturing	54.5	54.8	54.5	Off highs, but looks to have found some stability.
	Mar factory orders	-1.7%	0.9%	-	Investment climate poor, and likely to remain that way.
Thu 05					
NZ	Apr commodity prices	-1.3%	-	-	Small uptick in dairy prices outweighed by stronger NZD.
Aus	Apr AiG PSI	49.5	-	-	Lost momentum over Q1.
	Mar retail sales	flat	0.7%	0.3%	Nominal sales slowed in Q1 but CPI detail suggests this is due to ...
	Q1 real retail sales	0.6%	0.7%	0.8%	... price declines with real retail sales volumes actually picking up.
	Mar trade balance \$bn	-3.4	-2.9	-2.3	Deficit to narrow. Exports +3.7%, higher prices + vols. Imports -0.6%.
Chn	Apr Caixin China PMI services	52.2	-	-	Services the key to robust growth in 2016.
UK	Apr Halifax house prices	2.6%	-0.3%	-	Changes in stamp duty from 1 April may weigh on demand.
	Apr Markit services PMI	53.7	53.6	-	Services sector conditions have been softening.
US	Fedspeak	-	-	-	Kashkari Hosts Town Hall in Rochester, MN.
	Initial jobless claims	257k	-	-	At multi-decade lows.
Fri 06					
Aus	RBA Statement on Monetary Policy	-	-	-	Quarterly update of growth and inflation forecasts.
Chn	Q1 current account balance	91.9	-	-	Full detail on trade and finance flows.
US	Fedspeak	-	-	-	Bullard, Kaplan, Lockhart, Williams Speak at Stanford
	Apr non-farm payrolls	215k	200k	210k	Strong job gains likely given low firing rate.
	Apr unemployment rate	5.0%	5.0%	4.9%	Unemployment depends on participation rate volatility.
	Mar consumer credit	17.217	15.825	-	Auto and student loans remain the driver of growth.
Can	Apr Ivey PMI	50.1	-	-	Weakness in the resource sector and other parts of manufacturing.

New Zealand forecasts

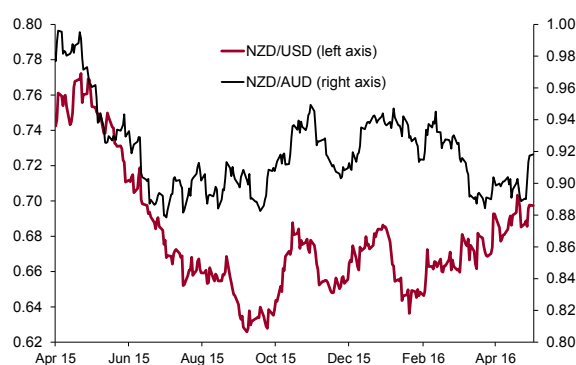
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.8	3.7	2.5	2.8	2.6
Employment	3.8	3.2	1.4	2.5	3.6	1.4	2.7	1.5
Unemployment Rate % s.a.	6.0	5.8	5.8	5.6	5.8	5.3	5.6	5.9
CPI	1.5	0.3	0.3	1.1	0.8	0.1	0.7	2.2
Current Account Balance % of GDP	-2.5	-3.4	-3.2	-3.4	-3.1	-3.1	-3.4	-3.7

Financial Forecasts	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day bill	2.10	2.10	2.10	2.10	2.10	2.10
2 Year Swap	2.10	2.10	2.10	2.10	2.10	2.10
5 Year Swap	2.60	2.70	2.80	2.90	3.00	3.10
10 Year Bond	3.00	3.10	3.20	3.40	3.50	3.60
NZD/USD	0.65	0.65	0.62	0.62	0.62	0.62
NZD/AUD	0.88	0.88	0.87	0.87	0.86	0.85
NZD/JPY	71.5	72.8	71.3	72.1	74.2	74.4
NZD/EUR	0.60	0.60	0.58	0.58	0.58	0.57
NZD/GBP	0.47	0.47	0.45	0.45	0.45	0.44
TWI	69.3	69.5	67.4	67.3	67.3	66.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 2 May 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.30%	2.26%	2.30%
60 Days	2.36%	2.32%	2.32%
90 Days	2.41%	2.34%	2.33%
2 Year Swap	2.26%	2.26%	2.20%
5 Year Swap	2.51%	2.52%	2.51%

NZ foreign currency mid-rates as at Monday 2 May 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6974	0.6873	0.6891
NZD/EUR	0.6086	0.6077	0.6046
NZD/GBP	0.4780	0.4834	0.4846
NZD/JPY	74.11	74.35	76.95
NZD/AUD	0.9182	0.9008	0.8983
TWI	73.51	72.80	72.88

International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
Australia						
Real GDP % yr	3.5	2.0	2.6	2.5	2.8	2.8
CPI inflation % annual	2.2	2.7	1.7	1.7	1.8	2.0
Unemployment %	5.3	5.8	6.2	5.8	5.5	5.3
Current Account % GDP	-4.4	-3.4	-3.0	-4.6	-4.3	-3.9
United States						
Real GDP %yr	2.2	1.5	2.4	2.4	2.0	2.1
Consumer Prices %yr	2.1	1.5	1.6	0.1	1.3	1.7
Unemployment Rate %	8.1	7.4	6.2	5.3	4.7	4.5
Current Account %GDP	-2.9	-2.3	-2.2	-2.3	-2.3	-2.3
Japan						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.7
Euroland						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.3	1.3
United Kingdom						
Real GDP %yr	1.2	2.2	2.9	2.2	2.2	2.2
China						
Real GDP %yr	7.7	7.7	7.3	6.9	6.5	6.2
East Asia ex China						
Real GDP %yr	4.6	4.2	4.1	3.7	3.9	4.1
World						
Real GDP %yr	3.5	3.3	3.4	3.1	3.3	3.5

Forecasts finalised 29 Apr 2016

Interest Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
Australia						
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.27	2.30	2.30	2.30	2.30	2.30
10 Year Bond	2.62	2.60	2.75	2.75	2.90	3.10
International						
Fed Funds	0.375	0.625	0.625	0.875	0.875	1.125
US 10 Year Bond	1.85	2.00	2.15	2.25	2.50	2.80
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.40

Exchange Rate Forecasts	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17
AUD/USD	0.7652	0.74	0.74	0.71	0.71	0.72
USD/JPY	107.18	110	112	115	117	120
EUR/USD	1.1404	1.09	1.08	1.07	1.06	1.07
AUD/NZD	1.0985	1.14	1.14	1.15	1.15	1.17

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