Lake Taupo

25 January 2016

Weekly Commentary

In this issue

Clear cut

Since July last year we have consistently predicted that the Reserve Bank would have to cut the OCR below 2.5% in 2016. Last week's data provided crucial evidence in favour of that view. Inflation turned out much weaker than the RBNZ expected. Housing data further confirmed a slowdown in Auckland. And another negative dairy auction compounded the dairy sector's woes. True, the data also confirmed that the New Zealand economy has good momentum behind it. But at the same time, global financial and economic conditions appear to be deteriorating rapidly.

We have been anticipating low inflation for some time, and last week's Consumer Price Index did not disappoint. Annual inflation fell to 0.1% – below our forecast of 0.2% and well below the Reserve Bank's forecast (issued in December) of 0.4%. Falling petrol prices have obviously been the main contributor to low inflation. But that was anticipated. The real surprise was weak prices for many tradable goods other than petrol.

That is a crucial development in the debate around monetary policy. The Reserve Bank has been arguing that the lower exchange rate will push prices for tradable goods higher, causing inflation to rise above 1% by March 2016. We demurred, instead arguing that retailers have little scope to pass on price increases, that tight retail margins are the new normal, and that prices for tradable goods would remain subdued. The details of the CPI strongly favoured the latter view.

Lack of exchange rate passthrough, combined with plunging global oil prices, will make for another year of ultra-low inflation (oil prices fell as low as $26 per barrel last week). Our latest forecast sees inflation dropping to zero in September 2016, and remaining below 1% until 2017. There is a good chance that inflation will actually go negative at some point during the year.

Clear cut continued

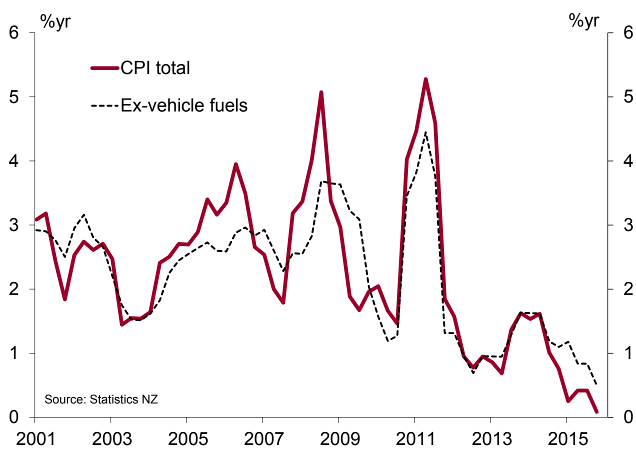
Another key factor in the OCR debate has been the Auckland housing market. Some have argued that rising Auckland house prices will preclude OCR cuts, while we have argued that the Auckland housing market will slow. Last week's Real Estate Institute data did actually show signs that the market is stabilising in Auckland. But that comes after extraordinarily weak data in October and November. It remains clear that the Auckland housing market has indeed slowed. In seasonally adjusted terms house sales are down 20% from the peak, and the House Price Index is down almost 6%. True, housing markets are clearly accelerating in many parts of New Zealand outside Auckland. But house prices averaged across New Zealand have far undershot the RBNZ's expectations. Back in December the RBNZ was forecasting 17% house price inflation for the year to June 2016. The latest data indicates that the market is more likely to register something below 10%.

Not all of last week's data favoured our view that the OCR will fall. The *Quarterly Survey of Business Opinion* showed that business confidence improved in December 2015, from -10% to +13%. Firms' own reported activity, which corresponds much more closely with GDP growth, posted a more modest increase from 12% to 18%. This posed some mild upside risk to our forecast of 0.6% GDP growth in the December quarter, and suggested that the New Zealand economy was travelling smoothly at the end of last year.

This confidence is a good sign, but we question how long the New Zealand economy can stand aloof from developments in the global economy. China's economic growth is slowing, and global commodity prices are falling. In our view, it is just a matter of time before New Zealand exporters feel the pinch. As a case in point, last week's GlobalDairyTrade auction registered a small decline in prices, and we revised our forecast of the current season's farmgate milk price to $4.20. That compares to Fonterra's forecast of $4.60, and will come as a disappointment to farmers.

So on balance we remain very comfortable with our forecast that the OCR will fall below 2.5% this year. The remaining uncertainty is timing. Prior to last week our best estimate was that cuts would occur in June and August. But with inflation falling short so soon, there is a risk that the Reserve Bank could cut as soon as March.

CPI inflation



There is, however, little chance that the Reserve Bank will cut the OCR at this Thursday's OCR review. Such a significant move would be reserved for a full *Monetary Policy Statement* rather than an interim OCR review. However, the Reserve Bank is going to have to acknowledge that the outlook for inflation has shifted, and that the case for cuts is now stronger.

The Reserve Bank's last statement amounted to a conditional easing bias: *"We expect to achieve [the inflation target] at current interest rate settings, although the Bank will reduce rates if circumstances warrant."*

We suspect that the Reserve Bank will shift that to an explicit easing bias, perhaps along the lines of: *"The OCR is expected to remain low for some time, and could even move lower."*

There are actually two opportunities for the Reserve Bank to make this shift to an explicit easing bias – either this week's OCR review, or at a speech the Governor will deliver to the Canterbury Employers' Chamber of Commerce on 3 February.

Fixed vs Floating for mortgages

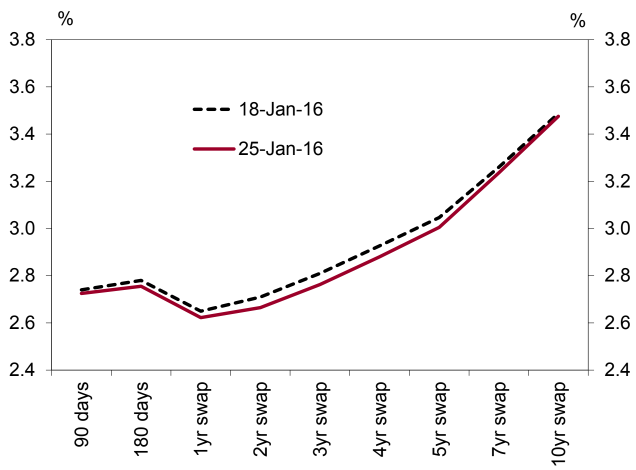
With short-term interest rates likely to fall further, borrowers should feel in no hurry to fix.

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



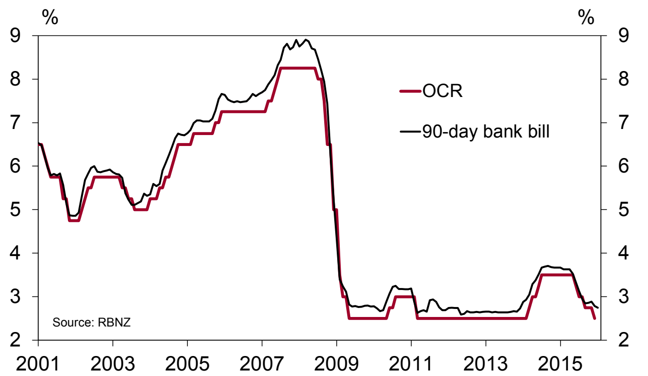
The week ahead

RBNZ Jan OCR review

Jan 28, Last: 2.50%, Westpac f/c: 2.50%, Mkt f/c: 2.50%

- In December the RBNZ said it expected to leave the OCR at 2.5%, but that it would reduce interest rates "if circumstances warrant." That was on the basis that inflation would rise above 1% in March.
- It now seems clear that circumstances warrant further cuts. Inflation is likely to remain below 1% until 2017, and could even drop below zero during 2016. The Auckland housing market has slowed, dairy prices have fallen, and global risks are rising.
- We expect the RBNZ to shift to a more explicit easing bias at Thursday's OCR review. A major speech by the RBNZ Governor the following week could be used to flesh out this shift.

NZ OCR and 90-day rate

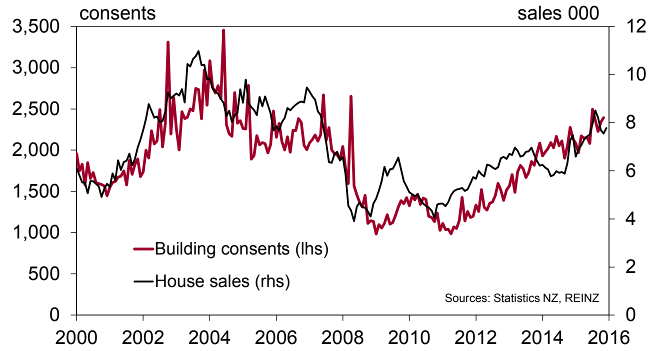


NZ Dec building consents

Jan 29, Last: 1.8%, Westpac f/c: -2.0%

- Seasonally-adjusted monthly residential consents have increased 7.3% over the last two months.
- We expect a slight dip this month, led by a fall in residential consents in Canterbury after the bump we forecast last month.
- The residential data for Auckland was weak in November, down 10%. It would be surprising to see consents there fall much further this month in seasonally-adjusted terms.
- Non-residential consents were up in November after a weaker October. We expect some moderation again in the December data.

NZ housing activity

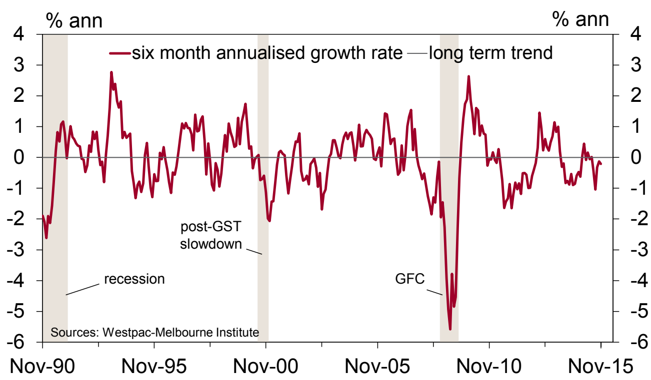


Aus Dec Westpac–MI Leading Index

Jan 27, Last: –0.21%

- The 6mth annualised growth rate of the Leading Index decreased from –0.13% in Oct to –0.21% in Nov. The growth pulse has been below trend since mid 2015.
- The Dec read is shaping up as a weak one with component updates including a hefty 6% fall in commodity prices in AUD terms (significantly extending on a 4% fall last month); a sharp 12.7% pull back in dwelling approvals (vs +3.3.% last month); and weaker reads on US industrial production, consumer sentiment based components, and the yield gap. Total hours worked improved slightly but were still flat vs down -0.8% last month.

Westpac-MI Leading Index

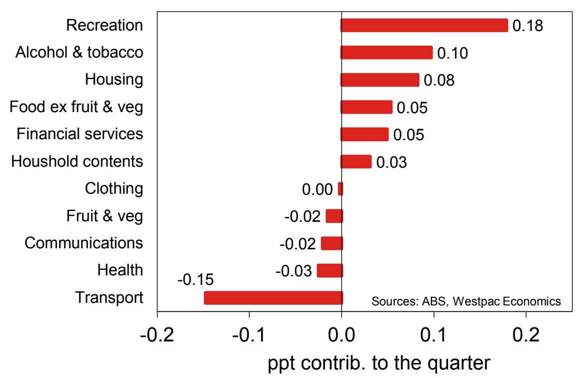


Aus Q4 CPI

Jan 27, Last: 0.5% (avg RBA core 0.3%) , WBC f/c: 0.3% (0.6%)
Mkt f/c: 0.3% (0.5%), Range: flat to 0.5% (0.4% to 0.6%)

- The headline CPI lifted 0.5% in Q3 vs Westpac's 0.8% forecast and the market's expectation of 0.7%. The annual rate was unchanged at 1.5%yr vs 1.3%yr in Q1, 1.7% in Q4 2014 and 2.3%yr in Q3 2014. The average of the two RBA core measure rose 0.3%qtr vs the market's expectation for 0.5%qtr. Annual core inflation was 2.2% vs 2.3% in Q2.
- Westpac expects the Q4 CPI to show a modest 0.3%qtr rise (1.6%yr). Rises for holiday travel, tobacco and house purchases are expected to be offset by a meaningful decline in fuel prices and muted price pressure elsewhere.
- Core inflation is forecast to hold near the bottom of the RBA's inflation target band with the average measure up 0.6%qtr, 2.2%yr. The six month annualised pace is expected to hold at a slower 1¾%yr pace.

Forecast contributions 2015Q4 CPI

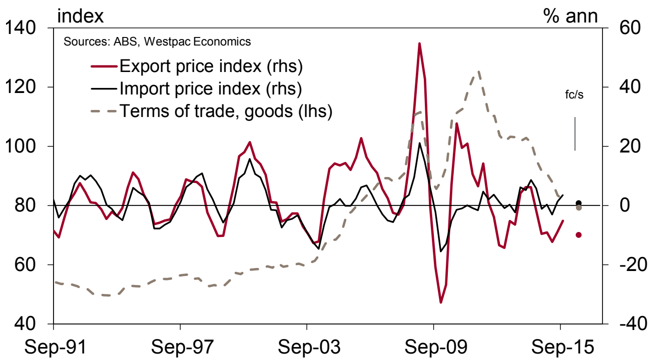


Aus Q4 import price index

Jan 28, Last: 1.4%, WBC f/c: –1.8%
Mkt f/c: –0.7%, Range: –1.8% to flat

- The import price index is forecast to fall by 1.8% in the December quarter, but to still be around 1% higher than a year earlier.
- The currency was not a factor in the quarter, with the TWI holding broadly steady at 61.5. However, over the past year, the currency weakened, placing upward pressure on import prices.
- In the December quarter, falling energy prices is the source of lower import prices, with oil down around 12% in the period.

Import & export prices (excluding services)

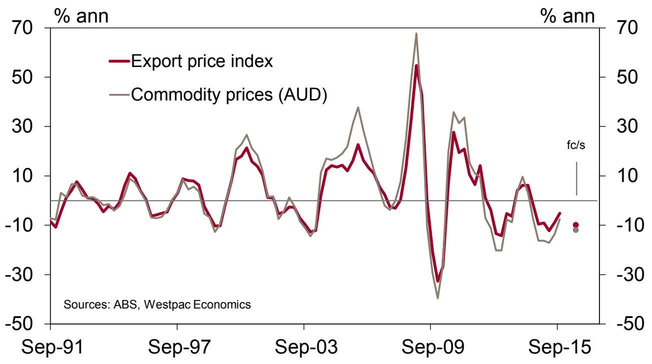


Aus Q4 export price index

Jan 28, Last: flat, WBC f/c: –5.0%
Mkt f/c: –3.7%, Range: –6.0% to x–3.0%

- Export prices have been hit by the slump in global commodity prices, a trend that extended into the December quarter.
- The export price index is forecast to fall by 5% in the December quarter, to be 10% lower than a year ago.
- Commodity prices fell by around 6% in US dollar terms. The Australian dollar was not a big mover in the quarter, averaging 72US¢, 0.7% lower than 72.6US¢ in Q3.
- The terms of trade for goods, on these estimates, drops a further 3% to be 12% below the level of a year ago.
- Note, quarterly movements in the export price index and the export price deflator (BoP) can vary, as occurred in Q3 - with outcomes of 0.0% and –3.5% respectively.

Commodity prices & export price index

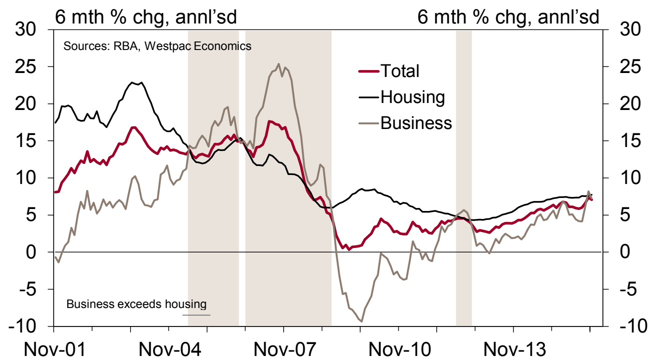


Aus Dec private sector credit

Jan 29, Last: 0.4%, WBC f/c: 0.5%
Mkt f/c: 0.6%, Range: 0.5% to 0.7%

- Credit posted a 0.4% rise in November, a more modest gain than over the previous four months (0.6%, 0.6%, 0.8% and a 0.7%).
- For December, we expect credit to expand by 0.5%.
- The business segment is typically key to monthly fluctuations in total credit. Through July to October business credit grew by a brisk 0.9% per month on average, with the results inflated by valuations effects associated with the falling dollar. In November, business credit stalled. We anticipate a moderate rise in December, more in keeping with new lending.
- Housing credit grew by 0.64%, 7.5%yr in November. A gradual loss of momentum is likely to begin to emerge in coming months, with new lending to investors falling of late.

Credit momentum

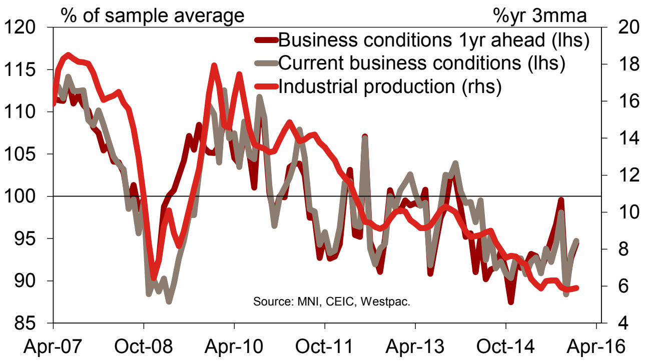


China Jan Westpac–MNI Consumer Sentiment

Jan 27, Last: 113.7

- The Westpac MNI China Consumer Sentiment Indicator rose 0.7pts to 113.7 in December to be up 1.1% on a year prior and a touch above its 18-month average.
- Households' views on business conditions have become more favourable of late, as have expectations over employment prospects. However, family finances are lagging.
- Key to the growth outlook, we are yet to see a strong vote of confidence in favour of housing: consumers' perceptions of the sector are mixed; and broader risk aversion has also risen. Further improvement on both fronts would be very welcome, given contineud weak growth in the sector.
- Of course the tension surrounding the Renminbi and the sharp falls seen on China's stock market are clear negatives for early 2016; although it bears noting that similar developments had little or no direct impact on sentiment in 2015.

Chinese IP & household views of business

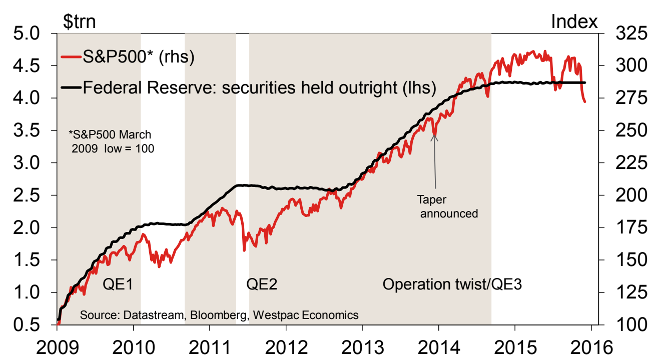


US Jan FOMC policy decision

Jan 26–27, Last: 0.375%, WBC f/c: 0.375% Mkt f/c 0.375%

- The key point of contention at this meeting will likely be the Committee's assessment of international developments and the implications for the US economy and its financial markets.
- Apparent in the December meeting minutes was a belief that "downside risks to U.S. economic activity from global economic and financial developments, although still material" were believed to have "diminished since late summer". A month on, that is arguably not the case.
- Nonetheless, the impulse from the real economy remains strong, and there is every reason to believe that domestic demand growth will continue at pace in 2016. As such, we look for the FOMC to hold the line and indicate that normalisation will proceed as data allows in 2016; although we will be looking out for any shift to a more dovish stance.

US equities: losses (to date) at the margin

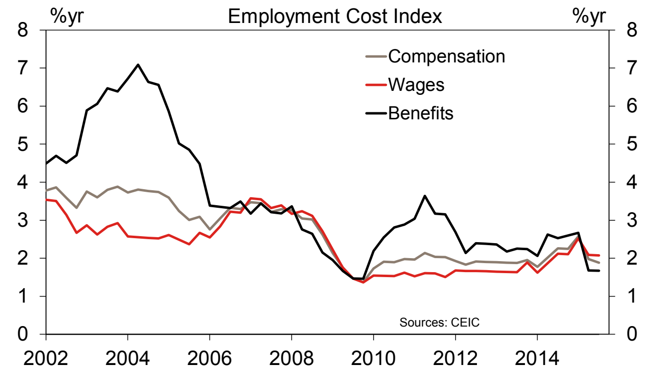


US Q4 employment cost index

Jan 29, Last: 0.6%, WBC f/c: 0.6% Mkt f/c 0.6%

- Total compensation rebounded in Q3, posting a healthy 0.6% gain following Q2's weak 0.2% result. Wages increased by 0.6% in the quarter as benefit costs rose 0.5%.
- During the past two years, wages growth has maintain a circa 2.0% pace despite continued rapid growth in employment. Now that the unemployment rate is verging on its full-employment level, this trend should gain some further momentum. That said, given the history of wages growth in the US, a stronger pulse is only likely to build slowly.
- Consequently, come Q4 we look for a 0.7% gain for wages which would see the annual rate edge up to 2.2%yr. Total compensation is however likely to be held back by softer growth in benefits. We see a total compensation gain of 0.6% in the quarter, taking the annual rate to 2.0%yr.

US growth to depend on consumer

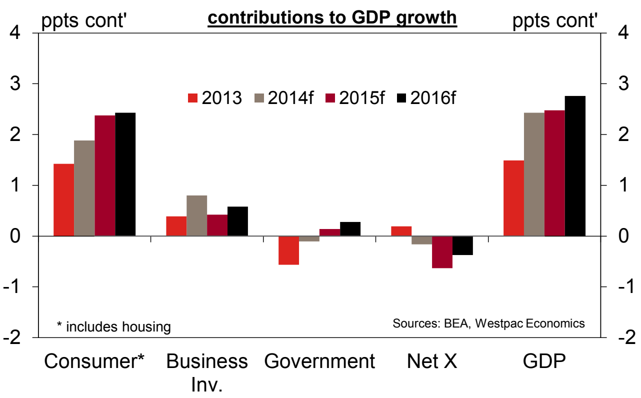


US Q4 GDP

Jan 29, Last: 2.1%, WBC f/c: 0.9% Mkt f/c 0.8%

- Despite favourable weather, partial data is pointing to a significant slowdown in Q4. In its latest reading, the Atlanta Fed's 'now cast' has GDP growth of just 0.6%.
- In line with this guide, we anticipate that the BEA will report a 0.9% annualised rise in GDP for Q4, leaving annual growth below trend at 1.9%yr.
- It must be noted that we anticipate domestic demand growth to maintain a healthy clip in Q4, circa 2.5%yr, after which it should re-accelerate to 3.0% or thereabouts by 2016. The consumer is critical to both of these expectations.
- The weakness in aggregate GDP expected in Q4 (and potentially extending into the early part of 2016) will instead come as a result of reduced inventory accrual and, of lesser importance, net exports continuing to subtract from growth.

Total nominal wage growth



Data calendar

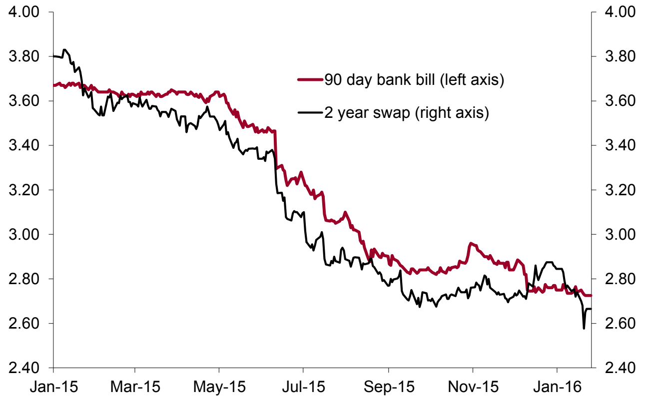
		Last	Market median	Westpac forecast	Risk/Comment
Mon 25					
Aus	Dec NAB business survey	10	–	–	Conditions index steady in Nov at an above avg +10.
Ger	Jan IFO business climate survey	108.7	108.5	–	German industry's perspective on globe & ECB's actions.
US	Jan Dallas Fed manufacturing activity	–20.1	–15.0	–	Weak external demand is dampening manufacturing.
Tue 26					
NZ	Dec BusinessNZ PSI	59.8	–	–	Firm domestic demand has boosted service sector activity.
Aus	Australia Day	–	–	–	Public holiday, markets closed.
US	Nov FHFA house prices	0.5%	0.5%	–	Housing sales activity looks to be rolling over....
	Nov S&P/C-S 20 city house prices	0.8%	0.8%	–	... but price momentum is continuing, circa 5.5%yr.
	Jan Markit service PMI (provisional)	54.3	53.8	–	Are we likely to see USD impact services demand in 2016?
	Jan consumer confidence	96.5	96.5	–	Remains robust.
	Jan Richmond Fed manufacturing index	6	2	–	Has remained moderate despite external headwinds.
Wed 27					
Aus	Dec Westpac-MI Leading Index	–0.21%	–	–	Components mostly weaker in Dec.
	Q4 CPI	0.5%	0.3%	0.3%	Falling fuel prices offset AUD and housing related prices gains ...
	Q4 core CPI	0.3%	0.5%	0.6%	... with a muted backdrop elsewhere holding core inflation at 2.2%yr.
Chn	Dec industrial profits %yr	–1.4%	–	–	Manufacturing and construction remain under significant pressure.
	Jan Westpac–MNI consumer sentiment	113.7	–	–	Headline a touch above 18mth average in December.
UK	Jan Nationwide house prices	0.8%	–	–	Tight supply and low borrowing costs are supporting prices.
US	Dec new home sales	4.3%	2.0%	–	Momentum in sales looks to be abating.
	FOMC policy decision, midpoint	0.375%	0.375%	0.375%	No change in Jan; but tone of statement key for March.
Thu 28					
NZ	RBNZ policy decision	2.5%	2.5%	2.5%	RBNZ may shift to explicit easing bias.
	Dec trade balance $m	–779	–112	100	Seasonal lift in export volumes and stabilising dairy prices.
Aus	Q4 import price index	1.4%	–0.7%	-1.8%	Import prices down on lower energy costs, with TWI broadly flat.
	Q4 export price index	flat	–3.7%	–5.0%	Export prices down again, as the slide in commodity prices continues.
Eur	Jan economic confidence	106.8	–	–	Critical for ECB to maintain confidence in outlook.
	Jan consumer confidence (final)	–6.3	–	–	Consumer confidence dependent on labour market.
	Jan business climate indicator	0.41	–	–	Businesses finally getting interested in real investmet – will it last?
Ger	Jan CPI (provisional)	–0.1%	–0.8%	–	Oil a major factor behind weakness – as is the case globally.
UK	Q4 GDP	0.4%	0.5%	0.4%	Domestic demand has firmed, external conditions still a drag.
US	Initial jobless claims	293k	–	–	Claims remain low, but have trended up in recent weeks.
	Dec durable goods orders	flat	–0.5%	–	Core trend continues to point to lacklustre investment growth.
	Dec pending home sales	–0.9%	1.0%	–	Leading indicator for existing sales.
	Jan Kansas City Fed Manuf. Survey	–9	–	–	Remains low, dampened by external headwinds and the USD.
Fri 29					
NZ	Dec building permits	1.8%	–	–2.0%	Record value of consents in November.
Aus	Dec private sector credit	0.4%	0.6%	0.5%	Business to record moderate gain, following a flat outcome for Nov.
	Q4 PPI	0.9%	–	–	Up 1.7%yr to Q3, but imported final goods up 10%yr due to lower AUD.
Eur	Dec M3 money supply %yr	5.1%	5.2%	–	Credit data also due; increasingly favourable.
	Jan CPI %yr	0.2%	0.4%	–	Core inflation at 0.9%; still well below target.
UK	Jan GFK consumer sentiment	2	1	–	A strengthening labour market is boosting consumer sentiment.
US	Q4 GDP	2.0%	0.7%	0.9%	Inventories and next exports subtract; domestic demand solid.
	Q4 employment cost index	0.6%	0.6%	0.6%	Uptrend to strengthen, albeit only at the margin.
	Jan ISM Milwaukee	48.5	–	–	Remains low with soft external demand a drag.
	Jan Chicago PMI	42.9	45.8	–	Has fallen to low levels due to the strong USD and weak export demand.
	Jan University of Michigan sentiment (final)	93.3	92.5	–	Remains robust.
	Fedspeak	–	–	–	Williams gives forecast speech in San Francisco.

New Zealand forecasts

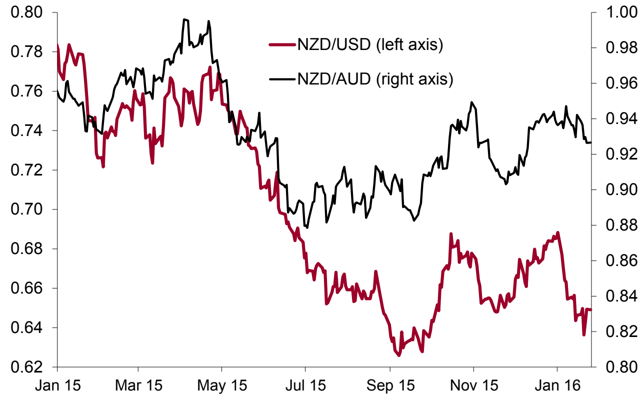
Economic Growth Forecasts		March years				Calendar years		
% change	2014	2015	2016f	2017f	2013	2014	2015f	2016f
GDP (Production) ann avg	2.5	3.2	2.2	2.2	2.3	3.3	2.4	2.0
Employment	3.8	3.2	1.0	2.3	2.9	3.6	1.2	2.1
Unemployment Rate % s.a.	6.0	5.8	6.4	6.3	6.1	5.7	6.3	6.4
CPI	1.5	0.3	1.1	1.5	1.6	0.8	0.3	1.7
Current Account Balance % of GDP	-2.6	-3.4	-3.7	-3.5	-3.2	-3.1	-3.4	-3.7

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	2.20	2.10	2.10	2.10	2.10
2 Year Swap	2.50	2.30	2.20	2.20	2.20	2.20
5 Year Swap	3.10	3.10	3.20	3.20	3.20	3.20
10 Year Bond	3.50	3.60	3.70	3.80	3.80	3.80
NZD/USD	0.63	0.62	0.62	0.62	0.62	0.62
NZD/AUD	0.93	0.94	0.93	0.90	0.89	0.87
NZD/JPY	78.1	77.5	78.1	78.7	76.9	76.9
NZD/EUR	0.60	0.60	0.60	0.60	0.59	0.58
NZD/GBP	0.43	0.42	0.42	0.41	0.40	0.39
TWI	69.8	69.6	69.4	68.7	68.0	67.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 25 January 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.58%	2.62%	2.65%
60 Days	2.65%	2.68%	2.70%
90 Days	2.73%	2.74%	2.75%
2 Year Swap	2.67%	2.78%	2.77%
5 Year Swap	3.01%	3.12%	3.11%

NZ foreign currency mid-rates as at Monday 25 January 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6491	0.6558	0.6718
NZD/EUR	0.6011	0.6004	0.6117
NZD/GBP	0.4550	0.4514	0.4413
NZD/JPY	77.00	76.90	81.33
NZD/AUD	0.9266	0.9414	0.9328
TWI	71.58	72.40	73.12

International forecasts

Economic and Financial 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	2.27	2.20	2.20	2.20	2.20	2.20
10 Year Bond	2.72	3.00	3.00	3.10	3.30	3.55
International						
Fed Funds	0.375	0.625	0.875	1.125	1.375	1.625
US 10 Year Bond	2.01	2.50	2.70	2.90	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	0.6996	0.68	0.66	0.66	0.67	0.69
USD/JPY	117.70	125	126	127	128	125
EUR/USD	1.0846	1.05	1.02	1.02	1.03	1.06
AUD/NZD	1.0724	1.08	1.06	1.06	1.08	1.09

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