

# Weekly Commentary

16 May 2016



## On the sidelines

Last week's Financial Stability Report put the run-up in debt (both households and dairy sectors) firmly front and centre. While no new lending restrictions were announced, the RBNZ is clearly mulling over its options. That's no surprise given rampant credit growth and ongoing broad-based strength in the housing market. We think the RBNZ will feel compelled to leave the sidelines and impose further lending restrictions on banks before the year is out. Other data last week showed that strong house price growth and a growing appetite for debt are supporting activity in the domestic economy. But that also increases the risk of things getting ugly further down the track.

The six-monthly Financial Stability Report (FSR) is the RBNZ's flagship publication for reporting on the health of New Zealand's financial system. It's chock full of interesting data and discussion of the inner workings of New Zealand's banks, payments systems and developments in supervision and regulatory policy. Ultimately the RBNZ concluded in the FSR that New Zealand's financial system remains resilient. However, it also noted that "*risks to the financial stability outlook have increased over the last six months*".

Key sources of risk identified in the document were the deteriorating global outlook, imbalances in the housing market and stress in the dairy sector. On the latter, strains in the dairy sector have increased as milk prices have remained low. However, the RBNZ remains comfortable that banks are well placed to cope with potential losses on loans to dairy farms. For now, banks continue to lend more to farmers, who are looking to bridge the gap between their income and expenses. That would be fine if the gap were to prove temporary. We are sure that in some cases it will. But in other cases, farmers will find themselves unable to repay their debts. Even for those who are able to repay their debt, today's additional borrowing means higher debt servicing costs and less money to spend elsewhere further down the track.

On the housing front, the RBNZ offered a timely reminder that it's not house price growth they are worried about, per se, but the potential consequences of the associated build-up in household debt. To this end, lending restrictions to date have successfully reduced the share of high loan-to-value loans on the banks' books. This means that in the event of a severe housing market downturn banks have a better chance of recouping what they lent.

But while the RBNZ might be happy with the impact of the lending restrictions to date, there's also clear evidence of broadening pressures in the housing market. The latest data show that nationwide annual house price inflation rose to 14.5% in April, as sales surged 8% in the month. In Auckland, annual house price inflation continued to strengthen and is now at 14%. But this is being eclipsed by rapid growth in house prices surrounding regions. April REINZ data showed house price inflation in the North Island (excluding Auckland and Wellington) is now over 20% - the fastest pace in over a decade. House prices in these regions are starting from a much lower base than Auckland, meaning they are less of a concern from a financial stability perspective right now. But if house prices in the likes of Tauranga and Hamilton continue to race ahead of income growth, financial stability concerns could emerge.

# On the sidelines continued

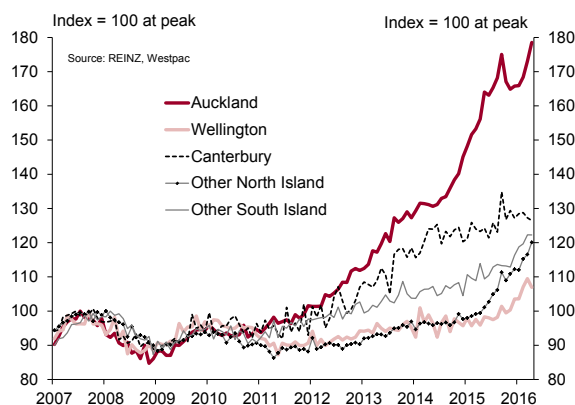
Also last week, we have seen strong evidence on consumer spending. Consumers opened their wallets in the March quarter, with a creditable 0.8% growth in retail sales.

Given this backdrop, there was much market interest in whether the RBNZ would use the FSR to announce a new round of macro-prudential policy tightening. We were doubtful. In the event, it didn't. But both the document and the Governor and Deputy Governor's comments at the associated press conference left us in no doubt that this option remains on the table.

The Report didn't give a strong sense of what those new measures might be. Restricting bank lending by setting a maximum debt-servicing-to-income ratio is clearly one option being considered. Although it is not without difficulties (for one, the RBNZ would need discuss the policy with the Treasury, as it's not one of the options covered in its existing memorandum of understanding with the Minister of Finance). Further tweaks to the existing LVR rules or requiring banks to hold more capital against their lending are also avenues the RBNZ could chose to explore. Whatever the case, we continue expect the RBNZ to announce some form of macroprudential tightening before the year is out.

Looking ahead to this week, attention will be focused on the Reserve Bank's survey of inflation expectations out on Tuesday. The sharp fall in inflation expectations last quarter

REINZ house price indexes, seasonally adjusted



was an important catalyst for the RBNZ's March rate cut. We don't expect to see a similar sized drop in expectations this quarter. The rebound in international oil prices is being reflected at the petrol pump, adding to the upward pressure on inflation in the near-term. But we'll certainly be watching for any surprises.

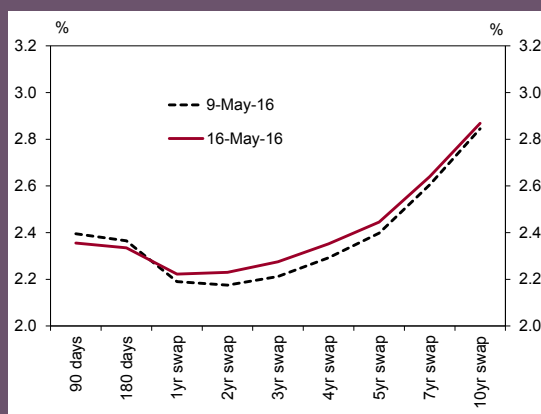
## Fixed vs Floating for mortgages

Fixed rates have fallen a long way recently, and are becoming a more attractive option for borrowers.

For borrowers with a deposit of 20% or more, the best value probably lies in the two-year rate or shorter terms. Four- and five-year rates seem high relative to where we think shorter-term rates are going to go over the next four or five years. That said, fixing for a longer term does offer the borrower greater 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



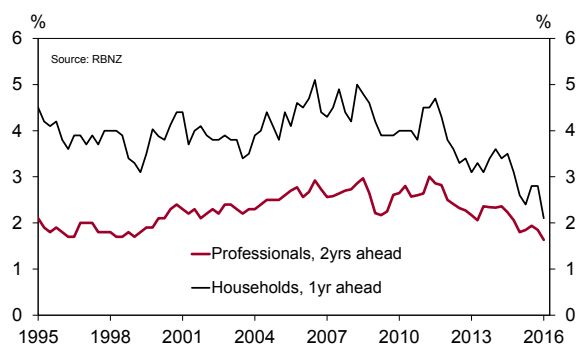
# The week ahead

## NZ Q2 survey of inflation expectations

May 17, 2 yrs ahead - Last: 1.63%

- Falls in inflation expectations were a key influence on the RBNZ's March OCR cut.
- The most closely watched measure of inflation expectations is the RBNZ's own survey of two year ahead expectations. It's fallen to 1.63% (a more than 20 year low) and has been below the mid-point of the RBNZ's target band for over a year now. Further declines would strengthen the case for a cut at the RBNZ's upcoming policy announcement.
- However, with signs that inflation has bottomed out, the downside risk for inflation expectations is now looking much more limited.

## RBNZ survey of inflation expectations



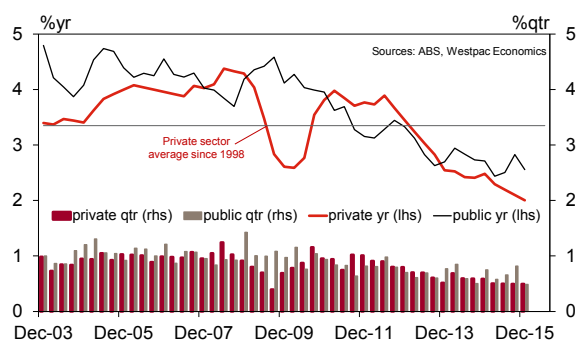
## Aus Q1 Wage Price Index

May 18, Last: 0.5%, WBC f/c: 0.4%

Mkt f/c: 0.5%, Range: 0.4% to 0.7%

- Total hourly wage rates ex bonuses (WPI) lifted 0.5% in Q4, less than market's and Westpac's expectation for 0.6%qtr. It follows on from an average rise of 0.6%qtr over the previous eight quarters. The annual pace was 2.2%yr, a moderation from the 2.5%yr in 2015Q4 and a new record low for the Index. The WPI started in the September quarter of 1997.
- Private sector wages lifted 0.5%qtr following a 0.5%qtr in each of the last three quarter. Before that it had a run of three quarters printing 0.6%qtr each quarter. The annual pace has hit a new record low of 2.0%yr. Private sector wage inflation recent peak was 4.0%yr in 2011Q1 and has been moderating ever since.
- Despite the improvement in the labour market, and firmer employment growth, wage pressures are yet to emerge.

## Private vs. public sector wages

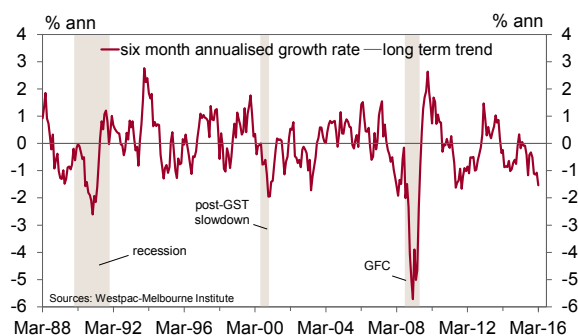


## Aus Apr Westpac-MI Leading Index

May 18, Last: -1.53%

- The Leading Index growth rate fell from -1.07% in February to -1.53% in March, pointing to a further loss of momentum through the middle of the year. The March reading is below the lows seen in 2014 and the weakest print since late 2011.
- The April update may be more positive with most components improving in the month: the ASX200 up 3.3% vs 4.1% last month; the Westpac-MI Consumer Expectations Index up 11.6% vs -6% last month; the Westpac-MI Unemployment Expectations Index, down -5.8% vs -1.8% last month (falls in the index indicate an improved outlook); dwelling approvals up 3.7% vs 2.9% last month; and commodity prices a touch firmer in AUD terms.

## Westpac-MI Leading Index



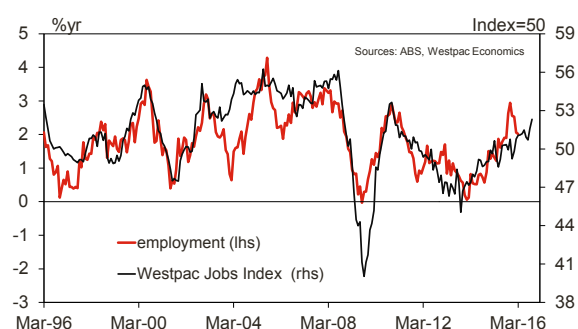
## Aus Apr Labour Force Survey - employment '000

May 19, Last: 26.1k, WBC f/c: -5k

Mkt f/c: 12k, Range: -5k to +38k

- The Mar Labour Force Survey was a bit of a mixed bag with total employment rising as expected but the unemployment rate falling as participation remained on a softer trend.
- Total employment rose 26.1k compared to a market median of +18k and a range of flat to +40k. Westpac's forecast was for +25k. Total employment has lifted 235.3k (or 2.0%yr) in the year and so remains in line with what our preferred leading indicators are suggesting. The pace peaked at 2.9% (340.2k) in Nov and the recent low was 1.6%yr (185.3k) in Jun 2015.
- Our Jobs Index has firmed of late pointing to strong employment growth as we head into the Sep quarter. But for now, with the election looming, we feel that the soft patch will continue for now and anticipate a 5k fall in April.

## Employment outpacing jobs index, a rare event



# The week ahead

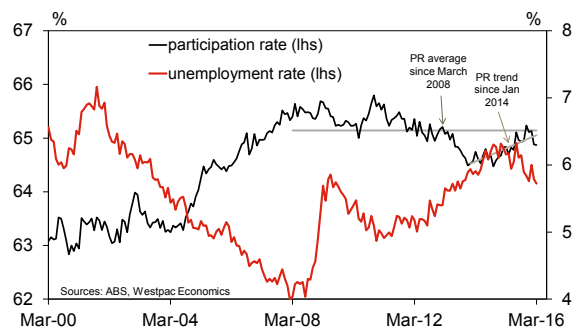
## Aus Apr unemployment rate

May 18, Last: 5.7%, WBC f/c: 5.8%

Mkt f/c: 5.8%, Range: 5.6% to 5.9%

- In March we were somewhat surprised that the participation rate was flat this month at 64.9. In February we noted that "you do have to be cautious about how far participation can rise from here" but were still surprised given the ABS comments about the issues with sample rotation, that participation did not rise in the month. What we now observe is a trend decline in participation from an average of 65.10 in Q4 to 64.96 in Q1.
- With the flat unemployment rate the labour force lifted just 18.8k so the 26.1k rise in employment was enough to see the unemployment rate fall 0.1ppt to 5.7%.
- In April, we see the risk of the participation rate dipping a bit further with a soft employment number which will limit the rise in unemployment to 5.8%.

## Unemployment and participation rates

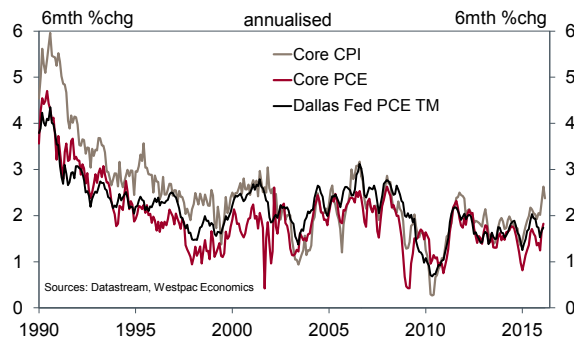


## US April CPI

May 17, Last: 0.1%, WBC 0.4%

- Inflation in the US, and indeed across the developed world, has remained very weak in 2016. The result of weak oil prices and USD strength, at 0.9%yr, annual headline inflation is more than a percentage point below the FOMC's medium-term target.
- However, the strength in core inflation continues to be underestimated: at March, annual inflation (excluding energy and food) stood above target at 2.2%yr.
- The underlying strength apparent here is the result of robust inflation in services: housing and food & accommodation services; and, to a lesser extent, health and financial services.
- Come April, stronger energy prices and a weaker USD will support food and energy inflation, seeing headline inflation bounce 0.4m/m. Core CPI will be more modest at 0.2% m/m, but that is enough to maintain an annual rate above 2.0%yr.

## US underlying inflation



# Data calendar

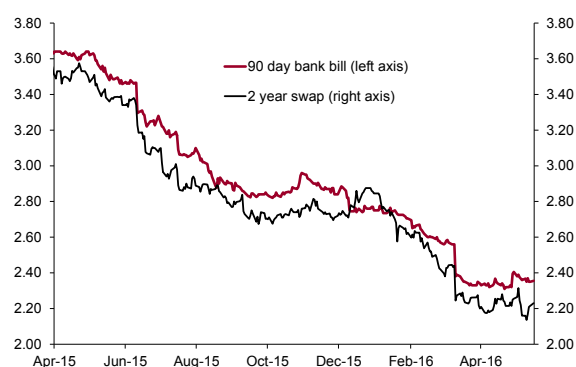
		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 16</b>					
<b>NZ</b>	Apr BusinessNZ PSI	54.8	-	-	The service sector has lost some momentum in recent months.
<b>UK</b>	May Rightmove house prices	1.3%	-	-	Price growth has eased off following April's stamp duty increase.
<b>US</b>	May Empire Fed manufacturing survey	9.56	7.00	-	Has picked up strongly in recent months.
	May NAHB housing market index	58	59	-	Remains near highs; starts/permits look to be reaching a plateau.
	Mar total net TIC flows	33.5	-	-	Long-term Treasury demand by country.
<b>Tue 17</b>					
<b>NZ</b>	Q2 RBNZ 2-year inflation expectations	1.63%	-	-	RBNZ will be looking to see if the slide in expectations has been halted.
<b>Aus</b>	RBA minutes May Board meeting	-	-	-	Colour around May rate cut decision and need for follow-up move(s).
	Apr new vehicle sales	2.2%	-	-0.5%	A softer month for sales after a reasonably solid gain in Q1.
<b>Eur</b>	Mar trade balance, €bn	20.2	-	-	External demand the major concern; EUR also unhelpful.
<b>UK</b>	Apr CPI	0.4%	0.3%	-	Headline and core have been picking up.
	Mar ONS house prices, %yr	7.6%	-	-	Dated relative to other measures; price growth solid in early 2016.
<b>US</b>	Apr housing starts	-8.8%	2.9%	-	Activity looks to be stabilising..
	Apr housing permits	-8.6%	4.8%	-	... pipeline significant in scale.
	Apr CPI	0.1%	0.4%	-	Energy and USD supportive; core pressures persist.
	Apr industrial production	-0.6%	0.3%	-	Mining continues to impact; external demand also unsupportive.
	Fedspeak	-	-	-	Kashkari town hall; William and Lockhart; and Kaplan.
<b>Wed 18</b>					
<b>NZ</b>	GlobalDairyTrade auction results	1.4%	-	-	Futures prices lift and Fonterra volumes offered down.
<b>Aus</b>	Apr Westpac-MI Leading Index	-1.53%	-	-	Hit a 4yr low in March but components looking a bit better in April.
	RBA Assist Governor (Financial Markets)	-	-	-	Guy Debelle, RMB FX Forum (via video link), 11:00am AEST
	Q1 Wage Price Index	0.5%	0.5%	0.4%	Despite the fall in unemployment there is no pressure on wages.
<b>Chn</b>	Apr property prices	-	-	-	Tier-1 soaring; others left behind.
<b>Eur</b>	Apr CPI (final), %yr	1.2%	1.2%	-	Slack must reduce before inflation pressures will firm.
<b>UK</b>	Mar ILO unemployment rate	5.1%	5.1%	-	Manufacturing slowdown and Brexit uncertainty may weigh on hiring.
<b>US</b>	Minutes of Apr 26 to 27 FOMC meeting	-	-	-	Asymmetric balance of risks at lower bound a key issue for policy.
<b>Thu 19</b>					
<b>NZ</b>	May consumer confidence	1.7%	-	-	Nationwide sentiment has stabilised, but is weaker in dairying regions.
<b>Aus</b>	Apr employment, chg '000	26.1	12	-5	The Jobs Index has firmed but soft spot continues for next few months.
	Apr unemployment rate	5.7%	5.8%	5.8%	Participation off its highs and will help hold unemployment below 6%.
<b>Eur</b>	Mar current account balance, €bn	19.0	-	-	External demand the major concern; EUR also unhelpful.
	ECB policy meeting minutes	-	-	-	Discussion on risks to outlook; implications of negative rates?
<b>UK</b>	Apr retail sales	-1.3%	0.7%	-	Some recovery after earlier falls; confidence weighing on spending.
<b>US</b>	Apr Chicago Fed national activity index	-0.4	-	-	Points to below trend growth.
	Initial jobless claims	294k	-	-	Claims have picked up, but remain at historically low levels.
	May Philly Fed index	-1.6	3.5	-	Points to continued headwinds for manufacturers.
	Fedspeak	-	-	-	Dudley speaks on macroeconomic trends in New York.
<b>Fri 20</b>					
<b>NZ</b>	Apr net migration	5,330	-	5,275	While still firm, there are signs that migration flows are levelling off.
<b>Eur</b>	May consumer confidence	-8	-	-	Has moderated in recent months; stability needed.
<b>US</b>	Apr existing home sales	5.1%	1.3%	-	Trend for sales activity is likely to flatten out in coming months.
<b>Can</b>	Apr CPI	0.6%	0.3%	-	Core inflation has been rising, some boost from oil price increases.

# New Zealand forecasts

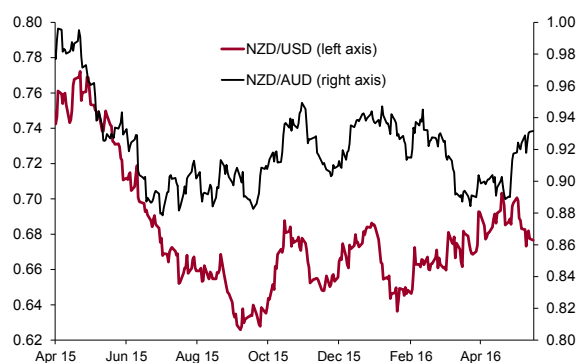
Economic Growth Forecasts	March years				Calendar years			
	% change	2014	2015	2016f	2017f	2014	2015	2016f
GDP (Production) ann avg	2.7	3.6	2.4	2.8	3.7	2.5	2.8	2.6
Employment	3.8	3.2	1.4	2.5	3.6	1.4	2.7	1.5
Unemployment Rate % s.a.	6.0	5.8	5.8	5.6	5.8	5.3	5.6	5.9
CPI	1.5	0.3	0.3	1.1	0.8	0.1	0.7	2.2
Current 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 16 May 2016

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.25%	2.25%	2.25%
30 Days	2.27%	2.30%	2.26%
60 Days	2.32%	2.36%	2.32%
90 Days	2.36%	2.41%	2.34%
2 Year Swap	2.23%	2.26%	2.26%
5 Year Swap	2.45%	2.51%	2.52%

NZ foreign currency mid-rates as at Monday 16 May 2016

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6766	0.6974	0.6873
NZD/EUR	0.5983	0.6086	0.6077
NZD/GBP	0.4712	0.4780	0.4834
NZD/JPY	73.51	74.11	74.35
NZD/AUD	0.9316	0.9182	0.9008
TWI	72.70	73.51	72.80

# International forecasts

Economic Forecasts (Calendar Years)	2012	2013	2014	2015f	2016f	2017f
<b>Australia</b>						
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
<b>United States</b>						
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
<b>Japan</b>						
Real GDP %yr	1.7	1.4	0.0	0.5	0.7	0.7
<b>Euroland</b>						
Real GDP %yr	-0.9	-0.3	0.9	1.6	1.3	1.3
<b>United Kingdom</b>						
Real GDP %yr	1.2	2.2	2.9	2.2	2.2	2.2
<b>China</b>						
Real GDP %yr	7.7	7.7	7.3	6.9	6.5	6.2
<b>East Asia ex China</b>						
Real GDP %yr	4.6	4.2	4.1	3.7	3.9	4.1
<b>World</b>						
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
<b>Australia</b>						
Cash	1.75	1.75	1.50	1.50	1.50	1.50
90 Day Bill	2.01	2.05	1.80	1.80	1.80	1.80
10 Year Bond	2.29	2.60	2.65	2.65	2.75	2.75
<b>International</b>						
Fed Funds	0.375	0.375	0.625	0.625	0.875	0.875
US 10 Year Bond	1.75	2.00	2.15	2.25	2.35	2.50
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	0.7320	0.73	0.72	0.70	0.70	0.70
USD/JPY	109.00	110	112	115	117	120
EUR/USD	1.1370	1.14	1.10	1.08	1.06	1.06
AUD/NZD	1.7030	1.09	1.09	1.09	1.11	1.13

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# Disclaimer continued

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