Rere Waterfall, Gisborne.

20 October 2014

Weekly Commentary

In this issue

Peaked oil

Over the past few weeks financial markets have been jittery and volatile. Concern about faltering economic growth in Europe and China has intensified, and last week there was even a bout of weaker data out of the United States. Markets are also coming around to the idea that global inflation will remain very subdued for a long while yet.

One consequence of this market volatility has been a sharp fall in global commodity prices. The fall in crude oil prices has been the most dramatic, down by almost 5% last week alone.

Lower global commodity prices have two important implications for New Zealand. First, as a food producer, New Zealand can expect to experience a noticeable downdraft in the price of the products it exports to the rest of the world – the 50%-odd fall in global dairy prices this year being just the leading edge. Actually last week's fortnightly dairy auction registered a small increase in prices. However, broader global developments raise the spectre of this year's farmgate milk payment being even lower than our current forecast of $4.80 per kg of milksolids. That forecast required a sharp increase in dairy auction prices from early 2015 onwards – for example, whole milk powder prices would have to rise from about $2,500/tonne at present to around $3,500/tonne by the end of the season. That is starting to look like quite a stretch in this environment of falling global commodity prices.

We do remain confident that faltering growth will spark a vigorous policy response in China and elsewhere (last week there was even chatter about the possibility of the US retaining its quantitative easing programme a little longer). However, it now looks as though any Chinese stimulus would translate into rising milk prices later in 2015 rather than earlier.

New Zealand's other main food exports have been experiencing very strong global conditions over the past year. We still expect prices for these products to remain high by historical standards, but the next year may not be quite so halcyonic as the past year.

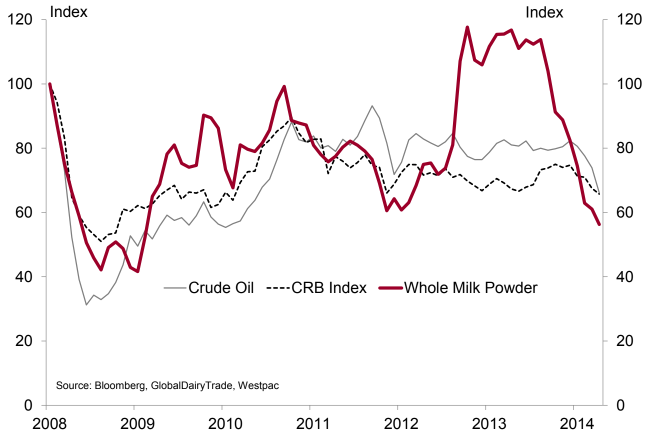
The more subtle, but perhaps more important, implication of falling global commodity prices is that the recent trend of low inflation in New Zealand may continue for longer. Inflation was 1.6% in the year to June 2014, but we suspect that Thursday's Consumer Price Index figures will show annual inflation plunging to 1.1%. The latest indicators suggest that inflation could still be as low as 1.4% by the March quarter next year – and if that's correct, the RBNZ won't be in a mood to be hiking the OCR any time soon.

Some of the weakness in inflation over the September quarter was due to low vegetable prices, reflecting favourable growing conditions over winter. This effect should reverse in the next quarter or two – lower than usual prices in winter doesn't mean that they will be lower in summer. But other elements of the weakness in food prices could linger for longer, such as the supermarkets' price war on bread, and cheaper dairy products as world prices have fallen.

The second key driver of the fall in annual inflation is petrol prices, which rose by less in the September quarter this year than they did last year. And recent price cuts mean that petrol prices are now tracking substantially lower for the December quarter. This could extend the weak inflation theme out to the end of this year and beyond.

The Reserve Bank has been becoming less confident that strong economic growth is translating into inflation pressure. So much so that in its latest *Monetary Policy Statement,* the RBNZ announced that it was going into wait-and-see mode. The RBNZ seems intent on waiting for evidence of actual inflation before it restarts its programme of OCR hikes. As soon as we heard that, we shifted our OCR forecast to 'on hold' right through until June 2015. The information we've absorbed over the past week or two suggests that the Reserve Bank might remain on hold for even longer than that, before it restarts the hiking cycle.

Commodity prices



Of course, low inflation and later OCR hikes have important implications for the housing market (which in our experience is more sensitive to interest rates than just about anything else). Financial markets have been pushing swap rates lower for some time, in anticipation of later OCR hikes. We suspect that swap rates might fall even further over the next week or two, and that will drag mortgage rates lower in tandem. In turn, lower mortgage rates will tend to stimulate the housing market.

The September round of housing data was fairly wishy-washy. House sales were fairly subdued, but we are reluctant to draw a strong conclusion from that because it may simply represent pre-election uncertainty. House prices virtually stagnated in the first quarter of 2014, rose sharply in the second quarter, and have risen more slowly since. With falling mortgage rates and booming population growth in the offing, we suspect that ongoing modest house price increase is a reasonable base case, even if economic confidence starts to moderate.

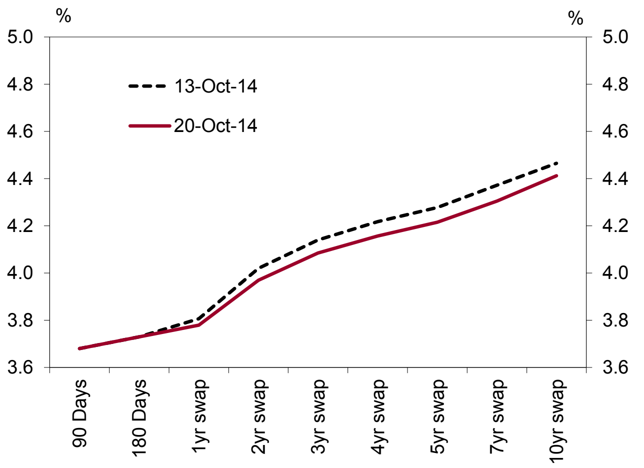
Fixed vs Floating for mortgages

Fixed mortgage rates have been falling recently, and may have further to fall in the weeks ahead. Those looking to fix their mortgage might find it is worth waiting a few weeks for better rates.

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.

Among the standard fixed rates, the best deal for borrowers with a deposit of 20% or more is the two-year term, which offers substantial value relative to where we expect shorter-term rates to go over the next two years. There is little point in fixing for just one year, given that these rates are higher than the two-year rate in most cases. Four- and five-year rates seem rather high relative to where we think shorter-term rates are going to go over the coming four or five years, but they do offer stability.

NZ interest rates

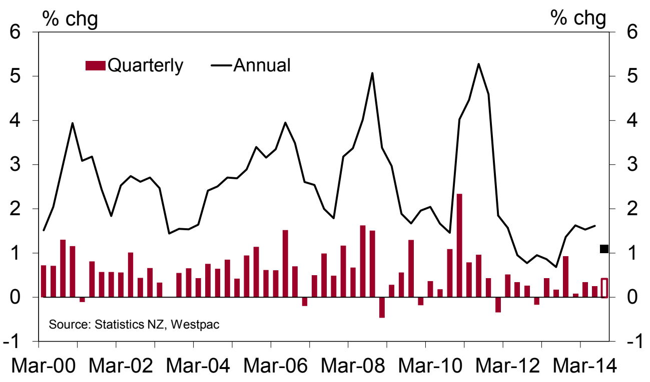


NZ Q3 CPI

Oct 23, Last: 0.3%, Westpac f/c: 0.4%, Mkt f/c: 0.5%

- We expect a subdued 0.4% rise in the CPI for the September quarter, taking annual inflation down from 1.6% to 1.1%.
- Unusually low food prices this winter, and a smaller increase in fuel prices compared to last year, explain most of the drop in the annual inflation rate.
- The underlying story is one of still-subdued domestic inflation pressures outside of housing, and with the legacy of past strength in the New Zealand dollar weighing on tradable goods prices.

NZ CPI inflation

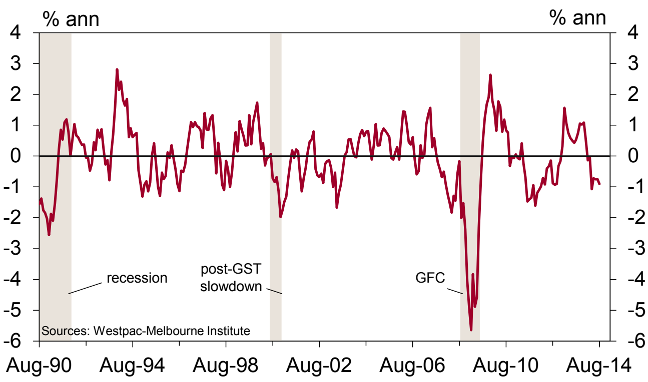


Aus Sep Westpac–MI Leading Index

Oct 22, Last: –0.90%

- The six month annualised growth rate of the Index, which indicates the likely pace of economic growth 3 to 9mths into the future, fell from –0.75% in Jul to –0.90% in Aug. This is the 7th consecutive month where the growth rate in the Index has been below trend and indicates growth is likely to stay below trend in the second half of 2014 and into 2015.
- Several components were sharply weaker in Sep including: the ASX, down 5.8% (vs no change in Aug); hours worked, down 0.9% (a large monthly fall for this component); and commodity prices down 1.4% in AUD terms. Other components improved though: the yield gap widened marginally after narrowing over the previous 8mths; dwelling appprovals rose 3%; US industrial production was up 1%; and the CSI Expectations Index and consumers' unemployment expectations both recorded modest improvements.

Westpac-MI Leading Index

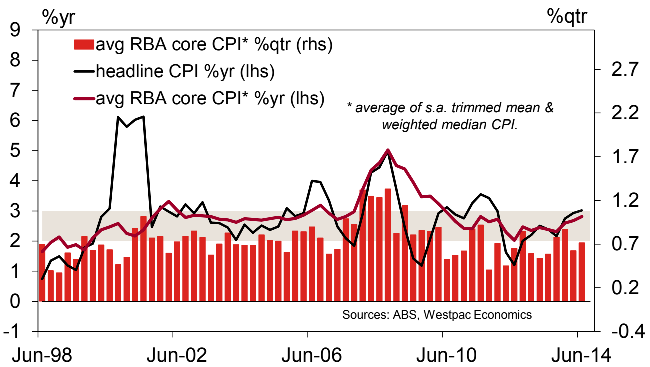


Aus CPI

Oct 22, Last: 0.5%qtr, WBC f/c: 0.6%qtr
Mkt f/c: 0.4%, Range: 0.0% to 0.6%

- The headline CPI rose 0.5% in Q2 with the annual rate picking up to 3.0%yr from 2.9%yr in Q1, 2.7%yr in 2013Q4 and 2.2%yr in 2013Q3. The June quarter is always on the softer side with the ABS estimating that seasonality was worth –0.1ppt. The seasonally adjusted CPI accordingly rose 0.6%qtr.
- For Q3, the removal of the carbon tax is a significant drag on what is normally a strong quarter; ABS seasonal factors suggest seasonality is worth +0.2ppt. There will also be strong gains in food, housing and tobacco. Our forecast is for a 0.6%qtr rise in the headline for an annual pace of 2.4%yr.
- As most of the impact of the carbon tax is trimmed out of the core measures its impact is marginal here. Our forecast for core CPI is for a 0.5%qtr rise easing the annual pace to 2.5%yr from 2.8%yr.

Q2 headline & core CPI in upper half of the band

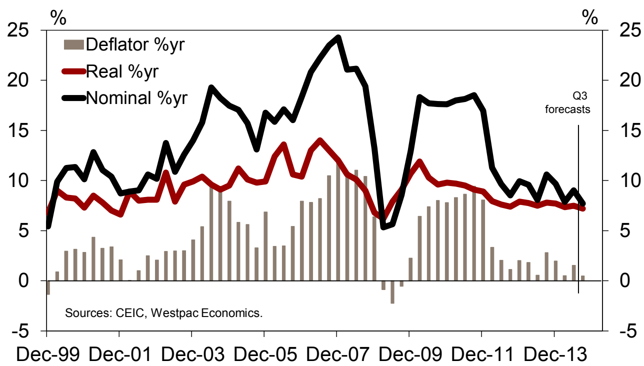


China Q3 real GDP

Oct 21, Last: 7.5%, WBC f/c: 7.2%
Mkt f/c 7.2%, Range: 7.0% to 7.7%.

- The NBS estimated that China grew at a real rate of 7.5%yr in Q2, with a seasonally adjusted change of 2.0%. Our forecasts for Q3 are a 0.3ppt decline in y/y rate, with downside risks, given 2013Q3 was the strongest quarter in recent times (2.3%qtr), and the pulse in domestic demand was obviously weak in 2014Q3. Tactically, we think that a y/y outcome in the 7.0% to 7¼% range would accomplish the two key tasks of: 1) producing a credible growth estimate; and 2) maintaining the perception that the trajectory of growth is broadly consistent with the annual target of 7½%.
- The substantial improvement in nominal activity growth seen in Q2 reversed in Q3. Nominal GDP tends to be more sensitive to swings in underlying demand conditions than the real estimate.
- Net exports will be a strong support for growth in Q3, with monster back-to-back trade surpluses in July and August.

Chinese GDP: real & nominal estimates

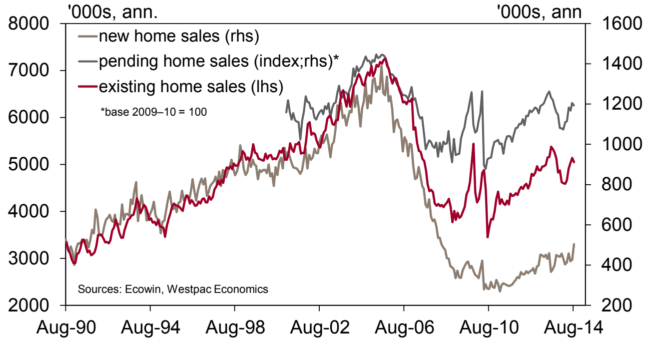


US Sep existing and new home sales

Oct 21, existing home sales, Last: –1.8%, WBC f/c: 0.0%
Oct 24, new home sales, Last: 18.0%, WBC f/c: –8.7%

- Existing home sale closings fell 1.8% in August, their first fall in five months, to a sales pace of 5.05mn, 6% below the mid 2013 cycle peak. Pending sales fell 1.0% in August, their second fall in 3 months. Sales have only recovered about two thirds of the 16% decline from mid 2013 in the past six months. Recent (unsustained?) strength in new home sales has not extended into the established market; existing home sales were probably just flat in Sep.
- New home sales soared 18% in August to the highest sales pace (504k annualised) since 2008 but year to date, sales are running a 439k annualised pace, just 2% higher than in same period last year. The latest fall in homebuilder confidence, and unimpressive housing starts data suggest a fall in sales, but from an inevitably revised August. We expect a 460k annualised pace in Sep, an 8.7% fall if no revision.

US housing sales

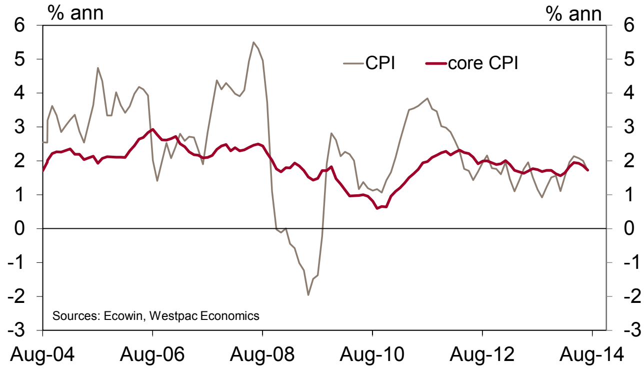


US Sep CPI

Oct 22, CPI, Last: –0.2%, WBC f/c: 0.0%
Oct 22, CPI core, Last: 0.0%, WBC f/c: 0.1%

- The CPI fell 0.2% in August, reflecting broad-based subdued price changes; notable declines included a 4.1% drop in gasoline prices, airfares down 4.7% on top of a near 6% fall in July, and apparel down 0.2%. Flat on the month were medical care, tobacco, and indeed the core CPI itself, its equal second lowest reading so far this century. So what went up? Food prices rose 0.2%, as did rents and new car prices, while booze jumped 0.8%.
- Gasoline prices were down again in Sep, but less than in Aug after seasonal adjustment. PPI suggests food prices should soon level out. Sub 0.2% core outcomes usually require one of more of autos, rents, clothing, tobacco, and medical care to print declines or below trend outcomes, but in Sep the last three will likely bounce. Our 0.1% core forecast assumes lower auto prices and below trend rents; headline CPI should be flat.

US consumer price inflation



Data calendar

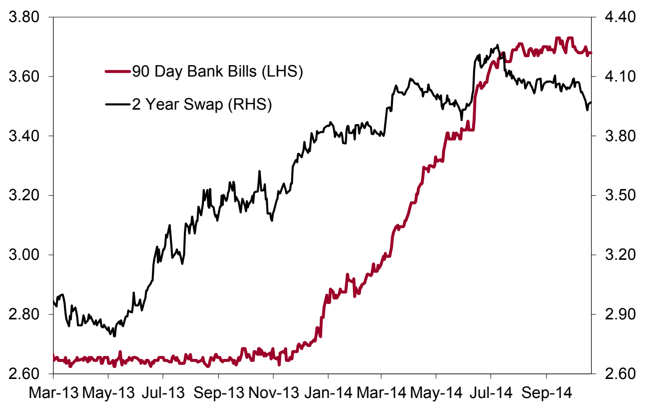
		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
NZ	Sep Performance of Services Index	57.9	–	–	Manuf. and services surveys both stronger in the last two months.
Aus	RBA Assist Gov Economic, Chris Kent	–	–	–	Speaking: Leading Age Services conf., topic tba, Adelaide 10:30am.
Eur	Aug current account balance, €bn	18.7	–	–	August trade surplus widened on falling imports.
Ger	Sep producer prices %yr	–0.8%	–1.0%	–	Weaker euro to curtail PPI fall of last couple of years.
UK	Oct house prices %yr	7.9%	–	–	Rightmove index of asking prices.
Can	Aug wholesale trade	–0.3%	–	–	Recent swings due to one-off factors such as strike and flooding.
Tue 21					
NZ	Sep net immigration	4,710	–	4,650	Immigration boom unlikely to ease until Aus jobs picture improves.
Aus	RBA minutes	–	–	–	Key focus: comments on risks to the outlook, asset prices etc.
	RBA Deputy Governor, Philip Lowe	–	–	–	Speech: "Investing in a low interest rate world", Sydney, 7:55pm.
Chn	Q3 GDP %yr	7.5%	7.2%	7.2%	Weak domestic demand, major net X boost, downside risk overall.
	Sep industrial production %yr	6.9%	7.5%	–	Core IP below headline, heavy manuf. stocks on the rise again.
	Sep fixed investment %yr	16.5%	16.3%	–	Real estate, mining & heavy industry soft, infrastructure partial offset.
	Sep retail sales %yr	11.9%	11.7%	–	Consumer sentiment remains weak, purchasing plans subdued.
UK	Sep PSNCR £bn	1.6	–	–	Public sector net credit requirement. PSNB ex banks £11.6bn in Aug.
US	Sep existing home sales	–1.8%	1.0%	0.0%	Pending home sales fell 1% in Aug giving little scope for a rise.
Wed 22					
Aus	Sep Westpac–MI Leading Index	–0.90%	–	–	In Aug, fell to –0.90% from –0.75%, pointing to sub-trend growth ahead.
	Q3 CPI %qtr	0.5%	0.4%	0.6%	The removal of the carbon tax is a drag on a seasonally strong quarter.
	Q3 core CPI %qtr	0.7%	0.5%	0.5%	The carbon tax impact much less on core, annual rate eases to 2.5%yr.
UK	BoE MPC minutes	7:2	–	7:2	BoE will have known 1.2% CPI; not enough to sway the 2 dissenters.
US	Sep CPI	–0.2%	0.0%	0.0%	Gasoline prices sharply lower; PPI suggests food prices stabilising.
	Sep CPI core	0.0%	0.2%	0.1%	Core pressures subdued after temporary pick up in H1.
Can	Aug retail sales	–0.1%	0.3%	–	Retail sales growth moderating after Q2 surge.
	BoC rate decision	1.0%	1.0%	1.0%	On hold with neutral bias and that will remain the BoC position.
Thu 23					
NZ	Q3 CPI	0.3%	0.5%	0.4%	Softer food and fuel prices take annual inflation down to 1.1%.
Aus	RBA Governor Glenn Stevens	–	–	–	Speaking: Australian Payments Clearing Assoc'n, topic tba, Sydney, 8am
	Q3 NAB business survey	–	–	–	Includes additional detail around capex plans.
Chn	Oct HSBC manufacturing PMI - flash	50.2	49.9	–	Exports the bright spot in Sep, upside risk to consensus in our view.
Eur	Oct PMI factory adv	50.3	50.0	49.5	Factory PMI should be below 50 given recent IP contraction.
	Oct PMI services adv	52.4	52.0	51.5	Composite PMI factory/services was 52.0 in Sep.
	Oct consumer confidence advance	–11.4	–	–12.0	Pessimism slowly returning.
UK	Sep retail sales incl fuel	0.4%	–0.2%	0.3%	Weak BRC survey, CBI held up, suggest discount driven volumes.
	Sep mortgages no.	41.5k	–	–	BBA approvals data covering about 70% of the market.
	Oct CBI industrial trends survey	–4	–	–	Total orders index. Oct report includes quarterly optimism survey.
US	Sep Chicago Fed national activity index	–0.21	–	–	Based on 80 or so data inputs, not a business survey.
	Initial jobless claims w/e 18/10	264k	–	285k	Claims at 21st century lows but Columbus Day might distort figures.
	Aug house prices	0.1%	0.4%	–	FHFA index.
	Oct PMI factory adv	57.5	57.3	–	Out earlier than ISM and Markit surveys more firms.
	Sep leading indicators	0.2%	0.7%	–	Jun to Aug strongest triple month reading since Sep-Nov last year.
	Oct Kansas City Fed factory index	6	–	–2	Other regional surveys for Oct mixed with NY down, Philly holding up.
Fri 24					
NZ	Sep merchandise trade balance $m	–472	–	–650	Dairy prices still dropping, export volumes down from August spike.
Chn	Sep property prices - new, net bal%	-95.7%	–	–	Previous trough -75.7% net bal. Growth: Tier 1 +2.1%yr, Tier 2 0.1%yr.
	Sep property prices - 2ndary, net bal%	-95.7%	–	–	Previous trough -70.0% net bal. Growth: Tier 1 +2.5%yr, Tier 2 -0.3%yr.
Ger	Nov GfK consumer confidence	8.3	8.1	–	Sep-Oct saw steepest fall since late 2009 when Greece triggered SDC
UK	Q3 GDP advance	0.9%	0.7%	0.7%	Partial/survey data suggest economy slowing in H2 2014.
US	Sep new home sales	18.0%	–6.8%	–8.7%	Volatile series due to correct lower.

New Zealand forecasts

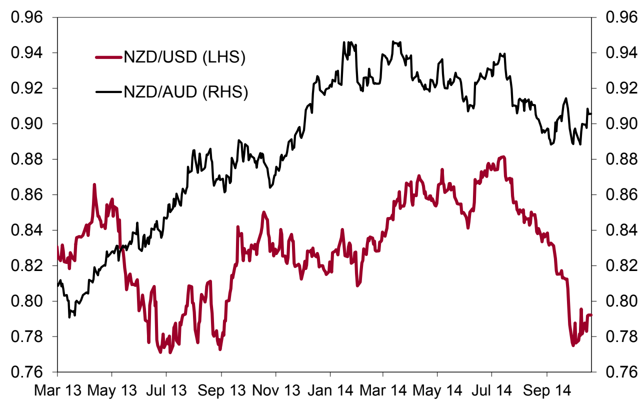
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2012	2013	2014f	2015f
GDP (Production) ann avg	2.3	3.2	3.4	3.1	2.5	2.8	3.6	3.1
Employment	0.4	3.8	2.8	2.6	0.4	2.9	3.0	2.9
Unemployment Rate % s.a.	6.2	5.9	5.3	4.7	6.8	6.0	5.4	4.7
CPI	0.9	1.5	1.7	2.1	0.9	1.6	1.4	2.1
Current Account Balance % of GDP	-3.8	-2.7	-4.9	-4.8	-4.1	-3.3	-3.8	-5.2

Financial Forecasts	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16
Cash	3.50	3.50	3.75	4.00	4.25	4.50
90 Day bill	3.70	3.70	3.90	4.20	4.40	4.60
2 Year Swap	4.20	4.40	4.60	4.80	5.00	5.10
5 Year Swap	4.60	4.80	5.00	5.10	5.20	5.30
10 Year Bond	4.40	4.70	4.80	4.90	5.00	5.10
NZD/USD	0.80	0.81	0.83	0.83	0.82	0.81
NZD/AUD	0.89	0.90	0.90	0.89	0.87	0.85
NZD/JPY	88.0	89.9	93.0	93.8	93.5	93.2
NZD/EUR	0.63	0.64	0.65	0.65	0.64	0.62
NZD/GBP	0.49	0.50	0.50	0.48	0.47	0.45
TWI	78.7	78.8	81.1	79.8	78.4	77.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 20 October 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.66%	3.66%	3.68%
60 Days	3.67%	3.68%	3.70%
90 Days	3.68%	3.69%	3.70%
2 Year Swap	3.97%	4.08%	4.06%
5 Year Swap	4.22%	4.36%	4.44%

NZ foreign currency mid-rates as at Monday 20 October 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7922	0.7769	0.8148
NZD/EUR	0.6214	0.6210	0.6350
NZD/GBP	0.4919	0.4869	0.5001
NZD/JPY	84.91	85.21	88.88
NZD/AUD	0.9056	0.8949	0.9122
TWI	76.93	76.26	78.75

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013	2014f	2015f
Australia						
Real GDP % yr	2.2	2.6	3.6	2.3	3.2	3.2
CPI inflation % annual	2.8	3.0	2.2	2.7	2.2	2.8
Unemployment %	5.2	5.2	5.3	5.8	6.1	5.8
Current Account % GDP	-3.5	-2.8	-4.4	-3.3	-3.3	-2.0
United States						
Real GDP %yr	2.5	1.6	2.3	2.2	2.1	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.9	1.9
Unemployment Rate %	9.6	8.9	8.1	7.4	6.3	5.8
Current Account %GDP	-3.0	-2.9	-2.9	-2.4	-2.4	-2.4
Japan						
Real GDP %yr	4.9	-0.3	1.5	1.5	1.0	1.4
Euroland						
Real GDP %yr	2.0	1.6	-0.6	-0.4	0.7	0.9
United Kingdom						
Real GDP %yr	1.7	1.1	0.3	1.7	2.6	2.1
China						
Real GDP %yr	10.4	9.3	7.7	7.7	7.4	7.5
East Asia ex China						
Real GDP %yr	7.7	4.5	4.5	4.3	4.1	5.1
World						
Real GDP %yr	5.4	4.1	3.4	3.3	2.9	3.7
Forecasts finalised 10 October 2014						

Interest Rate Forecasts	Latest	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
Australia						
Cash	2.50	2.50	2.50	2.50	2.75	3.00
90 Day Bill	2.72	2.65	2.55	2.65	3.00	3.25
10 Year Bond	3.23	3.50	3.80	4.00	4.50	4.60
International						
Fed Funds	0.125	0.125	0.125	0.125	0.250	0.500
US 10 Year Bond	2.16	2.55	2.70	2.80	3.20	3.30
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05

Exchange Rate Forecasts	Latest	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
AUD/USD	0.8780	0.90	0.90	0.92	0.93	0.94
USD/JPY	106.30	110	111	112	113	114
EUR/USD	1.2840	1.26	1.26	1.27	1.28	1.29
AUD/NZD	1.1040	1.11	1.11	1.10	1.12	1.15

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Disclaimer continued

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