21 October 2013

Weekly Commentary

Emerald Lakes, Tongariro National Park

In this issue

Eye on the Horizon

Last week we issued our long-run forecasts for the New Zealand economy, out to 2023. The primary motivation was to trace out to its full conclusion the upcoming economic cycle. We have long argued that the Canterbury rebuild and rising house prices would create an economic upswing. Our long-term forecasts make the additional point that the drivers of that upswing are temporary. The Canterbury rebuild will wind down in the second half of the decade, and house price inflation is likely to slow or go into reverse at the same time. When that happens, the economy will slow and interest rates will have to retreat off their highs.

The second motivation for issuing long-run forecasts was to outline our assumptions for the future "average" state of the economy. These are not meant to be precise predictions – in reality the economy will be buffeted in one direction or the other by as-yet-unforeseen economic shocks. But the long-run forecasts provide a reasonable basis for planning given what we do know today. The key points are that New Zealand's trend economic growth rate will be slower in the future than in the past, due to slower population growth; inflation will trend higher as Governments tinker with the Reserve Bank's targets; the Official Cash Rate will average 5%; and the New Zealand dollar will average 71 cents against the US dollar and 87 cents against the Australian dollar.

The bulletin explaining our long run forecasts can be found here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2013/Bulletins-2013/Eye-on-the-horizon-October-2013.pdf

And comprehensive forecasts of the economy out to 2023 are always available in spreadsheet form on our website: http://www.westpac.co.nz/business/economic-updates/economic-research-and-market-strategy/

Start of something big

Turning our attention to last week's, inflation figures served to confirm our core views of the near-term economic cycle. The narrative we laid out long ago is that the burgeoning construction industry, combined with rising house prices, will boost economic activity and generate inflation pressures that require the RBNZ to increase interest rates. The economic activity leg of that narrative is now well-established in the data and accepted by the financial literati. The inflation leg is just starting to make an appearance, although it is very early days yet.

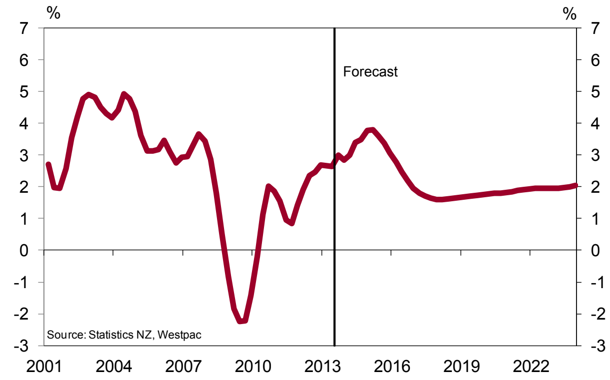
Consumer prices rose 0.9% in the September quarter, lifting annual inflation to 1.4%, from a 14-year low of 0.7% in the June quarter. However, this doubling of the annual inflation rate overstates the pace at which inflation pressures are picking up. The single biggest contribution to the rise in the annual inflation rate was a spike in fuel prices, with petrol up 5.6% and diesel up 6.1% on average over the quarter. Note, though, that the peak came in late July and that fuel prices have now fully unwound the spike. For that reason, we don't think that annual inflation in the December quarter will advance much further, if at all, from the current 1.4% pace.

Outside of petrol prices, most of the inflation regimen was fairly subdued. But there were two fundamental developments that do suggest underlying inflation is beginning to trend higher: a waning of the disinflationary effects of the high exchange rate, and a rise in housing and construction costs.

Over the past couple of years the rapid increase in the New Zealand dollar, combined with consumers' new-found ability to leverage their strong New Zealand dollars by shopping online, put great downward pressure on the price of tradable goods and services. But over the past year the New Zealand dollar's rise has slowed, implying less downward pressure on prices. We also suspect that the rate of decline in prices due to the online-shopping phenomenon has passed its peak.

Meanwhile, construction cost inflation is clearly gathering momentum, with purchase prices for new houses and property maintenance both up by more than 4% over the last year. What's more, there was further evidence that construction cost inflation is spreading beyond the Canterbury region (though the gap is still massive – up 9.8%yr in Canterbury compared to 3.1%yr in the rest of the country). This is consistent with our long-held view that the Canterbury rebuild will provoke more inflation pressure than the RBNZ has allowed for.

Westpac GDP forecast (annual average % change)



The last point of interest in the CPI figures was rents – they rose just 0.5% in the quarter, and are up only 2.0% for the year on a nationwide basis. A big chunk of that rise came from Canterbury, where rents are up 5% over the year. This was another nail in the coffin for those who think that Auckland house prices are rising solely because of physical shortages – if that were the case, rents would be rising alongside prices, as they are in Canterbury. Some other factor must be responsible for the massive divergence between house prices and rents in Auckland. We think the culprit is low interest rates. Another possibility is widespread expectation of a future rise in rents that will equilibrate the market. But this sounds rather implausible to us, because the increase in rents would have to be huge. A third possibility is that people are paying high prices for houses in Auckland simply because they believe prices will be even higher in the future – this may meet the definition of a bubble.

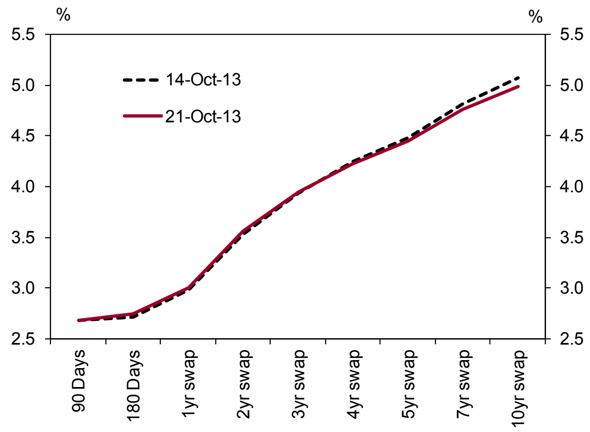
As we mentioned last week, we are keeping the housing market on a week-by-week watch at present, for signs that the recent increase in fixed mortgage rates and Reserve Bank mortgage restrictions are having an effect. The latter came into effect on 1 October. We did get a slice of data from the Real Estate Institute last week, but it related to the month of September. Unsurprisingly, the market was ultra-strong at that time. So far as the month of October is concerned, the only thing we have to go off is the value of mortgage approvals, which dipped slightly in the second week of the month. That's not enough evidence to confirm that the market is slowing, but it is a step in that direction.

Fixed vs Floating for mortgages

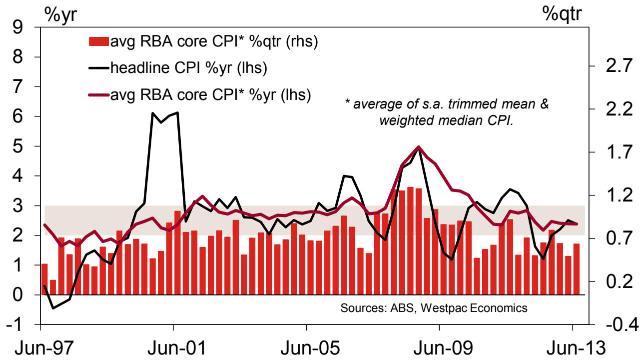
We are now indifferent between fixing and floating.

In our view, interest rate markets are now "fairly priced". We expect short-term rates to rise substantially over the next three years. The level of long-term fixed rates, which are higher than short-term rates, is in tune with that expectation. This means we can discern no obvious interest rate advantage in any particular term. The decision can be treated as a risk management choice according to individual circumstances.

NZ interest rates



Headline & core at the mid point of the band

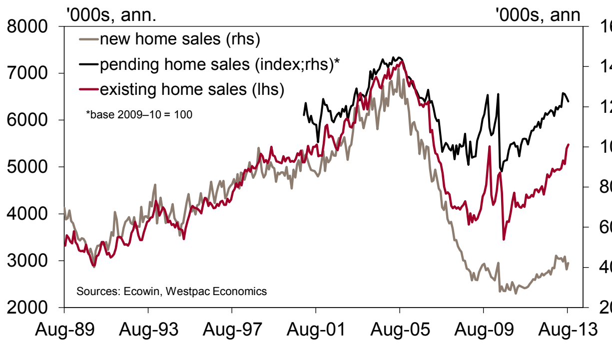


Aus Q3 CPI

Oct 23, Last: 0.4%, WBC f/c: 1.0%qtr (avg RBA core: 0.6%)
Mkt f/c: 0.8% (0.6%), Range: 0.6% to 1.0% (0.5% to 0.8%)

- The June quarter CPI printed broadly as expected, a 0.4%qtr rise compared to a market expectation for a 0.5%qtr rise. Weakness in food and petrol prices helped to hold down the rise in Q2.
- Our Q3 forecast of 1.0%qtr/2.0%yr incorporates the usual seasonal rises in utilities, rates & taxes, and clothing & footwear which more than offset seasonal falls in pharmaceuticals. There is also a strong boost from petrol prices.
- Core inflation, as measured by the average of the trimmed mean and weighted median, is forecast to rise 0.6%qtr/2.2%yr in the Sep quarter. This is a moderation from the 2.4%yr pace reported in Q2 and reflects the dropping-out of the carbon price.

US housing sales

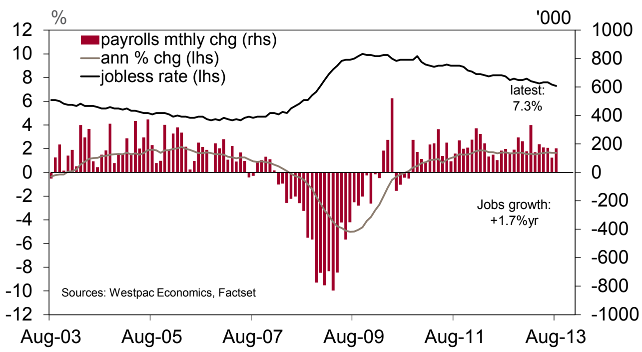


US Sep existing and new home sales

Oct 21, existing home sales, Last: 1.7%, WBC f/c: –1.0%
Oct 24, new home sales, Last: 7.9%, WBC f/c: 2.0%

- Existing home sale closings rose 1.7% in Aug to a 5.48mn annualised pace, the highest since early 2007, beating even the temporary surge in sales due to the 2009 homebuyer tax credit. However the NAR said the sales jump represented the 'last hurrah' as buyers scrambled to lock in loan rates which were rising on Fed taper talk. Pending sales fell in June, July and Aug.
- Limited supply also constrains existing sales; new home sales rose 7.9% in Aug, but it was still the second weakest sales month of the year so far, after July at 420k annualised. Homebuilder confidence stalled at an 8 year high in Sep. Our tentative forecast is for a 2% rise in new home sales but watch for violent revisions. Delayed Sep data on housing starts and building permits are are now scheduled for release between Oct 22 and 26.

US payrolls

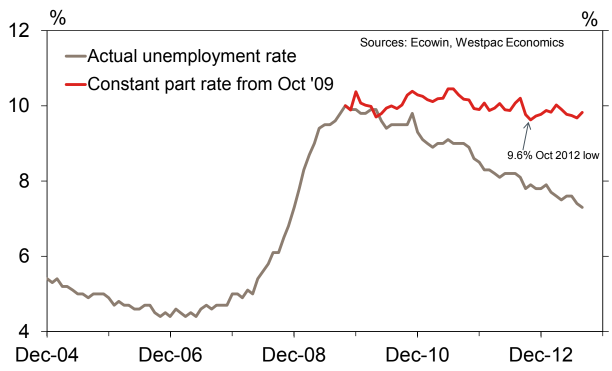


US Sep non-farm payrolls

Oct 22, Payrolls: Last: 169k, WBC f/c: 192k

- **Note that this release has been rescheduled due to the US government shutdown.** Payrolls rose 169k in Aug, with downward revisions of 74k to June-July. That followed a similarly disappointing July report. The 3mth avg gain of 148k in Jun-Aug followed 172k in Mar-May and 181k in Sep-Nov last year, when QE3 was started by the Fed.
- Aug saw jobs bounce in auto plants and government after July falls on temporary factors, so Q3's avg pace so far (132k total /140k private) is our forecast starting point. Lower jobless claims indicate fewer layoffs, yet one standout sector (business services) saw payrolls growth slump from Q2's 68k avg to just 28k in Jul-Aug. An 80k correction higher here could lift private payrolls to 200k for a 192k total and155k Q3 mth avg. That would still be the weakest qtr for payrolls since QE3 began in Q3 last year. Note: private payrolls grew by 200k or more in six months in both 2011 and 2012; but, so far this year, its only been seen in Feb.

Fall in unemp driven by part rate decline

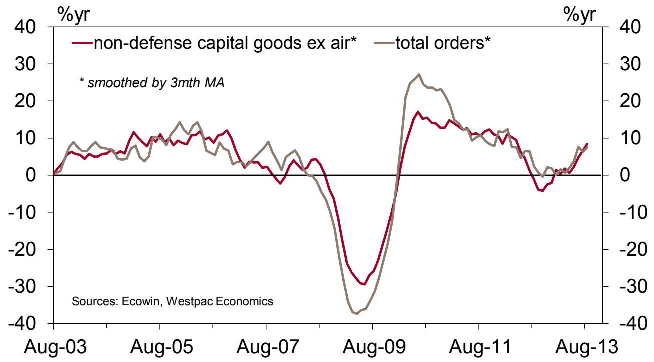


US Sep unemployment rate

Oct 4, Unemp rate: Last: 7.3%, WBC f/c: 7.3%

- **Note that this release has been rescheduled due to the US government shutdown.** The jobless rate fell from 7.4% to 7.3% in Aug despite a 115k fall in household survey jobs. This was due to a 312k fall in the labour force, including 198k previously unemployed. Indeed, the decline in the unemployment rate from the peak of 9.9% in April 2010 has been primarily driven by a decline in the labour force participation rate (to a record low of 63.2% in Aug). A bounce in Sep jobs would likely be accompanied by a rise in participation, if only temporarily, holding the jobless rate at 7.3%.
- Household survey jobs growth has averaged 108k so far this year vs the 208k average of Jan-Aug 2012 and payrolls' 180k in 2013 ytd. Sep 2011/12 saw 294k/810k gains; so a 300k+ jump should not surprise. As with the payrolls forecast, we are trying to pick monthly statistical noise. Both measures are softer this year.

US durable goods orders



US Sep durable goods orders

Oct 25, Last: 1.7%, WBC f/c: 4.0%

- Durable goods orders rose 0.1% in Aug, reflecting gains in autos and core capital goods offsetting falling defence and aircraft orders. Despite that 1.5% rise in core orders, the 3 mth annualised pace of 4.4% was a qtr of the 19% pace 6 months prior. Shipments of same rose 1.3% after falling in 3 of the prior 4 months but 3 mth annualised core shipments were down 3.3%, from up 7% in Dec-Feb.
- ISM factory orders held near 30 mth highs at 60.5 in Sep. Boeing took 127 orders in Sep from 16 in Aug (2012 Aug also weak but 2011 Aug not so seasonal adjustment won't mask the jump). Auto sales fell 5% in Sep. These signals point to a headline gain in durable orders but outside of aircraft there should be weakness.
- We expect a 4% headline durables rise due to aircraft, but core capital orders to remain. Note that this data release may yet be delayed due to the US government shutdown.

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
NZ	Sep net immigration	2100	–	2100	Weaker Aussie job prospects are boosting NZ net immigration.
Ger	Sep producer prices %yr	–0.5%	–0.7%	–	Renewed price declines this year; weakest PPI outcomes since 2010.
UK	Oct house prices %yr	4.50%	–	–	Rightmove index of asking prices.
US	Sep existing home sales	1.70%	–3.3%	–	Constrained by lack of supply, higher mortgage rates on taper talk
Can	Aug wholesale trade	1.50%	–	–	Recent swings due to one-off factors such as strike and flooding.
Tue 22					
Chn	Sep property prices % net bal	90	–	–	Prices firmed through Q3 - policy response post Plenum?
UK	Sep PSNCR £bn	–3.0	–	–	Public sector net credit requirement. PSNB ex intv'ns £13.2bn in Aug.
US	Oct Richmond Fed factory index	0	–	0	Richmond often presages weakness in Phily, NY detail.
	Sep non-farm payrolls ch'	169k	180k	192k	Stronger Sep gain still leaves trend weak. See text box.
	Sep jobless rate	7.30%	7.30%	7.30%	Higher participation stalling jobless rate improvement.
	*Aug construction spending	0.60%	0.40%	0.60%	Higher single family starts in Aug to lift residential spending.
	*Aug factory goods orders	–2.4%	0.30%	2.00%	Durables known flat. Prices not a big factor for Aug non-durables.
	*Aug trade balance $bn	–39.1	–39.5	–	Exports down 0.6%; imports up 1.6%: Jul deficit widened $4.6bn.
	*Aug wholesale inventories	0.10%	0.30%	0.10%	Inventories expanded 1.1% in Jan but kept tight since then.
	*Sep retail sales	0.20%	flat	flat	Auto and gasoline sales probably declined, offsetting cautious core ...
	*Sep retail sales ex autos & gas	0.10%	–	0.20%	... retail sales growth for a flat overall outcome.
	*Aug business inventories	0.40%	0.30%	0.20%	Inventories expanded 1.0% in Jan but kept tight since then.
	*Sep housing starts	0.90%	2.10%	3.00%	Starts pace for (single-family dwellings) still down 3.7% on Feb, but ...
	*Sep building permits	–2.9%	1.00%	3.00%	... back in line with permits pace. See text box.
Can	Aug retail sales	0.60%	0.30%	–	Recent retail sales swings in part due industrial dispute and flooding.
Wed 23					
Aus	Q3 CPI %qtr	0.40%	0.80%	1.00%	Usual seasonal lift from utilities & property rates plus a boost from petrol.
	Q3 CPI average RBA core measure %qtr	0.50%	0.60%	0.60%	As the carbon price fades, annual rate drops to 2.2%yr from 2.4%yr.
Eur	Oct consumer confidence advance	–14.9	–14.5	–	Pessimism diminished, but little evidence household spending higher.
UK	BoE MPC minutes	–	–	–	To Oct 8-9 meeting.
	Sep mortgages no.	38.2k	–	–	BBA approvals data covering about 70% of the market.
US	Aug house prices	1.00%	–	–	FHFA index.
	Sep import prices	flat	0.20%	0.20%	Oil prices little changed on average relative to Aug.
	Sep Chicago Fed national activity index	0.14	–	–	Based on 80 or so data inputs, not a business survey.
Can	BoC rate decision	1.00%	1.00%	1.00%	On hold despite long held mild tightening bias. Increased US risks.
Thu 24					
NZ	Sep merchandise trade balance $m	–1191	–680	–1200	Dairy export volumes expected to pick up in the coming months.
Aus	RBA Deputy Gov. Lowe speaking	–	–	–	Topic TBA, 2.00pm AEDT, Melbourne.
Chn	Oct HSBC manufacturing PMI - flash	50.2	–	–	Headline edged up in Sep, but detail softened marginally: flat or down.
Eur	Oct PMI factory adv	51.1	51.5	50.5	PMIs probably stalled in the very low 50 area, until the next shock hits
	Oct PMI services adv	52.2	52.2	51	Composite PMI factory/services was 52.2 in Sep.
	EU Leaders' Summit	–	–	–	Banking union, national backstop and bank stress testing discussed.
UK	Oct CBI industrial trends survey	9	10	–	Total orders index. Oct report includes quarterly optimism survey.
US	Initial jobless claims w/e 18/10	358k	–	–	Claims back at pre-recession levels.
	Sep new home sales	7.90%	1.00%	2.00%	Volatile series, higher mortgage rates to impact? See text box.
	Oct Kansas City Fed factory index	2	–	–2	Q3 saw first three >0 readings since Q3 last year.
Fri 25					
Eur	Sep money supply M3 %yr	2.30%	2.40%	–	Slowed from 3.9% yr peak in Oct 2012, LTRO paybacks a factor.
Ger	Oct Ifo business climate index	107.7	108	107.5	IFO upswing almost stalled in Sep on weaker current assessment
UK	Q3 GDP advance	0.70%	0.70%	0.80%	Partial data suggest economy at least maintained stronger Q1 pace.
US	Sep durable goods orders	0.10%	1.70%	4.00%	Headline for once reflects underlying softer story; see text box.
	Oct UoM consumer sentiment final	75.2 a	75	–	Revision adds 200 respondents to 300 in prelim survey.

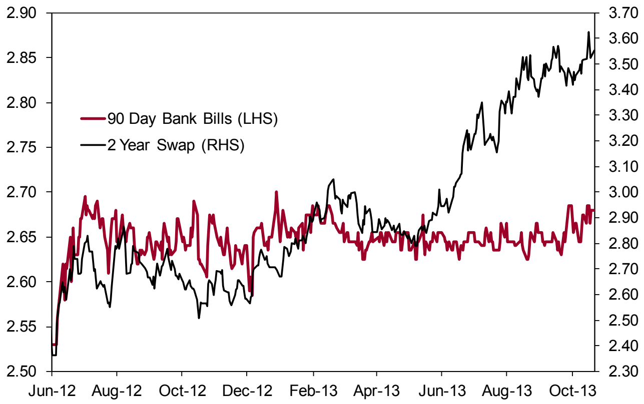
*Data tentatively re-scheduled for release Oct 22-26.

New Zealand forecasts

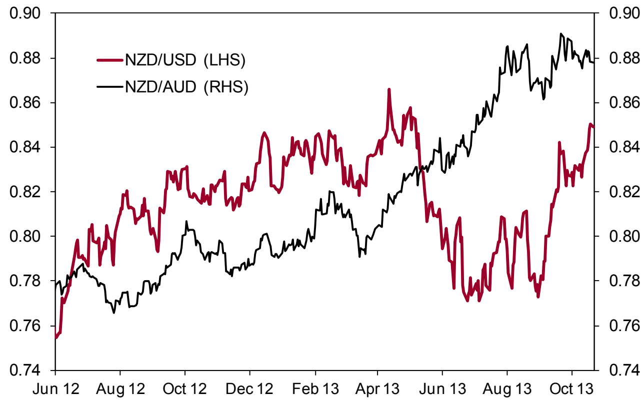
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.7	3.0	3.8	1.4	2.7	2.8	3.8
Employment	1.0	0.4	2.5	2.8	1.5	-1.4	3.7	2.8
Unemployment Rate % s.a.	6.8	6.2	5.6	4.8	6.3	6.8	5.8	4.8
CPI	1.6	0.9	1.5	2.3	1.8	0.9	1.5	2.1
Current Account Balance % of GDP	-3.8	-4.5	-4.4	-5.4	-3.6	-4.7	-4.2	-5.4

Financial Forecasts	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Cash	2.50	2.75	3.00	3.25	3.50	3.75
90 Day bill	2.75	3.00	3.25	3.50	3.75	4.00
2 Year Swap	3.50	3.70	3.80	3.90	4.10	4.20
5 Year Swap	4.40	4.45	4.50	4.60	4.70	4.80
10 Year Bond	4.40	4.50	4.60	4.70	4.75	4.80
NZD/USD	0.83	0.84	0.82	0.79	0.77	0.76
NZD/AUD	0.87	0.90	0.91	0.91	0.90	0.90
NZD/JPY	81.3	81.5	78.7	75.1	71.9	71.1
NZD/EUR	0.63	0.64	0.64	0.64	0.64	0.63
NZD/GBP	0.53	0.53	0.51	0.51	0.50	0.48
TWI	77.7	78.8	77.9	76.5	74.8	74.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 21 Oct 2013

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.66%	2.64%	2.63%
60 Days	2.67%	2.65%	2.63%
90 Days	2.68%	2.66%	2.64%
2 Year Swap	3.55%	3.46%	3.49%
5 Year Swap	4.45%	4.37%	4.47%

NZ foreign currency mid-rates as at Monday 21 Oct 2013

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8491	0.8321	0.8350
NZD/EUR	0.6205	0.6133	0.6161
NZD/GBP	0.5250	0.5192	0.5217
NZD/JPY	83.09	80.95	82.79
NZD/AUD	0.8779	0.8812	0.8914
TWI	78.14	77.17	77.80

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2009	2010	2011	2012	2013f	2014f
Australia						
Real GDP % yr	1.4	2.5	2.4	3.7	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.1	2.7
Unemployment %	5.6	5.2	5.2	5.4	6.1	6.7
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.6	-3.0
United States						
Real GDP %yr	-3.1	2.4	1.8	2.8	1.5	1.7
Consumer Prices %yr	-0.3	1.6	3.1	2.1	1.4	1.6
Unemployment Rate %	9.3	9.6	8.9	8.1	7.6	7.5
Current Account %GDP	-2.7	-3.0	-2.9	-2.7	-2.5	-2.7
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.9	2.4
Consumer Prices %yr	-1.3	-0.7	-0.3	0.0	-0.2	0.1
Unemployment Rate %	5.2	5.1	4.5	4.3	4.3	4.3
Current Account %GDP	2.8	3.6	2.0	2.1	2.0	2.0
Euroland						
Real GDP %yr	-4.4	1.9	1.6	-0.6	-0.5	-0.1
Consumer Prices %yr	0.3	1.7	2.7	2.2	1.4	1.2
Unemployment Rate %	9.5	10.0	10.1	11.7	12.4	13.0
Current Account %GDP	-0.2	-0.1	0.0	0.9	1.0	1.0
United Kingdom						
Real GDP %yr	-4.0	1.8	0.9	0.2	1.1	0.9
Consumer Prices %yr	2.2	3.2	4.0	2.8	2.3	1.8
Unemployment Rate %	7.6	7.8	8.4	8.0	8.5	8.5
Current Account %GDP	-1.3	-2.5	-1.9	-3.8	-2.5	-1.5
Forecasts finalised 7 October 2013						

Interest Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
Australia						
Cash	2.50	2.50	2.25	2.00	2.00	2.00
90 Day Bill	2.57	2.60	2.35	2.10	2.10	2.10
10 Year Bond	4.12	3.75	3.60	3.40	3.80	4.00
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.60	2.35	2.40	2.40	2.80	3.00
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Dec 13	Mar 14	Jun 14	Sep 14	Dec 14
AUD/USD	0.9670	0.95	0.93	0.90	0.87	0.85
USD/JPY	97.79	97	96	95	94	93
EUR/USD	1.3685	1.36	1.33	1.28	1.23	1.20
AUD/NZD	1.1377	1.14	1.11	1.10	1.10	1.10

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