Cape Reinga lighthouse, North edge of New Zealand

24 February 2014

Weekly Commentary

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Swings and roundabouts

New Zealand's housing market is clearly slowing, and retailers ended 2013 on a less exuberant note than expected. However, we've also had early signs that the next actual inflation print may be closer to 2% than we thought. On balance we continue to expect the RBNZ to embark on an extended series of interest hikes starting in March.

The New Zealand housing market is now firmly in slowdown mode. House sales fell for the fourth month in a row in January, the average time taken to sell lengthened, and the impact on prices is starting to show through – the REINZ House Price Index actually fell for the first time since early 2012, while the Quotable Value equivalent slowed sharply.

We've long argued that theories based on physical housing shortages have done a poor job at explaining New Zealand's recent house price cycle. A supply shortage doesn't convincingly explain why the market should have ramped up in 2012-2013 – Auckland's housing squeeze was already old news by that stage, the Canterbury earthquake was a year old, and net immigration was the lowest in more than a decade. Similarly, there has been no easing in those shortages to account for the current market slowdown. While the rate of house-building has certainly picked up, outside Canterbury it's still pretty subdued, and net immigration is currently at multi-year highs.

As we have emphasised in the past, financial factors tend to be better predictors of year-to-year swings in the housing market. Back in mid-2012 we observed a very sharp decline in fixed mortgage rates, and correctly predicted that double-digit house price inflation would promptly ensue. Similarly, we foreshadowed the current slowdown after fixed mortgage rates rose and the Reserve Bank restricted low-equity lending.

Looking ahead, our assessment is that the impact of the RBNZ's mortgage restrictions has probably passed its peak. Banks have reduced low-equity lending by more than

Swings and roundabouts continued

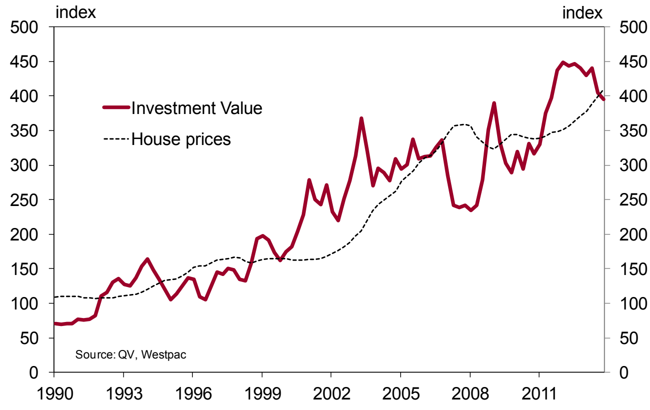
enough to meet the RBNZ's requirements, and can now afford to ease off the brakes a bit. But if anything, the impact of higher mortgage rates will get stronger as floating rates rise this year – property investment will look less attractive, as will buying rather than renting. (See our Investment Value of Housing model to the right, which calculates the fair value of a median house to a property investor.) So even if the impact of the lending restrictions fades, the sweet spot for the housing market is probably over.

How slow will it go? For some time, we've been forecasting 6.5% house price inflation over 2014, down from 10% last year, before prices slow more decisively in 2015. That forecast may look benign in light of what we've seen over the past few months, but we're unlikely to get clean reads on underlying trends until the housing market fully digests the RBNZ's lending restrictions. So that forecast still seems appropriate for now.

What did surprise us is the underwhelming performance of last week's December quarter retail trade survey. Solid rather than spectacular, retail activity rebounded just 1.2% from its 0.2% soft patch in September. Some of this may be the usual survey volatility – for example, car sales slowed inexplicably despite a big rise in car registrations. But there was also a slowdown in housing-related spending, which could persist depending on what happens to housing turnover. Overall it does seem that consumer spending is ramping up a bit less rapidly than we had expected.

This has little bearing on whether the RBNZ hikes the OCR in March. A 25 basis point hike is as good as locked in - the RBNZ has clearly communicated its intention to start raising the OCR back to more normal levels soon, and is unlikely to back away from that plan without warning. But along with the slowing housing market, the softer than expected retail sales data may raise questions around the total number of OCR hikes we should expect from the RBNZ this year.

Investment value of housing

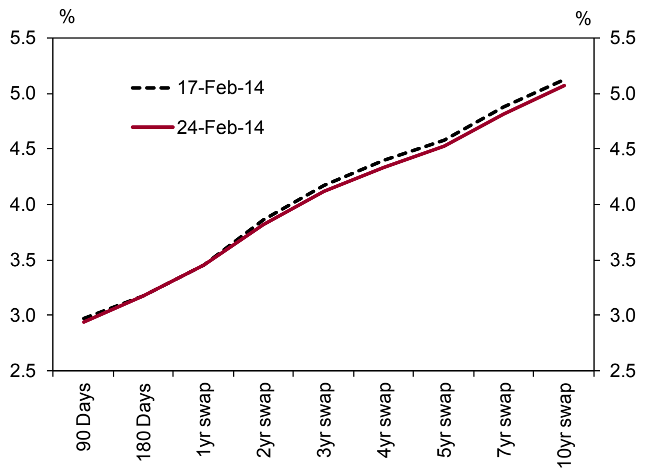


However, there have also been developments on the inflation front that leave us comfortable with our forecast for 125 basis points worth of hikes in 2014. So far this year, food and petrol prices have proven considerably more resilient than expected given the recent strength in the NZ dollar – and unless we see a correction, inflation could sail closer to the wind of the RBNZ's 2% target mid-point than we previously thought. Given the newly established importance of that target for the RBNZ, that's a significant development. As with the housing market, we will be maintaining a watching brief – the next relevant piece of information is the RBNZ's survey of inflation expectations, out on Tuesday. But for now the risks to our interest outlook remain balanced. Markets seem to agree.

Fixed vs Floating for mortgages

We are indifferent between fixing and floating at present. Interest rates are currently higher for longer fixed terms. However, we expect floating rates and short-term fixed rates to rise substantially over the coming three years. In our view, floating and short-term fixed rates offer no better or worse value than longer-term fixed rates.

NZ interest rates

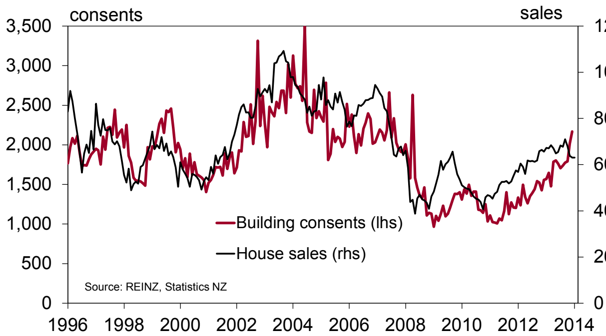


NZ Jan building consents

Feb 28, Last: +7.6%, Westpac f/c: -15.0%

- Residential building consents are due for a sizeable pullback after gains of 12.5% in November and 7.6% in December.
- Consents for apartment units were remarkably strong in those two months, well beyond their normal volatility (reaching 492 in Nov and 473 in Dec compared to an average monthly pace of around 150). We have assumed that apartment consents drop back to trend for January, but the plausible range could be anywhere from 0 to 300.
- Ex-apartment consents rose 10.7% in December, having softened a little in the two previous months. All of that growth came from Canterbury as the post-quake rebuild progressed; consents in Auckland have softened markedly in recent months, despite the legislative push (and the price incentive) to step up new home construction. We expect a 3% pullback in ex-apartment consents, though we could be surprised on the upside if the Auckland market shows a fresh lease of life.

NZ housing activity

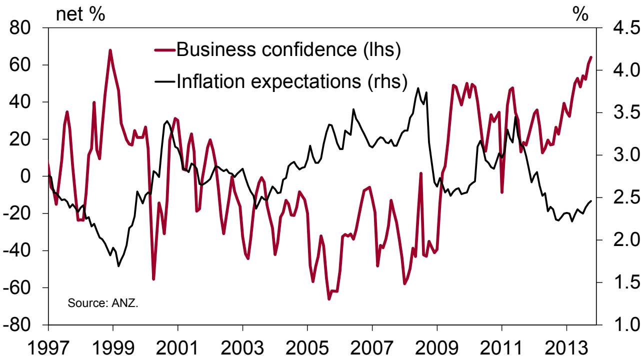


NZ Feb business confidence

Feb 28, Last: 64.1

- Business confidence has surged over the last year, reaching a 20-year high in the December 2013 survey (there is no January survey). Data since the start of the year has generally remained positive; business contacts also suggest that this momentum has not only been maintained but is becoming more widespread.
- With the upturn in activity now well established, we are increasing our focus on the indicators of capacity pressures. Employment intentions, investment intentions and capacity utilisation have also picked up sharply in recent months; pricing intentions and inflation expectations for the year ahead have also picked up, although the latter is still below average. Another upside surprise on the CPI since December should help to nudge these measures higher.

NZ business confidence & inflation expectations

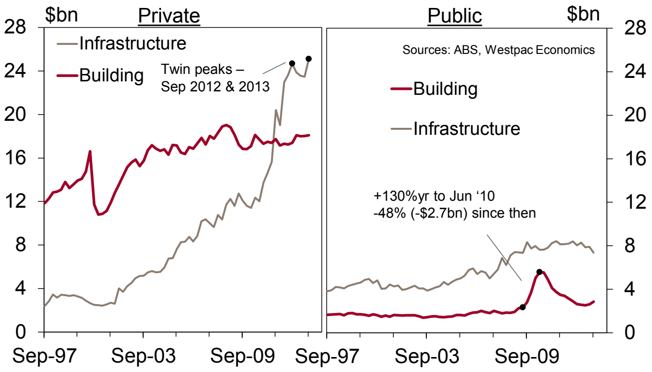


Aus Q4 construction work done

Feb 26, Last: 2.7%, WBC f/c: 1.0%
Mkt f/c: 0.4%, Range: –2.0% to 3.5%

- Construction work is forecast to expand by around 1.0% in the final quarter of 2013. That comes after a 2.7% rise in Q3. Annual growth lifts from 1.3% to 2.0%.
- New dwelling construction is set to rise, up a forecast 4.0%, following a flat quarter, with approvals up strongly in response to lower rates. Renovation work is likely to be subdued.
- Private engineering is a source of potential surprise given the lumpy nature of the work pipeline. We're forecasting a 2.0% fall, partially reversing a 7% jump in Q3, which followed three consecutive quarters of decline.
- Private non-residential building and public engineering work both have near-term upside, as suggested by approvals/ commencements data.

Construction work: divergent trends

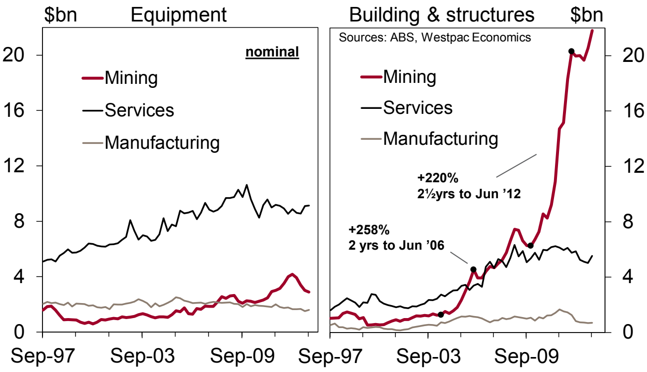


Aus Q4 CAPEX

Feb 27, Last: 3.6%, WBC f/c: –1.0%
Mkt f/c: –1.0%, Range: –3.0% to 1.5%

- Private business CAPEX spending is forecast to fall by 1.0% in Q4, with equipment spending and building & structures to decline by a similar magnitude.
- The sharp run-up in total CAPEX ended in 2012 Q2, with spending then almost 60% above that of two years earlier. Since then, it has been a case of one-step back (down 6% in the three quarters to 2013 Q1) and one-step forward (up 5% in the two quarters to 2013 Q3).
- Equipment investment fell for a fourth consecutive quarter in Q3, down 8.8% over the year, with weakness concentrated in the mining sector.
- The CWD survey, out on Wednesday, will give a guide to the risks surrounding our forecast for Q4 building & structures.

CAPEX: by industry by asset

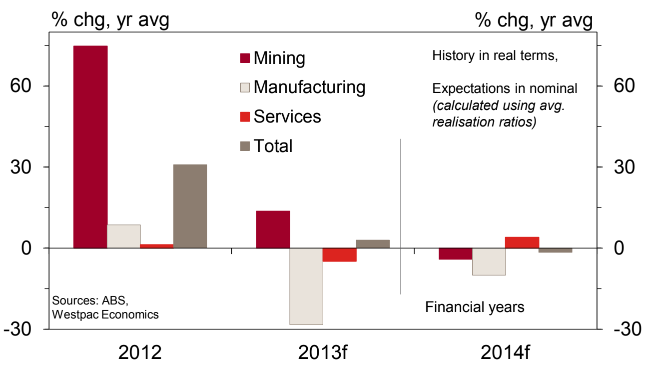


Aus CAPEX plans, AUDbn

Feb 27, Last: 166.8

- The December survey suggested CAPEX plans for 2013/14 were upgraded from those three months earlier. In part, that may be because plans as at September were constrained by uncertainty ahead of the September 14 Federal Election.
- Est 4 of plans for 2013/14 printed at $166.8bn, some 2% below Est 4 for 2012/13, whereas Est 3 was 10% below the corresponding estimate of a year ago.
- Private surveys report that business conditions have improved over recent months, pointing to the possibility that firms respond by lifting investment plans somewhat.
- Est 1 of plans for 2014/15, which will be released in this upcoming survey, is of particular interest with the economy in a transition phase. Although, we caution Est 1 and Est 2 are typically a less reliable guide to the outlook that Est 3 on.

CAPEX plans by industry

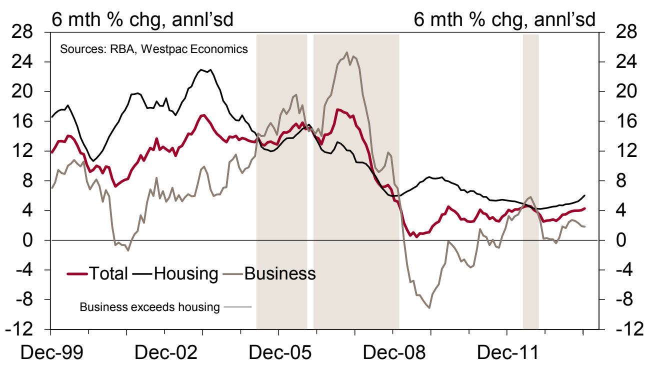


Aus Jan private sector credit

Feb 28, Last: 0.5%, WBC f/c: 0.5%
Mkt f/c: 0.4%, Range: 0.4% to 0.6%

- Credit growth to the private sector ticked higher in December, printing at 0.5% following four consecutive gains of 0.3%. Both housing and business improved.
- Back-to-back monthly increases of 0.5% appear plausible.
- Business credit rose 0.4% in December and we anticipate a result approaching that in January. This follows a flat spot, with a rise of only 0.1% over the four months to November.
- Housing credit strengthened over the second half of 2013, from a gain of 0.43% in July to a rise of 0.59% in December, as the sector responded to lower interest rates. This trend most likely extended into January, although we note that new lending was flat in December.

Credit momentum

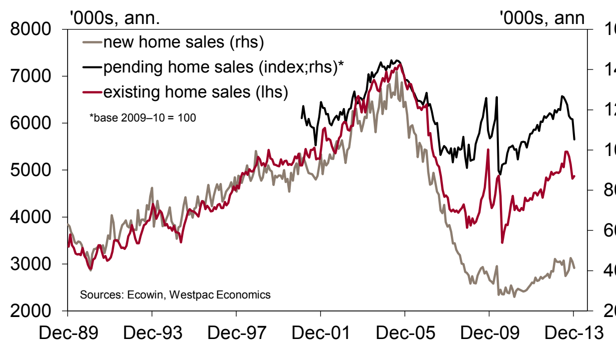


US new/pending home sales in Jan

Feb 26, New: Last: –7.0%, WBC f/c: 3.0%
Feb 28, Pending: Last: –8.7%, WBC f/c: 2.0%

- New home sales fell a further 7% in Dec, so most of Oct's near 15% sales spike has been reversed. Sales ran a 414k annualised pace in H2 2013 compared to 445k in H1; lower affordability due to higher mortgage rates/prices and stalled income growth were probably factors at play. Bad weather disrupted the market in Dec (after a mild weather boost earlier in Q4), so seasonally adjusted sales could rise in Jan, even with more snow. Starts collapsed in Jan, but you can sell a house inside or offsite, not possible with starts. Recall this notoriously volatile series is revised sharply.
- Pending home sales plunged 8.7% in Dec, their seventh consecutive decline; it was broad-based across all regions, so its unlikely it was just a weather story. A lack of supply of decent homes and ongoing weather disruption will limit the size of the expected bounce in Jan sales.

US housing sales

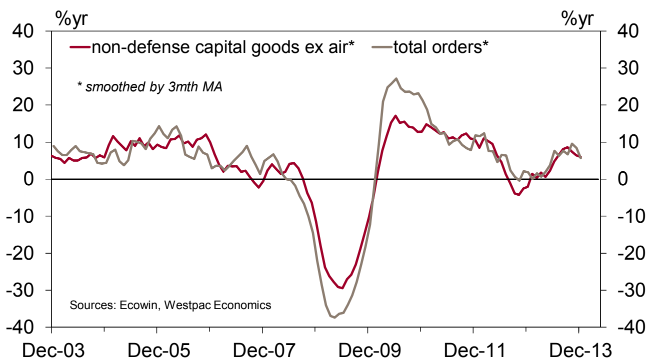


US Jan durable goods orders: another fall expected

Feb 27, Last: –4.2%, WBC f/c: –2.5%

- Durable goods orders fell 4.2% in Dec, unexpectedly weak with autos down 6% (their first fall since May), aircraft down 18%, defence down 22%, and the core capital goods component (ex air/defence) falling 1.6% – Nov's 4.1% core gain was revised down to 2.6%. The core component rose just 0.9% annualised in Q4 after falling 7.1% in Q3, indicative of a weak H2 2013 for business investment plans.
- ISM factory orders plunged from 64 to 51 in weather disrupted Jan. Boeing took just 38 orders in Jan after 319 in Dec (seasonals should adjust for much of that). Auto sales slipped, production fell 5% in Jan, and business equipment output fell for the third month running. There is little evidence pointing to an orders gain, so we expect the headline down at least 2.5%, with core capital good orders probably down 1% or so.

US durable goods orders



Data calendar

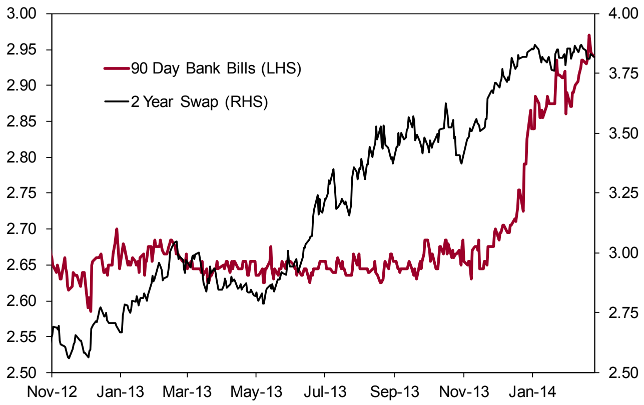
		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
Chn	Jan 70 city house prices %mth net bal	88.6%	–	–	Secondary market at 84.3. Tier 1 due to ease after resilient H2.
Eur	Jan CPI final %yr	0.7%		0.7%	Core rate was 0.8%yr in flash report.
Ger	Feb Ifo business climate index	110.6	110.7	111.0	Decent Q4 GDP growth despite some weaker end year partials.
UK	Feb house prices %yr	8.8%	8.8%	–	Tentative date for Nationwide index, due 24-28/2.
US	Feb Dallas Fed factory index	3.8	–	–2.0	Weather impact in the south.
	Jan Chicago Fed national activity index	0.16	–	–	Based on 80 or so data inputs, not a business survey.
Tue 25					
NZ	Q1 RBNZ 2yr inflation expectations	2.34%	-	-	Follows strong growth and a second upside surprise on the CPI.
UK	Feb CBI retail survey	14	14	–	Reported sales index not as volatile as official Dec-Jan retail.
	Jan mortgages no.	46.5k	–	–	BBA data covering 70% of market; last month of FfL support.
US	Dec house prices %yr	13.7%	13.3%	–	S&P Case Shiller 20-city index.
	Dec house prices	0.1%	0.4%	–	FHFA index.
	Feb Conf Brd consumer confidence	80.7	80.0	81.0	Confidence at close to six-year highs.
	Feb Richmond Fed factory index	12	–	0	Regional surveys did not identify Jan weather impact, but likely in Feb.
Wed 26					
Aus	Q4 construction work done	2.7%	0.2%	1.0%	Dwelling work up. Engineering f/c to fall, but upside surprise a risk.
Ger	Mar GfK consumer confidence	8.2	8.3	–	Surveyed Feb but labelled March. At highest since 2007 last month.
UK	Q4 GDP 1st revision	0.7% a	0.7%	0.7%	More detailed breakdown.
	Q4 business investment	2.0%	–	–	Surveyed separately to national accounts capital formation data.
US	Jan new home sales	–7.0%	–2.2%	3.0%	End year fall largely weather-related, but may be revised. See text box.
	Fedspeak	–	–	–	Rosengren.
Thu 27					
NZ	Jan trade balance $m	523	230	240	Exports continue to be boosted by sky high dairy prices.
	Jan net migration	2,820	-	2,800	Net immigration holding steady at cyclically high levels.
Aus	Q4 CAPEX	3.6%	–1.0%	–1.0%	Both building & structures and equipment f/c to fall, see textbox.
	2013/14 CAPEX plans, AUDbn	166.8	–	–	Est 4 2% < Est 4 for 2012/13. Business conditions have improved.
	2014/15 CAPEX plans	–	–	–	Est 1 for 2014/15. We caution, Est 1 & 2 not always a reliable guide.
Eur	Jan money supply M3 %yr	1.0%	1.1%	–	LTRO repayment, contracting lending, stress test deleveraging.
	Feb business climate indicator	0.19	–	0.25	Faster pace of Q4 GDP growth encourages hope some momentum...
	Feb economic confidence	100.9	–	102.0	will continue into 2014. Consumer confidence near 2011 highs.
	EU Commisssion Winter Forecasts	1.1%	–	1.1%	Even after Q4 13's upside surprise, we expect 0.7% 2014 GDP growth.
Ger	Feb unemployment ch	–28k	–10k	–	German joblessness saw steep back-to-back falls in Dec-Jan.
	Jan retail sales	–1.7%	0.9%	–	Dec saw steepest fall since –2.1% in Jan 2012 (tentative release date).
	Feb CPI prelim %yr	1.3%	–	–	German inflation almost twice the Eurozone average but still low.
US	Jan durable goods orders	–4.2%	–1.0%	–2.5%	Boeing orders down sharply, autos likely weak, see text box.
	Initial jobless claims w/e 21/2	336k	333k	335k	Claims have been noisy but are running a little lower than last year.
	Feb Kansas City Fed factory index	5	–	0	Jan survey did not identify the weather impact in Fed IP/ISM data.
	Fedspeak	–	–	–	Pianalto, Lockhart, George.
Can	Q4 current account C$bn	–15.5	–16.8	–	Deficit stabilised below Dec 2010 C$19.4bn record.
Fri 28					
NZ	Jan building consents	7.6%	-3.5%	-15.0%	Primed for a downward correction, especially for apartment units.
	Feb ANZ business confidence	64.1	-	-	Data and anecdotes have pointed to a strong start to the year.
	Jan private sector credit %yr	4.8%	-	-	Mortgage growth likely to slow with the housing market.
Aus	Jan private credit	0.5%	0.4%	0.5%	An uptick in growth in Dec, housing & business, to extend into Jan.
Eur	Feb CPI flash %yr	0.7%	–	–	Low inflation does not necessarily require further stimulus.
	Jan unemployment rate %	12.0%	12.0%	12.0%	Steady German jobless rate and stabilising employment elsewhere.
UK	Feb GfK consumer confidence	–7	–7	–5	Economic recovery fuelling confidence upswing, and vice versa.
US	Q4 GDP 1st revision	3.2%	2.5%	2.6%	Partial data point to downward revision to Q4 and soft start to 2014.
	Feb Chicago PMI	59.6	57.8	53.0	Regional surveys did not identify the weather impact in Fed/ISM data...
	Feb Milwaukee NAPM	52.8	–	47.0	but the midwest was hit especially hard.
	Feb UoM consumer sentiment final	81.2 a	81.2	81.5	Weekly confidence data points to improved sentiment.
	Jan pending home sales	–8.7%	2.7%	2.0%	Sales hit by weather in Dec. Jan weather was disruptive too. See box.
	Fedspeak	–	–	–	Stein, Kockerlakota, Evans and Plosser.
Can	Q4 GDP % annualised	2.7%	2.7%	2.5%	BoC forecast is 2.5% for final qtr of 2013.
	Dec GDP	2.6%	–	–	Less acceleration in Q4 vs Q3 than in Q3 vs Q2.

New Zealand forecasts

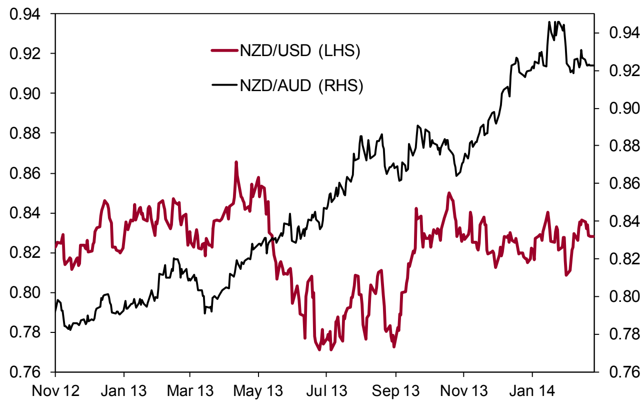
Economic Growth Forecasts		March years				Calendar years		
% change	2013	2014f	2015f	2016f	2012	2013e	2014f	2015f
GDP (Production) ann avg	2.3	3.2	4.2	3.0	2.6	2.8	4.2	3.2
Employment	0.4	3.3	2.8	1.5	0.4	2.9	3.0	1.7
Unemployment Rate % s.a.	6.2	5.8	5.1	4.8	6.8	6.0	5.1	4.7
CPI	0.9	1.4	1.8	2.3	0.9	1.6	1.7	2.2
Current Account Balance % of GDP	-3.9	-3.7	-5.7	-6.0	-4.1	-3.8	-5.0	-6.2

Financial Forecasts	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15
Cash	2.75	3.25	3.50	3.75	4.00	4.00
90 Day bill	3.10	3.50	3.75	4.00	4.20	4.30
2 Year Swap	3.90	4.10	4.30	4.50	4.65	4.80
5 Year Swap	4.60	4.70	4.80	4.90	5.05	5.20
10 Year Bond	4.70	4.80	5.00	5.10	5.20	5.30
NZD/USD	0.84	0.83	0.82	0.81	0.80	0.80
NZD/AUD	0.93	0.94	0.94	0.94	0.94	0.93
NZD/JPY	85.7	83.8	82.0	80.2	80.0	81.1
NZD/EUR	0.63	0.64	0.63	0.64	0.63	0.63
NZD/GBP	0.53	0.52	0.52	0.51	0.50	0.48
TWI	79.5	79.4	78.6	78.1	77.6	77.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 24 Feb 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.76%	2.69%	2.74%
60 Days	2.85%	2.79%	2.82%
90 Days	2.94%	2.90%	2.91%
2 Year Swap	3.82%	3.87%	3.81%
5 Year Swap	4.52%	4.59%	4.51%

NZ foreign currency mid-rates as at Monday 24 Feb 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.8283	0.8289	0.8246
NZD/EUR	0.6033	0.6090	0.6034
NZD/GBP	0.4984	0.5053	0.4975
NZD/JPY	84.91	85.00	84.70
NZD/AUD	0.9228	0.9254	0.9422
TWI	77.85	78.14	78.04

International forecasts

Economic and Financial Forecasts

Economic Forecasts (Calendar Years)	2010	2011	2012	2013f	2014f	2015f
Australia						
Real GDP % yr	2.3	2.6	3.6	2.4	2.6	3.0
CPI inflation % annual	2.8	3.0	2.2	2.7	2.3	2.5
Unemployment %	5.2	5.2	5.3	5.8	6.4	6.1
Current Account % GDP	-3.5	-2.8	-4.1	-2.9	-3.2	-2.2
United States						
Real GDP %yr	2.5	1.8	2.8	1.9	2.2	2.5
Consumer Prices %yr	1.6	3.1	2.1	1.5	1.5	1.5
Unemployment Rate %	9.6	8.9	8.1	7.4	6.8	6.2
Current Account %GDP	-3.0	-2.9	-2.7	-2.3	-2.2	-2.2
Japan						
Real GDP %yr	4.7	-0.6	2.0	1.8	1.8	1.4
Euroland						
Real GDP %yr	2.0	1.5	-0.6	-0.5	0.4	0.6
United Kingdom						
Real GDP %yr	1.7	1.1	0.2	1.9	2.6	1.9
China						
Real GDP %yr	10.4	9.3	7.7	7.7	7.4	7.5
East Asia ex China						
Real GDP %yr	7.8	4.3	3.9	3.9	3.7	4.8
World						
Real GDP %yr	5.2	3.9	3.2	2.9	3.2	3.7
Forecasts finalised 7 February 2014						

Interest Rate Forecasts	Latest	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
Australia						
Cash	2.50	2.50	2.50	2.25	2.00	2.00
90 Day Bill	2.63	2.55	2.30	2.10	2.10	2.10
10 Year Bond	4.21	4.10	3.90	3.70	4.00	4.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.75	2.70	2.60	2.60	2.80	3.00
ECB Repo Rate	0.25	0.25	0.25	0.25	0.25	0.25

Exchange Rate Forecasts	Latest	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15
AUD/USD	0.8994	0.90	0.88	0.87	0.86	0.85
USD/JPY	102.57	102	101	100	99	100
EUR/USD	1.3718	1.35	1.31	1.31	1.28	1.27
AUD/NZD	1.0830	1.07	1.06	1.06	1.06	1.06

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