28 October 2014

Weekly Commentary

Rere Waterfall, Gisborne.

In this issue

Back to square one

Last week's Consumer Price Index showed that inflation fell to 1.0% in the year to September 2014. That was not much different to our forecast of 1.1%, but there was still a great deal of shock value in the headline for markets.

Inflation is much weaker than almost anybody predicted a year ago, and has persistently surprised economists on the downside for the past three years. One percent is the very bottom of the allowable range under the Reserve Bank's inflation target – markets have rightly deduced that the Reserve Bank will be very nervous about that, and will be in no mood to hike the OCR any time soon.

The main drivers of the low rate of annual inflation were food and petrol, both of which have declined in price over the past year. In and of itself, food and petrol price volatility is not a big deal. In particular, vegetables were cheap relative to winter norms owing to favourable growing conditions, but that doesn't mean they will stay cheap.

But beneath the headlines the underlying trend in inflation has been amazingly subdued relative to the perky state of the economy. Construction and housing-related inflation did accelerate in response to the construction boom, as anticipated. But that has not infected inflation in a broader sense. Non-tradables inflation actually fell to 2.5% in the latest figures. The Reserve Bank's Sectoral Inflation Factor Model, which is published following each CPI release and is charted to the right, is one method of stripping out the noise in inflation and distilling the underlying trend. It shows how impervious underlying inflation has been to the latest economic upswing.

There are a range factors that have all conspired to produce this trend of low inflation: rising labour force participation and population growth, which have kept wage inflation subdued; improved productivity growth in New Zealand, which has boosted the supply side of the economy; sector-specific developments such as falling broadband prices and slower increases for electricity and council rates; the strong exchange rate; consumer access to internet purchases undercutting retailers' margins; low inflation expectations under the current, stricter-on-inflation RBNZ Governor; and of course, low inflation in New Zealand is part of a broader global trend.

Back to square one continued

We suspect that low inflation is going to persist for a while yet. Global commodity prices have tumbled, and business surveys have shown little evidence of near-term cost increases. We are forecasting inflation of just 1.3% in March 2015, and we expect inflation to remain below 2% until December 2015.

With this type of inflation outlook in the offing, it seems unlikely that the RBNZ will entertain the idea of hiking the OCR any time soon. The RBNZ's message in the September *Monetary Policy Statement* was that it wanted to see the whites of the eyes of actual inflation before it hikes the OCR again. That is not going to happen before late 2015. Accordingly, we are now forecasting the OCR to remain at 3.5% right through until September 2015.

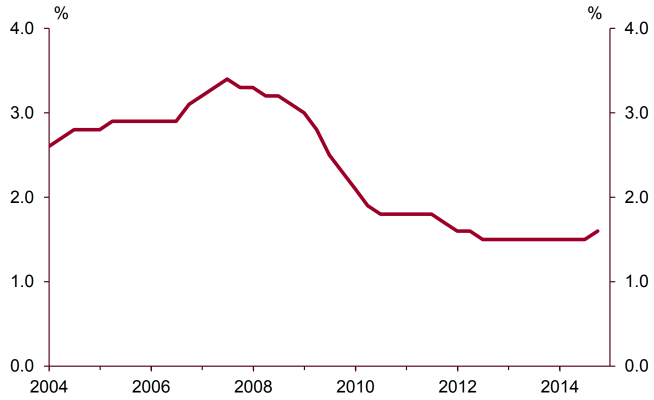
When it releases its OCR review this Thursday, the RBNZ will probably express a similar sentiment. We suspect that the RBNZ will explicitly rule out any near-term OCR hike, perhaps by saying something along the lines of:

"The current period of monitoring and assessment is likely to continue for some time."

But the RBNZ will also have to remind markets that over the longer-term inflation can be expected to rise towards two percent, and therefore the next move in the OCR is more likely to be up than down – even if the timing of that move is now up in the air.

For every action there is a reaction, and in this case the reaction will be felt in the housing market. As financial markets push swap rates down in anticipation of fewer OCR hikes, fixed mortgage rates are falling. Over the past two weeks there has been a 24 basis point reduction in advertised two-year fixed mortgage rates, averaged across the six biggest mortgage providers. After last week's news, we suspect that a further round of fixed mortgage rate reductions lies ahead.

Sectoral factor model



The housing market, which has been relatively subdued recently, will obviously get a boost from lower mortgage rates. Booming net immigration will provide a further boost – data last week showed that annual net immigration had reached an all-time high of 45,000. Finally, housing market sentiment will have been buoyed by the general election result, which returned a Government opposed to capital gains tax. It is not difficult to imagine the housing market gathering some steam over the months ahead.

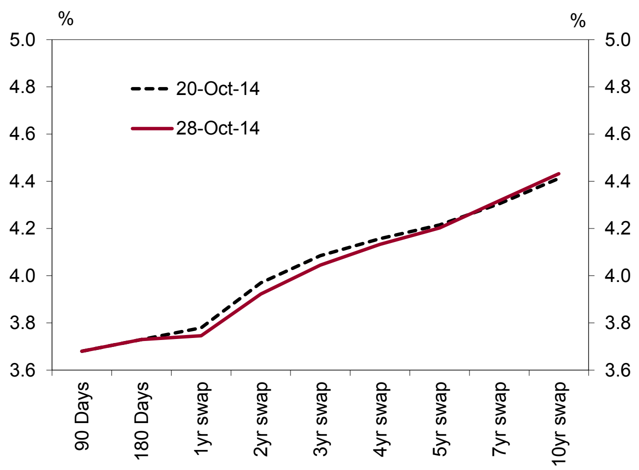
Fixed vs Floating for mortgages

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 Oct business confidence

Oct 29, Last: 13.4

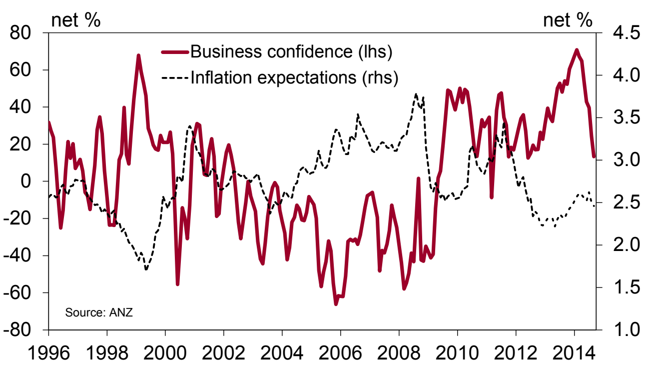
- General business sentiment fell sharply in September, continuing its slide from record highs earlier in the year. However, the detailed survey questions revealed a lift in firms' own-expectations for the first time in seven months.
- The September survey's mixed messages could well have been a product of pre-election uncertainty, with firms anxious about the possibility of a change of government, but not experiencing any tangible consequences. The October survey will shed some light on this.
- Recent data suggests that domestic activity has picked up momentum in the last few months. In contrast, the outlook for the agricultural sector has darkened as world dairy prices have continued to slide.

RBNZ OCR review

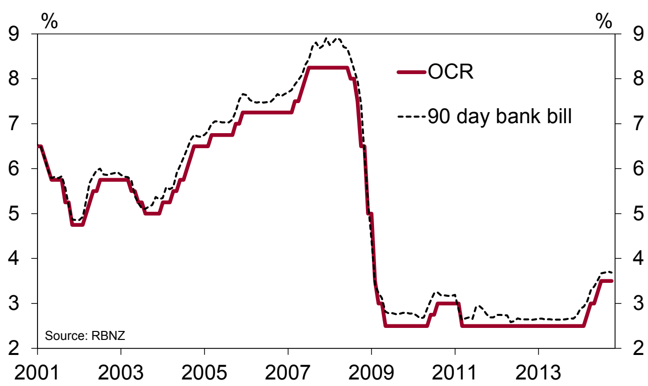
Oct 30, Last: 3.50%, Westpac f/c: 3.50%, Mkt f/c: 3.50%

- In September, the RBNZ signalled "a period of monitoring and assessment", with inflation remaining softer than expected given the strong domestic economy, surging net immigration and a construction boom.
- Since then, annual inflation has fallen back to the lower edge of the 1-3% target band and is expected to stay there for at least another quarter.
- Subdued domestic inflation, falling commodity prices and risks to global growth offer plenty of reason for the RBNZ to remain on hold for an extended period. We expect the next OCR hike to be delayed until September 2015.

NZ business confidence and inflation expectations



NZ OCR and 90 day rate



NZ Sep building consents

Oct 31, Last: 0.0%, Westpac f/c: 1.0%

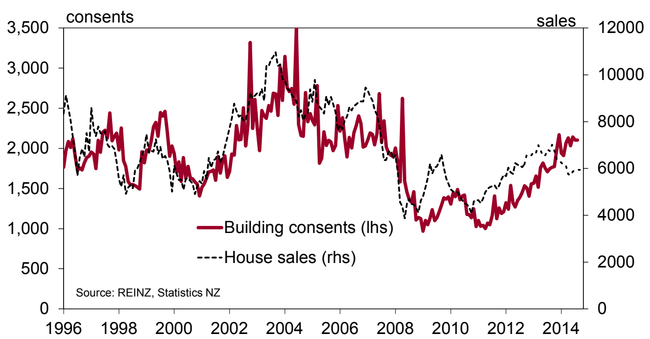
- The upward trend in residential building consents has remained intact this year, though with the usual choppiness in the monthly balances. Pre-election uncertainty may have played a role in the last couple of months, but this should amount to no more than a timing issue.
- The post-quake Christchurch rebuild is still gathering momentum, and construction in Auckland has room to expand much further given population pressures and still-rising house prices. Consents have also picked up modestly in the rest of the country.
- Non-residential consents have seen a particularly strong lift in recent months. Most of this reflects large projects being signed off in Christchurch.

Aus Q3 import price index

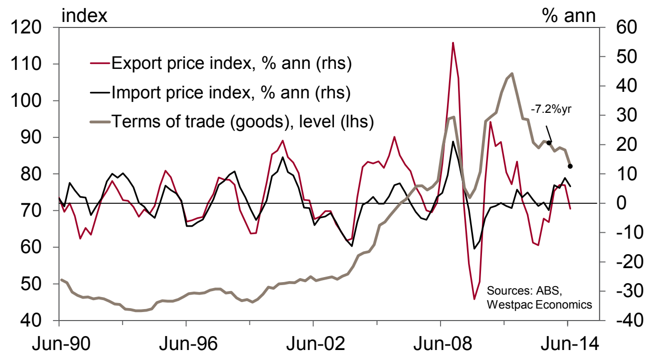
Oct 30, Last: –3.0%, WBC f/c: –0.3%
Mkt f/c: 0.2%, Range: –1.0% to 2.5%

- Import goods prices are expected to be little changed in the September quarter, edging down by a forecast 0.3% to be 0.7% lower than the corresponding quarter a year ago.
- Currency fluctuations are typically central to quarterly movements in import prices. In the September quarter, the Australian dollar consolidated on a TWI basis, declining by only 0.4%. Another consideration is global oil prices. They weakened in the quarter, down 4.2% in AUD terms.
- On balance, we expect the fall in energy prices in the quarter to more than offset the boost to import prices from a slightly lower currency.

NZ housing activity



Import & export price index



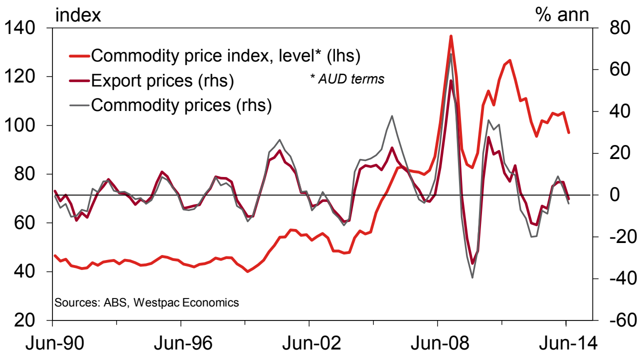
Aus Q3 export price index

Oct 30, Last: –7.9%, WBC f/c: –4.8%
Mkt f/c: –4.7%, Range: –6.0% to –2.5%

- Export prices have taken a further hit as the downturn in global commodity prices extended into the September quarter.
- The export price index is forecast to decline by 4.8% in the quarter, to be more than 10% lower than a year earlier.
- Global commodity prices slumped in Q3 by around 6.5% in USD terms. A slight softening of the currency, down 0.8% against the USD, provided a partial offset.
- The terms of trade for goods, on these estimates, declined by 4.5% in the quarter and fell by 10% over the year.

(Note, the Balance of Payments estimates of import and export goods prices can differ from the trade price indexes.)

Commodity prices and export price index

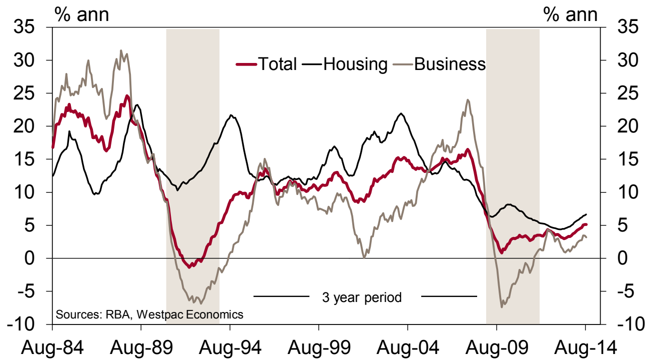


Aus Sep private sector credit

Oct 31, Last: 0.4%, WBC f/c: 0.4%
Mkt f/c: 0.4%, Range: 0.3% to 0.6%

- Credit growth is tracking a little higher in 2014 than 2013 as record-low interest rates encourage a lift in borrowing by both business and households. Total credit grew by 5.1% in the year to August, up from 3.3% this time a year ago.
- For September, credit is forecast to increase by 0.4%, an outcome in line with the August result and the monthly average for the year to date.
- Business credit, which can be volatile month-to-month, was flat in August and rose by 3.2% over the year, up from 1.4%yr in August 2013. We anticipate a modest increase in September.
- Housing credit growth consolidated in the first half of 2014 after accelerating over the second half of last year in response to RBA rate cuts. The August outcome was 0.6%mth, 6.7%yr.

Credit mix: annual growth

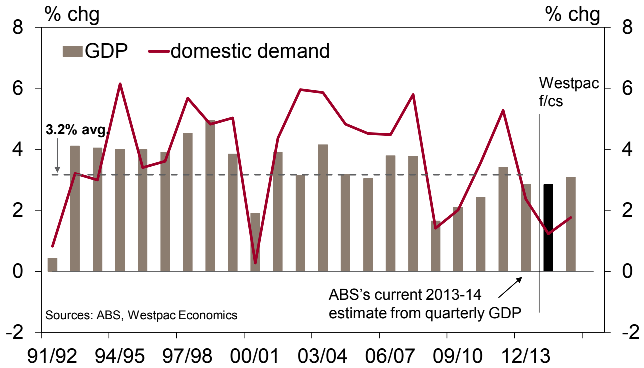


Aus 2013-14 national accounts

Oct 31, Current estimate: 2.8%

- Australia's economy expanded by 2.8% in 2013/14, as reported in the June quarter national accounts.
- The annual national accounts provides new 'benchmark' estimates of income, expenditure, production and balance sheets, with detailed sectoral and industry estimates. The accounts also include new estimates of the capital stock – including its average age – and of multi-factor productivity, which we expect to have shown an improvement in 2013-14 after declining 0.5% in 2012-13 and by 3.6% since 2003-04.
- The annual accounts often see revisions. Last year GDP growth for 2012-13 was revised down from 2.9% to 2.6%. These changes can also alter the composition of growth and its quarterly profile – the latter only becoming fully apparent with the Q3 GDP release (due Dec 3).

Australia: annual economic performance

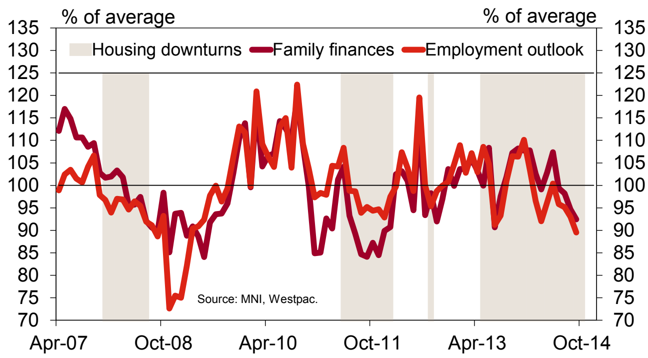


China Oct Westpac-MNI Consumer Sentiment

Oct 29 Last: 113.2

- The headline index was basically steady in September, which left sentiment 6.8% below the long-run average. Concern about jobs and housing were prominent themes in the detail.
- We have repeatedly noted that households have been less impressed with the state of the economy than the two PMIs throughout the current soft patch. Given the domestic demand slowdown evident in the official data, it seems that the instinctive scepticism of the consumer is closer to the mark.
- We will be looking for the following in October: 1) Is the survey consistent with a pick-up in consumption in Q4? 2) Updated views on the labour market, with some modest momentum emerging in September IP; 3) The evolving attitude of consumers towards the ongoing housing correction, in the context of easier policy; and 4) New developments in savings attitudes (avenues and motivations) against this backdrop.

Westpac MNI China CSI & housing downturns



The week ahead

US Sep durable goods orders

Oct 28, CPI: Last: –18.4%, WBC f/c: 0.3%

- Durable goods orders fell 18.2% on lower aircraft and auto orders in Aug, but core capital goods orders rose 0.6%, a reasonable result given June's 5.4% jump and July's minimal 0.2% pull-back. Indeed, the 3mth annualised pace for core orders in Jun-Aug was 17% compared to 12% in Q2 and 4% in Q1. Shipments rose 0.1% in Aug for a 3mth pace of 9% from 7%/2% in Q2/Q1. The quarterly pace for orders and shipments will slow if the monthly data don't resume solid rises imminently (in Sep for orders).
- ISM factory orders dipped to a 3mth low at 60 in Sep. Boeing took 122 orders in Sep from 107 in Aug (less of a gain than recent wild swings). Auto sales fell 6% and production was down sharply in Aug and a further 1.4% in Sep. Business equipment output posted a modest 0.3% rise. These mixed signals point to subdued headline and core orders gains.

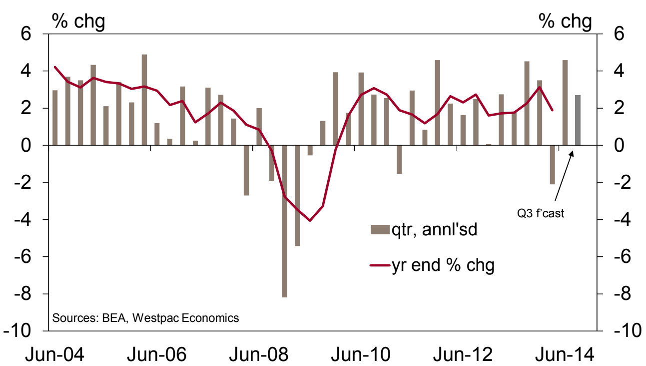
US durable goods orders

US Q3 GDP growth

Oct 30, Last: 4.6%, WBC f/c: 2.7%

- US GDP growth was revised from 4.2% to 4.6% annualised in the final Q2 report. There were no standout contributors to the stronger growth estimate; rather, all components of the economy saw modest revisions which summed to the equal-fastest quarterly growth rate since Q1 2006.
- Q2 was of course boosted as activity and inventories normalised following Q1's snow disruption. Partial data for Q3 points to slower consumption spending, steady at best housing growth, some moderation in capex growth, and little contribution from net exports or government for a 2.7% annualised Q3 growth outcome.
- Early indications are that Q4 growth will be even slower; we expect around 2% annualised.

US GDP growth

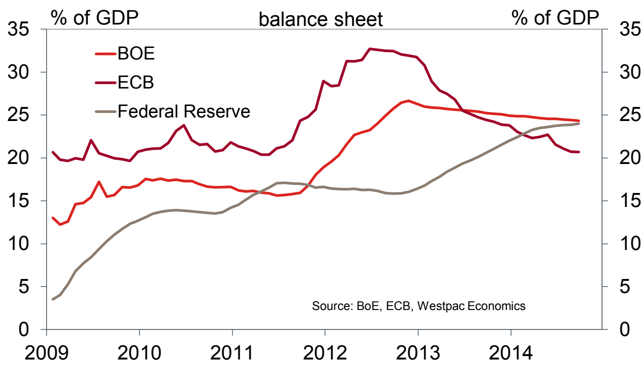


US FOMC QE decision: third time lucky?

Oct 29, Last: $15bn, WBC f/c: $0bn

- Despite emerging downside risks to growth and inflation from the stronger dollar, weaker global growth and falling inflation expectations, the FOMC is unlikely to keep QE ticking over "just in case" these risks crystalise, or are even fuelled by ending QE3. That said, to pause the taper would be the most effective forward guidance that interest rate rises are still a considerable way off: nearly a year on our forecasts.
- Janet Yellen has been on the FOMC for the entirety of the three QE programs, initially as architect, then advocate and now adjudicating over its retirement. More than most, she will be conscious that the Fed has twice before ended the program, in hindsight prematurely. If all goes to plan, the usual lightly edited brief statement will be all that marks the third farewell to this unorthodox policy tool. There's no Yellen presser this month, but the $3trn dollar bulge on the Fed's balance sheet means it won't soon be forgotten, in any case

North Atlantic – central bank balance sheets



Data calendar

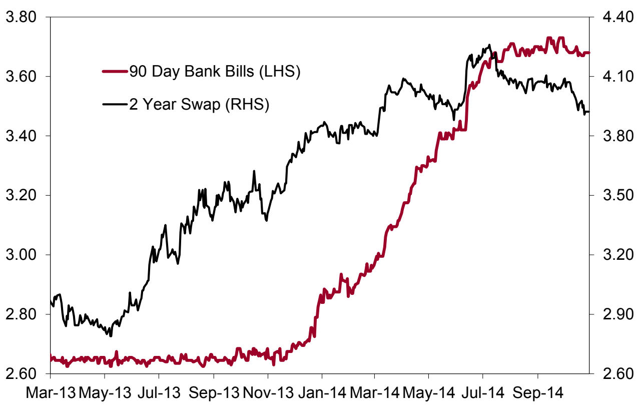
		Last	Market median	Westpac forecast	Risk/Comment
Tue 28					
Chn	Sep industrial profits %ytd	10.0%	–	–	Most interest in margins in excess capacity sectors and mining.
Eur	European Commission forecasts	1.2%	–	0.7%	2014 GDP growth forecast for Euroland last updated May 2014.
Ger	Nov GfK consumer confidence	7.1	7.2	–	Surveyed early Oct but labelled Nov. At highest since 2007.
US	Sep durable goods orders	–18.4%	0.4%	0.3%	Aircraft orders volatility past; core capital goods slowing?
	Aug S&P/CS 20-city house prices %yr	6.8%	12.4%	–	Established housing market recovery stalling.
	Oct Conf Board consumer confidence	86.0	87.2	86.5	Sep fall was from 6 year high.
	Oct Richmond Fed factory index	14	10	8	Richmond Fed at 3+ year high, due for correction.
Wed 29					
NZ	Oct ANZ business confidence	13.4	–	–	First survey following the decisive election outcome.
Chn	Oct Westpac–MNI consumer sentiment	113.2	–	–	Confidence weak, weighed down by housing, job insecurity.
UK	Sep net mortgage lending £bn	2.3	1.9	–	Household loan outstandings are rising more quickly, led mostly by
	Sep net consumer credit £bn	0.9	0.8	–	mortgages.
	Sep M4 money supply ex IOFCs % ann	3.1%	–	–	Down from 7.9%yr in Aug 12, a function of BoE APP suspension.
US	FOMC decision $bn per mth	15	0	0	For the third time in five years, the Fed to suspend QE.
Can	Sep industrial product prices	0.2%	–	–	Slight downtrend has emerged since April.
Thu 30					
NZ	RBNZ OCR review	3.50%	3.50%	3.50%	Subdued inflation will delay further rate hikes for some time.
Aus	Q3 import price index	–3.0%	0.2%	–0.3%	Import prices edge lower on drop in global energy prices.
	Q3 export price index	–7.9%	–4.7%	–4.8%	Export prices hit by lower commodity prices.
Eur	Oct business climate indicator	0.07	–	–0.10	Business surveys point to contractionary growth pulse early in Q4,
	Oct economic confidence	99.9	–	99.5	though very modest overall Euroland growth is still likely.
Ger	Oct unemployment ch'	12k	5k	–	Unemployment up in four of last five months.
	Oct CPI prelim %yr	0.8%	–	–	Lower oil prices may offset euro depreciation.
US	Q3 GDP advance	4.6%	3.0%	2.7%	Q3 lacks Q2's bounce from Q1 disruption.
	Initial jobless claims w/e Oct 25	283k	–	–	Low level of claims continues to point to minimal firing.
Fri 31					
NZ	Sep building consents	0.0%	–	1.0%	Uptrend in Auckland and Canterbury remains intact.
	Sep private sector credit %yr	4.4%	–	–	Housing lending growth has continued to slow.
Aus	Sep private credit	0.4%	0.4%	0.4%	Growth a notch higher in 2014 than in 2013 - supported by low rates.
	Q3 PPI %qtr	–0.1%qtr	–	1.0%qtr	It is now second tier data as it is released after the CPI.
	2013-14 national accounts	–	–	–	Full annual accounts, often result in revisions to qtly GDP estimates etc.
Eur	Oct CPI flash %yr	0.3%	–	0.2%	Ger/Sp CPIs due 30/10 helpful clues. Eurozone core was 0.7yr% in Sep.
	Sep unemployment rate %	11.5%	–	11.5%	Steady German jobless rate; elsewhere both higher and lower rates.
UK	Oct GfK consumer confidence	–1	–	–	No longer rising, but recent outcomes highest since 2005.
US	Sep core PCE deflator	0.1%	0.1%	0.1%	Core CPI was 0.1% in Sep. GDP report includes qtrly data.
	Sep personal income	0.3%	0.3%	0.2%	Hourly earnings flat in Sep, hours worked up 0.5%.
	Sep personal spending	0.5%	0.1%	0.0%	Core retail sales down in Sep, as were auto unit sales. Services higher?
	Q3 employment cost index	0.7%	0.5%	0.5%	Q2 spike was not beginning of new uptrend but mostly due one-offs.
	Oct Chicago PMI	60.5	61.0	58.0	Chicago PMI has become excessively volatile this past year.
	Oct Milwaukee NAPM	63.2	–	60.0	Milwaukee lesser watched.
	Nov UoM consumer sentiment prelim	86.4 a	86.4	85.0	Lower gasoline prices, equities factors at play.
Can	Aug GDP %yr	2.5%	–	–	July growth slowed from June bounce to three year high at 3.1%yr.
Sat 1					
Chn	Oct manufacturing PMI	51.1	–	–	Flash edged up 0.2pts, on underwhelming details.

New Zealand forecasts

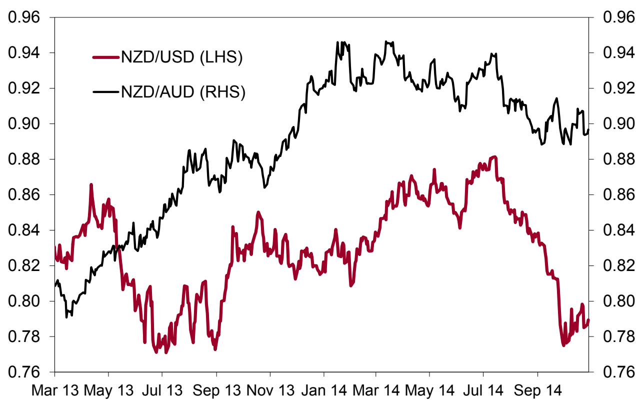
Economic Growth Forecasts	March years				Calendar years			
% change	2013	2014	2015f	2016f	2012	2013	2014f	2015f
GDP (Production) ann avg	2.3	3.2	3.4	3.1	2.5	2.8	3.6	3.1
Employment	0.4	3.8	2.8	2.6	0.4	2.9	3.0	2.9
Unemployment Rate % s.a.	6.2	5.9	5.3	4.7	6.8	6.0	5.4	4.7
CPI	0.9	1.5	1.3	2.1	0.9	1.6	1.0	2.0
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	3.50	3.75	4.00	4.25
90 Day bill	3.70	3.70	3.75	4.00	4.25	4.60
2 Year Swap	4.00	4.20	4.40	4.80	5.00	5.10
5 Year Swap	4.30	4.40	4.60	5.10	5.20	5.30
10 Year Bond	4.10	4.20	4.40	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 Tuesday 28 October 2014

Interest Rates	Current	Two weeks ago	One month ago
Cash	3.50%	3.50%	3.50%
30 Days	3.65%	3.64%	3.68%
60 Days	3.67%	3.66%	3.71%
90 Days	3.68%	3.68%	3.73%
2 Year Swap	3.92%	4.02%	4.04%
5 Year Swap	4.20%	4.28%	4.37%

NZ foreign currency mid-rates as at Tuesday 28 October 2014

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7894	0.7821	0.7864
NZD/EUR	0.6212	0.6190	0.6196
NZD/GBP	0.4895	0.4864	0.4842
NZD/JPY	85.04	84.08	85.88
NZD/AUD	0.8967	0.8992	0.8979
TWI	76.68	76.27	76.63

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	2.74	2.65	2.55	2.65	3.00	3.25
10 Year Bond	3.27	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	2.25	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	0.8759	0.90	0.90	0.92	0.93	0.94
USD/JPY	107.99	110	111	112	113	114
EUR/USD	1.2654	1.26	1.26	1.27	1.28	1.29
AUD/NZD	1.1178	1.11	1.11	1.10	1.12	1.15

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