26 August 2013

Weekly Commentary

Spring Lupines, Lake Tekapo

In this issue

Invention and intervention

The Reserve Bank headed into the unknown last week, intervening in the housing market with its loan-to-value ratio (LVR) restrictions. As to whether this newly-minted tool slows the runaway housing market and to what extent, no-one including the Reserve Bank really knows. In a nutshell, our view is that the restrictions will slow house price growth for a while, before investors return to the market and prices rise once again. Meanwhile, the economic upswing continues and inflation pressures build.

From 1 October, the Reserve Bank has required banks to restrict home loans that exceed 80% of the value of the house to no more than 10% of new lending (though with some exemptions, the share is expected to be closer to 15% in practice).

Recent estimates have shown that high-LVR loans make up about 30% of new lending. Halving this ratio to 15% should produce a 'sticker shock' effect and lead to a sharp, but temporary, drop-off in house sales and household credit growth in late 2013. However, beyond this short-term effect, we think that the long-term effect on the housing cycle will be limited.

Our view is that the RBNZ's proposed 'speed limit' approach to high-LVR lending will lead to a bifurcation of mortgage rate pricing. High-LVR lending (i.e. above 80%) is likely to be rationed via price, in the form of either higher interest rates or a higher low-equity premium. But those borrowers who can muster a deposit of 20% or more may enjoy lower mortgage rates than otherwise, as lenders are likely to compete harder for this limited pool of customers.

Some buyers, including first-timers, are likely to be shut out of the market. As a result, home ownership rates will fall.

Invention and intervention continued

But for those who can provide a large enough deposit (a group which includes many investors), their willingness to pay is unaffected by LVR restrictions. If anything, lower interest rates for low-LVR loans would leave them willing to pay more than otherwise. We suspect that, over time, house prices would be bid up to much the same levels, but at a marginally slower pace, as they would in the absence of LVR restrictions.

Bottom line, we still forecast house to rise over the next two years, with the LVR restrictions trimming 1.5 percentages points off our house price growth forecast over this period. For the record, our house price forecast now stands at 8.5% this year and 6.5% for 2014.

Also in his speech, the RBNZ Governor was bullish on economy's growth prospects: "New Zealand's economy is now one of the most rapidly growing among the advanced economies. Growth is likely to remain strong and become more broadly based over the next two years, particularly as construction activity in Christchurch, Auckland and elsewhere gathers momentum and provides further stimulus to the manufacturing sector."

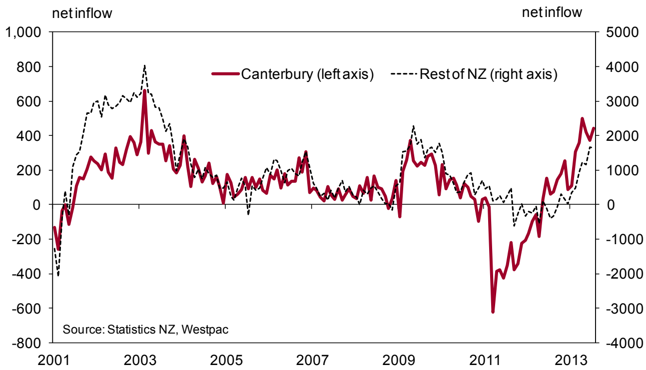
We agree. Moreover, as we have been pointing out in recent commentary the upswing is becoming self-reinforcing.

Net immigration is now clearly one example of this phenomenon. Monthly net immigration continued its recent solidly positive trend in July, with a net inflow of just under 2,000 people. Arrivals of foreign migrants eased back from last month's surge, but departures of New Zealanders to Australia fell further - to 2,540, the lowest since April 2010.

Better economic prospects here and softer prospects in Australia are boosting net immigration, which will further increase domestic demand and fuel housing market pressures. There is no reason to expect this trend to stop any time soon, and annual net immigration (now sitting at just above 10,500, the highest since November 2010) could easily approach 20,000 by the end of the year (about 0.4% of NZ's population).

The service sector is also seeing this growth broaden across the economy. Service sector survey data last week rose to the highest July reading since 2007. And the standout performer was the Northern region (i.e. Auckland) and not Canterbury/

Net immigration, seasonally adjusted



Westland, indicating that the upswing is spilling over from booming Canterbury.

The positivity in the service sector also points to further expansion. New orders surged to their highest level since November 2007. And this is gradually translating to hiring intentions with the employment index also up during the month.

Meanwhile, Fonterra and the dairy sector will have breathed a collective sigh of relief, as world dairy prices are back where they started before the whey contamination issue. In last Tuesday's GlobalDairyTrade auction prices rose 2.3%, effectively wiping out the 2.4% fall in the previous auction.

If anything, we see emerging upside risk to our forecast of Fonterra's milk price (currently at $7.40/kg). While it's still early days in the season, despite the whey contamination scare the world continues to pay high prices for New Zealand dairy products. Prices are the fourth highest on record and are over 62% higher than a year ago.

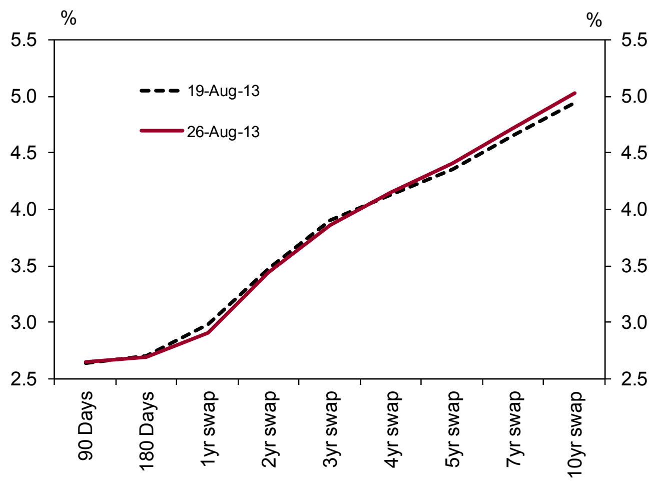
All up, the economy is developing largely in line with our expectations. We expect the upswing to gather pace over the next two years.

Inflation pressures, the final piece of our puzzle, are generally subdued. However, inflation expectations data released during the week did raise a red flag. The key 2 years ahead expectations rose from 2.06% to 2.36%. While this is just one data point and may reverse next quarter, if the RBNZ is looking for signs that generalised inflation is picking up, this is one such sign. We expect those signs to be more obvious by early next year, prompting a hiking cycle starting in March 2014.

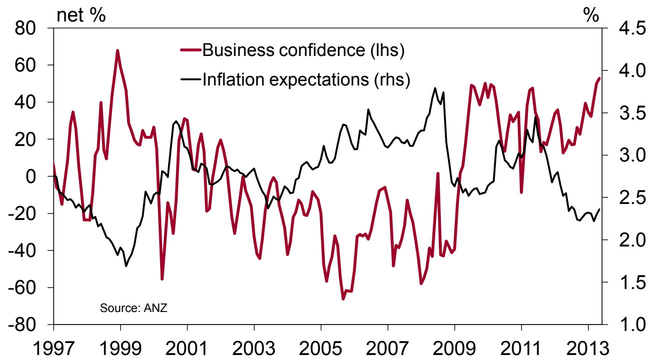
Fixed vs Floating for mortgages

We favour fixing for longer terms. The RBNZ is now widely expected to begin an extended series of OCR hikes from early next year, which will drive floating rates substantially higher over the next few years. So while fixed-term rates for three years or more are higher than the current floating rate, we believe that they still offer some value at the moment. This opportunity may not last for long - with wholesale interest rates at their highest in two years, there could be further upward pressure on retail rates.

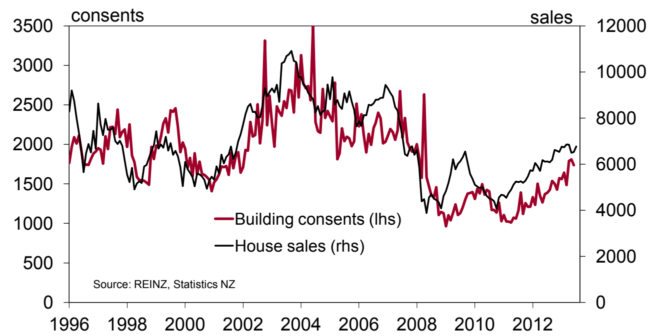
NZ interest rates



NZ business confidence and inflation expectations



NZ housing activity



NZ Aug ANZ business confidence

Aug 29, Last: 52.8

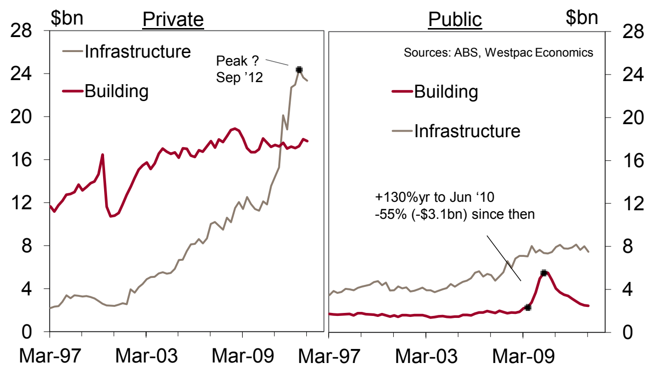
- Business confidence remained very strong in July, with general sentiment reaching its highest in over 14 years. The construction sector understandably remains the most buoyant, but confidence has strengthened considerably across all of the broad sectors over the course of this year.
- It's clear that activity has gathered substantial momentum so far this year, outside of the agricultural sector which was struck by a short but sharp drought early this year. The next step to watch for is when this will translate through to capacity constraints and price pressures. Pricing intentions in this survey have risen above their long-run average in recent months, and the RBNZ's survey of inflation expectations two years ahead was startlingly stronger in the latest quarter - up from 2.1% to 2.4%, compared to the RBNZ's 2% target.

NZ Jul building consents

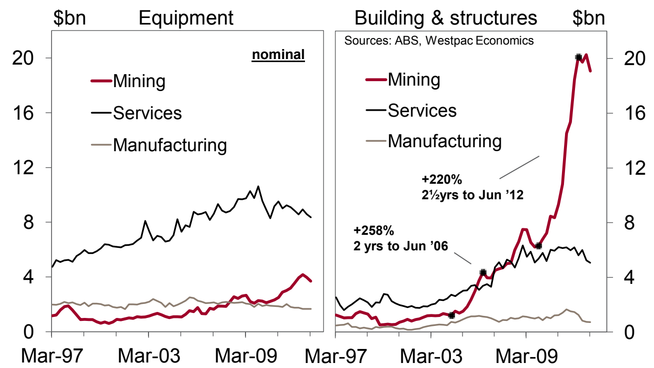
Aug 30, Last: -4.0%

- Residential building consents eased in June but remained on a strong upward trend, led by the under-supplied Auckland and Canterbury regions.
- The big uncertainty for the July figures is that the Christchurch City Council was stripped of its accreditation for building consents at the start of the month. Our understanding is that the council is still obligated to issue consents, but faces liability for any mistakes; we have no clear sense of how this might have disrupted the consenting process.
- As a result, we are reluctant to attempt a forecast of the July outturn. That said, the headline change is likely to be negative if we see a moderation in the volatile apartments component, which has been abnormally strong over the last three months.

Construction work: divergent trends



CAPEX: by industry by asset



Aus Q2 construction work done

Aug 28, Last: –2.0%, WBC f/c: –0.7%
Mkt f/c: 1.0%, Range: –1.0% to 3.0%

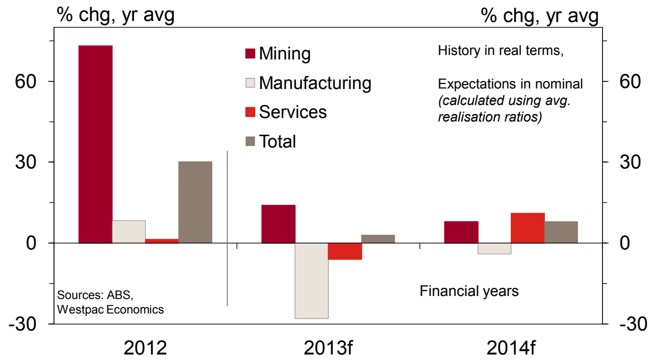
- Construction work moderated early in 2013 and we see the risk of a further decline in the June quarter, forecasting a fall of 0.7%.
- Private infrastructure activity doubled in the two years to September quarter 2012. Since then work has edged lower, –3% in Q4 and -1% in Q1, as momentum as mining investment crests. We anticipate a 2% decline in Q2.
- Private building fell 1% in Q1. We expect a small rise in Q2, with further gains in housing offsetting a dip in non-residential building.
- Public construction, down 10% over the past four quarters, is expected to be broadly flat as building work stabilises.

Aus Q2 private new capital expenditure

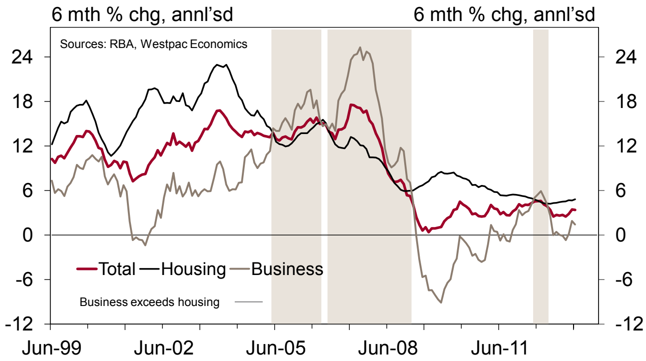
Aug 29, Last: –4.7%, WBC f/c: –1.0%
Mkt f/c: 0.5%, Range: –4.0% to 2.5%

- Private business capex spending weakened at the turn of the year, in response to challenging conditions domestically and internationally. We anticipate a further fall in the June quarter, forecasting a 1% decline, following declines of 2.1% in Q4 and 4.7% in Q1.
- Building & structures spending is expected to decline for a fourth consecutive quarter, down by around 2%, as mining investment moderates. Mining capex peaked in 2012, with moves of –0.5% in Q3, +1.5% in Q4 and –6.2% in Q1 2013.
- Equipment spending may well have stabilised in Q2, after falls of around 3% in each of the past two quarters. We note that civil aircraft imports rebounded in Q2, reversing a dip in Q1.

CAPEX plans by industry



Credit momentum



Aus 2013/14 private new capital expenditure plans

Aug 29, Last: $156.5bn

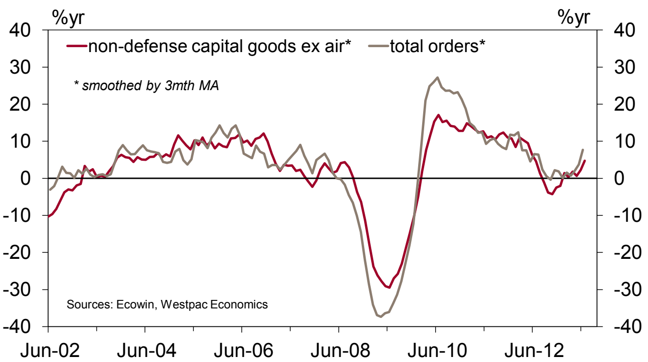
- Est. 2 of plans for capex spending in 2013/14 was $156.5bn.
- We calculate that Est. 2 implies a rise of 8% upon the likely outcome for 2012/13. That is surprisingly strong.
- However, this calculation is based upon average realisation ratios, which may not be appropriate in the current environment (particularly for mining).
- Mining plans of $102bn imply an 8% rise (based on the 3yr realisation ratio). We doubt that this will occur.
- Services plans of $46bn imply a rise of 11%, little changed from 12% implied by Est. 1. Subdued domestic conditions point to a less promising outlook. However, we do note that strength in the survey is not broadly based across the eight industries, but rather is centred on: transport, postal & warehousing; and rental, hiring & real estate.

Aus Jul private credit

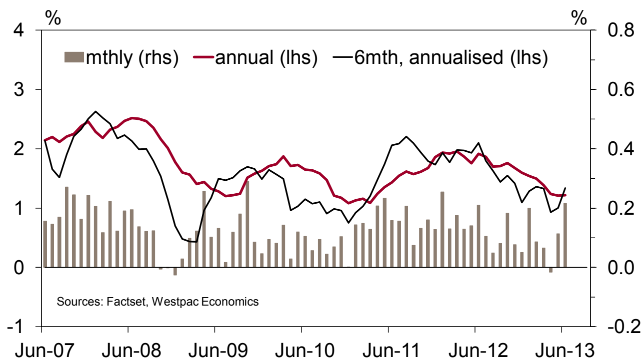
Jul 31, Last: 0.4%, WBC f/c: 0.3%
Mkt f/c: 0.4%, Range: 0.3% to 0.4%

- Credit to the private sector improved a touch over the past three months, centred on a bounce in business. However, we see the risk of a slight retracement in July, forecasting +0.3%, following +0.4%.
- Housing credit growth was a soft 0.4% in June and a similar result is likely in July. New lending is trending higher in response to lower interest rates but existing mortgage holders have accelerated their repayments.
- Business credit, which stalled in mid-2012, staged rises of 0.3% in April and 0.2% in May, strengthening to 0.5% in June. Given the current subdued domestic backdrop the risk is that July reports a more modest gain.

US durable goods orders



US core PCE deflator



US Jul durable goods orders to fall sharply

Aug 26, Last: 3.9%, WBC f/c: –5.0%

- Orders jumped 3.9% in June. Autos up 1.3%, aircraft up 31% drove most of the rise but core capital goods orders posted a fourth straight rise of 0.7%, to be up 8.3% annualised in Q2, down from 21.4% in Q1. Also, core capital goods shipments fell 1.2% annualised in Q2 after rising 5.8% in Q1.
- ISM factory orders jumped 6 points in July to their highest for the year so far. But given that the 12 point jump in ISM production contrasted with July's fall in factory output, maybe ISM orders is a contrarian signal as well. Boeing took 287 orders in June but only 90 in July. Last year July was up sharply on June so the seasonality is not clear. Auto sales fell slightly and production was down 1.7% in July; business equipment output was flat and machinery down 1.0% last month. These signals point to a headline fall in durable orders led by transport, and a fall in core capital goods orders.

US core PCE deflator and personal income/spending

Aug 30, Core PCE deflator: Last: 0.2%, WBC f/c: 0.1%
Aug 30, Personal income: Last: 0.3%, WBC f/c: 0.0%
Aug 30, Personal spending: Last 0.4%, WBC f/c: 0.1%

- Personal income growth through Q2 was 0.0%, 0.4%, 0.3% (Apr, May, Jun) with Apr and May revised down from 0.1% and 0.5%; given the hours worked/earnings declines in July income will be flat or negative. That should be a constraint on household spending, which rose 0.5% in June after being essentially flat in Apr-May. That June savings rundown will be hard to maintain in Q3 with incomes so weak at the start of the quarter. Recall too that retail sales rose only 0.2% in July.
- The core PCE deflator rose 0.2% in June but in Q2 was up just 0.8% annualised, the second lowest on record. The core CPI rose 0.2% in July. But different weights and rounding suggest a softer 0.1% rise in the core PCE deflator in July

Data calendar

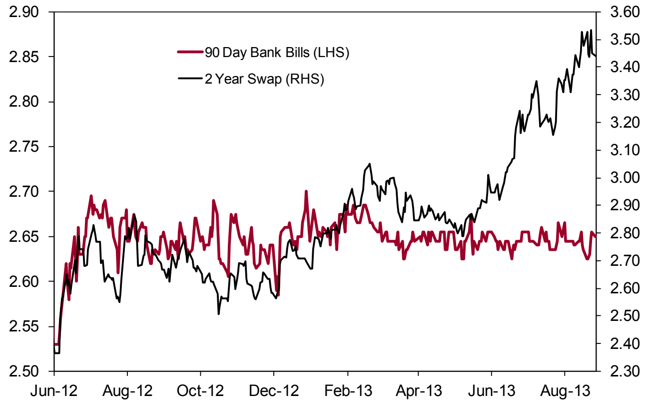
		Last	Market median	Westpac forecast	Risk/Comment
Mon 26					
NZ	Jul merchandise trade	$414m	-$16m	-$350m	One-offs to push July down, dairy export strength to return over H2.
UK	August bank holiday	–	–	–	FTSE closed.
US	Jul durable goods orders	3.90%	–3.6%	–5.0%	Recent swings due to aircraft; underlying story softer; see text box.
	Aug Dallas Fed factory index	4.4	–	flat	Weakness in detail in district Fed surveys so far in Aug.
Tue 27					
Chn	Jul industrial profits %ytd	11.80%	–	–	A positive outlier amid disappointment of Q2, other data catching up?
Ger	Jul retail sales	–0.8%	0.40%	–	Tentative date.
	Aug Ifo business climate index	106.2	106.9	105.8	German economy may have lost momentum according to Bundesbank.
UK	Aug house prices %yr	3.90%	–	–	Tentative date for Nationwide index due 27-30/8
US	Aug Richmond Fed factory index	–11	–	flat	In July Richmond presaged Aug weakness in Phily, NY detail.
	Jun house prices %yr	12.20%	11.90%	–	S&P Case Shiller 20 city index.
	Aug Conf Board consumer confidence	80.3	79.3	77	IBD-TIPP, UoM both weaker in Aug.
	Fedspeak	–	–	–	Williams in Sweden.
Wed 28					
Aus	Q2 construction work	–2.0%	1.00%	–0.7%	Housing trending higher, but risk infrastructure down for a 3rd qtr.
Eur	Jul money supply M3 %yr	2.30%	2.10%	–	Slowed from 3.9% yr peak in Oct 2012, LTRO paybacks a factor.
Ger	Sep GfK consumer confidence	7	7.1	–	Surveyed early Aug but labelled Sep. Aug was highest since 2007.
UK	Aug CBI retail survey	17	–	–	Reported sales index. Recently boosted by hot weather, Royal baby.
US	Jul pending home sales	–0.4%	0.10%	–1.0%	Lack of supply, higher mortgage rates.
	Q2 GDP 1st revision	1.7% a	2.30%	2.00%	Net exports to drive upward revision.
Can	Jun average weekly earnings	2.50%	–	–	Downtrend in pace of growth since mid 2012.
Thu 29					
NZ	Aug ANZ business confidence	52.8			Confidence strong; capacity/inflation pressures the next one to watch.
Aus	Q2 private new capex	–4.7%	0.80%	–1.0%	Building & structures down. Equipment spend +0.5%. See text box.
	2013/14 capex plans, AUDbn	156.5	–	–	Est 2 implies a surprisingly strong +8% (based on avg realisation ratios).
Ger	Aug unemployment ch	–7k	flat	–	German joblessness posted back to back declines in Jun-Jul.
	Aug CPI prelim %yr	1.90%	1.70%	–	Apr CPI at 1.2% yr lowest since 2010, recent upside due food, fuel.
US	Initial jobless claims w/e Aug 23	336k	–	330k	Claims back at pre-recession levels.
	Fedspeak	–	–	–	Bullard and Lacker
Can	Jul industrial product prices	0.30%	–	–	June rise due auto prices, weaker C$.
Fri 30					
NZ	Jul private sector credit %yr	4.10%	–	–	Signs that households are becoming less focussed on debt repayment.
	Jul building consents	-4.00%	1.30%	–	Trending up, but risk of disruption to Christchurch figures in July.
Aus	Jul private sector credit	0.40%	0.40%	0.30%	Housing remains soft. Business unlikely to match June's 0.5% gain.
Eur	Aug business climate indicator	–0.53	–	–0.35	Business surveys mostly stronger in Aug (except in France).
	Aug economic confidence	89.4	90.3	90	Consumer confidence data for Aug due 23/8.
	Aug CPI flash %yr	1.60%	1.40%	1.60%	Although inflation has edged higher, Jul core rate was just 1.1% yr.
	Jul unemployment rate %	12.10%	12.10%	12.20%	Steady German jobless rate no longer offsets rises elsewhere.
UK	Aug GfK consumer confidence	–16	–15	–12	Aug survey was taken just after Royal Baby born so likely to rise again.
	Jul net mortgage lending £bn	1	1	1.2	BoE/Treasury FLS credited with rise in household loan outstandings ...
	Jul net consumer credit £bn	0.5	–	0.7	... though demand for credit remains weak.
	Jul M4 money supply ex IOFCs %yr	4.70%	–	–	Down from 7.9% yr in Aug 12, partly due BoE APP suspension.
US	Jul core PCE deflator	0.20%	0.20%	0.10%	Core CPI was 0.2% in Jul but core PCE likely to round down to 0.1%.
	Jul personal income	0.30%	0.20%	0.00%	Hourly earnings and hours worked both fell in July. See text box.
	Jul personal spending	0.50%	0.30%	0.00%	Retail sales up just 0.2%; recent savings rundown unsustainable.
	Aug Chicago PMI	52.3	53	52	Aug regional surveys have mostly had a weaker tone so far.
	Aug Milwaukee NAPM	52.4	–	–	Little watched.
	Aug UoM consumer sentiment final	80.0 a	80.5	79.5	Latest equity downswing unhelpful.
	Fedspeak	–	–	–	Bullard, twice - in Tupelo and Memphis
Can	Q2 GDP % annualised	2.50%	1.60%	–	Q1 saw fastest growth since Q3 2011, but Q2 likely slower, with ...
	Jun GDP	0.20%	–0.5%	–	... monthly pace running behind that of Q1 in Apr-May.

New Zealand forecasts

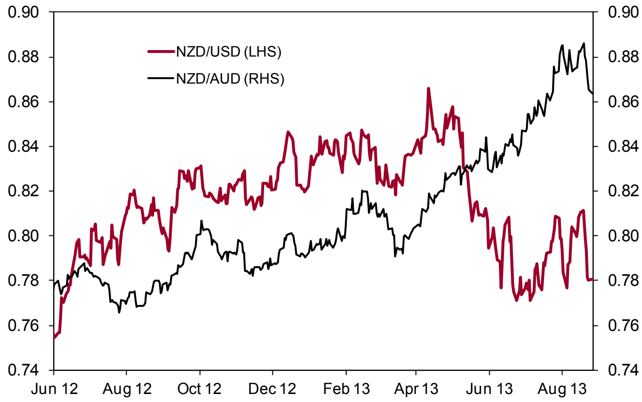
Economic Growth Forecasts	March years				Calendar years			
% change	2012	2013f	2014f	2015f	2011	2012	2013f	2014f
GDP (Production) ann avg	1.9	2.5	2.8	3.8	1.4	2.7	2.6	3.7
Employment	1.0	0.4	2.3	2.8	1.5	-1.4	3.5	2.9
Unemployment Rate % s.a.	6.8	6.2	5.7	4.8	6.3	6.8	5.9	4.9
CPI	1.6	0.9	1.7	2.5	1.8	0.9	1.6	2.3
Current Account Balance % of GDP	-4.4	-4.8	-5.0	-5.9	-4.0	-5.0	-4.7	-5.8

Financial Forecasts	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14
Cash	2.50	2.50	2.75	3.00	3.25	3.50
90 Day bill	2.70	2.75	3.00	3.25	3.50	3.75
2 Year Swap	3.40	3.40	3.50	3.60	3.80	4.00
5 Year Swap	4.20	4.00	4.00	4.10	4.20	4.40
10 Year Bond	4.30	4.10	4.10	4.20	4.30	4.40
NZD/USD	0.80	0.82	0.83	0.81	0.78	0.76
NZD/AUD	0.87	0.89	0.90	0.90	0.90	0.89
NZD/JPY	79.2	80.4	80.5	77.8	74.1	71.4
NZD/EUR	0.60	0.62	0.62	0.62	0.62	0.62
NZD/GBP	0.51	0.51	0.51	0.50	0.50	0.49
TWI	75.3	77.0	77.7	76.6	75.1	73.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on Monday 26 Aug 2013

Interest Rates	Current	Two weeks ago	One month ago
Cash	2.50%	2.50%	2.50%
30 Days	2.62%	2.63%	2.64%
60 Days	2.63%	2.63%	2.65%
90 Days	2.65%	2.64%	2.67%
2 Year Swap	3.44%	3.42%	3.36%
5 Year Swap	4.40%	4.23%	4.16%

NZ foreign currency mid-rates as at Monday 26 Aug 2013

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7804	0.8029	0.8080
NZD/EUR	0.5831	0.6027	0.6081
NZD/GBP	0.5012	0.5185	0.5253
NZD/JPY	76.94	77.24	79.24
NZD/AUD	0.8636	0.8736	0.8726
TWI	73.62	75.30	75.96

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	3.6	2.5	2.3
CPI inflation % annual	2.1	2.8	3.0	2.2	2.2	2.5
Unemployment %	5.6	5.2	5.2	5.4	6.2	6.4
Current Account % GDP	-4.2	-2.9	-2.3	-3.7	-2.4	-2.3
United States						
Real GDP %yr	-3.1	2.4	1.8	2.8	1.4	1.5
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	7.7	7.6
Current Account %GDP	-2.7	-3.0	-3.0	-2.8	-3.0	-3.1
Japan						
Real GDP %yr	-5.7	4.9	-0.5	1.9	1.7	2.2
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	-4.3	1.9	1.5	-0.5	-1.0	-0.6
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 9 August 2013						

Interest Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
Australia						
Cash	2.50	2.50	2.25	2.00	2.00	2.00
90 Day Bill	2.60	2.55	2.30	2.10	2.10	2.10
10 Year Bond	4.05	3.60	3.40	3.30	3.20	3.10
International						
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	2.89	2.40	2.20	2.10	2.00	2.00
ECB Repo Rate	0.50	0.50	0.50	0.50	0.50	0.50

Exchange Rate Forecasts	Latest	Sep 13	Dec 13	Mar 14	Jun 14	Sep 14
AUD/USD	0.9012	0.92	0.92	0.92	0.9	0.87
USD/JPY	99.02	99	98	97	96	96
EUR/USD	1.3338	1.33	1.33	1.33	1.3	1.25
AUD/NZD	1.1514	1.15	1.12	1.11	1.11	1.12

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