Australia & NZ weekly

Week beginning 20 July 2015

- Rigid labour markets, housing affordability weigh on consumer sentiment.
- RBA: Minutes of July Board meeting, Governor Stevens speaking.
- Australia: Q2 CPI, Westpac-MI Leading Index.
- NZ: RBNZ OCR review, trade balance.
- China: Caixin flash manufacturing PMI.
- UK: BoE minutes.
- US: new and existing home sales.
- Key economic & financial forecasts.

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Rigid labour markets, housing affordability weigh on consumer sentiment

The Westpac–Melbourne Institute Index of Consumer Sentiment fell by 3.2% in July to 92.2, down from 95.3 in June.

This was the lowest print of the Index since December last year. The Index is now firmly in the range where pessimists outnumber optimists. In fact the Index has printed below 100 in 15 of the last 17 months.

It is not surprising that we saw a solid fall in the Index in July. We had a taste for households' sensitivity to disturbing news around European instability in December 2011 when the Index tumbled by 8.4% from 103.4 to 94.7. This time the concerns around Greece have been complemented by sensational coverage of the collapse in the Chinese share market.

Back in 2011 the Index recovered by 6.7% once European fears settled down and it is likely that the impact on confidence of the European developments will once again prove to be transitory. However, such volatility will not disguise the fact that underlying consumer confidence in Australia remains consistently low.

Markets also appear to be of the view that the current Greek controversies are political rather than forboding any significant short term risks for the European economy. Through 2011 the spread between periphery bonds (Italy and Spain) and German bunds blew out by 600 and 375 basis points respectively whereas in the current "crisis" spreads have increased by 25 and 40 basis points respectively. These spreads will have been partly impacted by the ECB's QE program but much more importantly by the minimal fears around any contagion from Greece to other European countries in the event of a Grexit. With the IMF calculating that the only sensible chance for a Greek recovery is a total restructure / moratorium on debt for 30 years the current arrangements which are being negotiated are only likely to further delay another crisis in the near future.

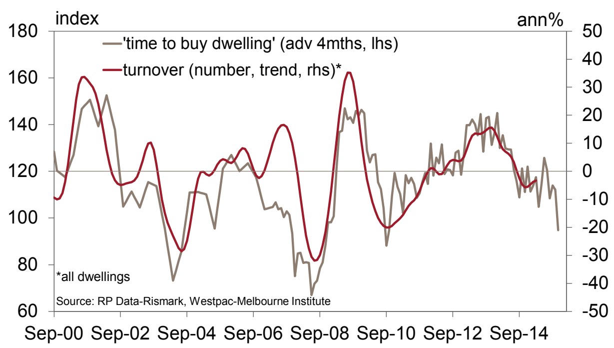
Further evidence that this headline impact from overseas news is unlikely to be sustained can be found in the response of households to the outlook for the unemployment rate. As readers will be aware we have been concerned for some time around the persistently elevated concerns that respondents have for the outlook for the jobs market. The Westpac Melbourne Institute Index of Unemployment Expectations actually fell 1.3% in the month indicating that slightly fewer consumers expect unemployment to rise. Households remain highly concerned about job prospects but the recent overseas developments did not exacerbate those concerns.

These disturbing measures of job security prospects are likely to be much more aligned with Australia's rigid industrial relations structure which now sets wages through the central mechanism of the Fair Work Commission where not only are the minimum wages for the lowest paid determined but also minimum wages for thousands of other job classifications as well as fixing relationships across job classifications. With Australian Workplace agreements, which were much more likely to allow an alignment between productivity and compensation while providing employers and workers with flexibility, being phased out in favour of a rigid centralised format for setting wages and relativities across industries firms' preparedness to employ full time workers (as opposed to casual workers who work for longer than 32 hours) is likely to be constrained. Combined with rigid unfair dismissal laws particularly for small businesses (those with more than 15 employees) our survey results which now show heightened concerns around job prospects are hardly surprising in a world where firms are generally facing difficult demand conditions.

Sentiment around housing was, arguably, the most significant development in the survey. The index tracking assessments of 'time to buy a dwelling' tumbled 16.7%. That Index is now at its lowest level since June 2010. The weakest read in this Index came in New South Wales where the Index fell 19% to its lowest level since February 2008 when mortgage interest rates were peaking and there were clear early signs of significant difficulties in the global financial system. It is likely that this sentiment is being driven by affordability concerns and may be signalling a slowdown in the Sydney property market.

Certainly our research around the relationship between housing sentiment and general turnover in the market (Chart 1) makes a fairly convincing case for a marked slowdown in conditions.

'Time to buy a dwelling' vs turnover



However that relationship and the signals from the survey are likely to be capturing the sentiment of the owner occupier rather than the investor. For example, new lending to the owner occupier over the last year has fallen by 2% whereas new lending to investors has surged by 19%. Investors tend to be less sensitive to income pressures and, arguably, affordability. In addition, strong buying by investors based abroad, particularly China, is also reportedly a significant factor driving some markets. With prices showing strong momentum in key markets and mortgage rates low, in some cases below gross rental yields, the main drivers of activity in this segment remain broadly positive.

We also expect that with anti-corruption policies likely to remain firmly entrenched in China and gradual progress towards capital account reform these international investors are likely to remain important factors in markets for the foreseeable future. The most likely constraint on these investors will come from Australian government policy which should be targeted at existing properties rather than new developments.

However, some softening in investor activity looks likely. APRA and the RBA have introduced macro-prudential measures aimed at managing risks in this segment (capping investor lending growth to 10% and tightening criteria). The Federal Government has also 'tightened up' some conditions around foreign buying with measures aimed at improving monitoring, increased penalties for illegal purchases and a high profile prosecution.

How these and the aforementioned regulatory measures impact investor demand is difficult to assess and, as such, is a key risk to the outlook for house prices.

Despite these affordability concerns respondents expect even further house price increases. The Westpac Melbourne Institute Index of House Price Expectations rose by 8.2% in the July survey including an 8.1% increase in the NSW Index.

The Reserve Bank Board next meets on August 4. The Board has demonstrated recently that at these low levels of rates any further cuts will be gradual and most likely timed for the months of February; May; August and November when the Bank revises its forecasts for growth and inflation. Having cut rates in both February and May the August meeting does become a 'live' event.

However we expect that it is very unlikely that the Board will decide to cut rates in August. In May it was still forecasting above trend growth in 2016 of 3.25% and we expect that the catalyst for any decision to cut rates would come from a substantial downward revision to its growth forecast for 2016 to 'below trend' territory. That decision will be largely influenced by the assessed momentum in the economy in the second half of this year and developments in the labour market. With insufficient available evidence on the former and, for now, the unemployment rate having stabilised there is almost no case for an August move.

The significance of the August meeting for markets will be around the Bank's decision on its assumptions for the interest rate path. Note that in February the RBA diverged from its usual practice of forecasting steady interest rates and chose "market pricing". At the time markets had a full second rate cut priced in. In May the RBA retained that approach and is likely to continue with that policy. If current pricing prevails by that time (around 20 bps of cuts expected by November) markets will be emboldened to strengthen their rate cut views.

However we would see that approach ensuring downward pressure on the AUD while retaining a "standard" policy approach.

Therefore despite current market expectations and a likely encouraging signal in August we would still put a limited chance of a move in November. In fact, we are comfortable to retain the view that rates will remain on hold for the remainder of this year and throughout 2016.

Bill Evans, Chief Economist

New Zealand: week ahead & data wrap

How low can you go?

The challenges facing the New Zealand economy have continued to mount, prompting us to change our expectations for rate cuts from the RBNZ. We now expect the RBNZ to cut the OCR to a record low of 2.0% by the end of this year. This will involve one reduction of 50bp - most likely in September, but possibly as early as next week's July OCR Review. We expect 25bp reductions in the OCR at each of the other three meetings this year.

In recent weeks we've noted the increasing signs that the economy is losing momentum, including sharp declines in household and business confidence. On top of those earlier developments, there have been two major developments over the past week that have prompted us to change our OCR call.

The first is the continued sharp decline in global dairy prices. Prices were down 10.7% in the latest GlobalDairyTrade auction, taking them to their lowest level in six years. There were large declines for almost every product, and that downward pressure is likely to spill over into the next auction in early August.

We've made a significant downward revision to our forecast for Fonterra's milk price for the current season. We now anticipate a payout of $4.30/kg, which would be even lower than last season's already very weak outcome. This means export earnings will be around $2 billion lower than we had expected.

Two very low payout years in a row signals tough times ahead for many in the dairying sector. But the impact of lower prices will also be felt more widely in the economy. Household and investment spending in rural communities can be expected to drop back. In addition, it's inevitable that challenging conditions in the rural sector will pass through to lower confidence in the economy more generally. This signals downside risk for businesses' investment and hiring decisions over the coming year.

The second major development over the past week has been the lingering softness in inflation. Consumer prices rose by 0.3% over the past year. While this is up from the very weak March result, it's still the second slowest pace in 15 years. And the underlying detail won't be of much comfort to the RBNZ. The main factor boosting inflation was higher petrol prices, which will weigh on household demand over the coming months. At the same time, the domestic side of the inflation picture continue to look very weak. Non-tradables inflation was just 2% in the year to June. That's the lowest level since 2001. And it's not just because of a few rogue prices. The RBNZ's sectoral core inflation measure is languishing at very low levels.

Inflation will pick up over the coming year as last year's sharp falls in oil prices drop out of annual figures, and the fall in the NZD pushes up the prices of imports. But the extent of any pick-up in the domestic components of inflation still looks likely to be modest. Indicators of cost pressures remain low, wage pressures are muted, and the heightened concern around both domestic and international economic conditions means that businesses are likely to remain cautious when it comes to adjusting prices for the next while.

Adding to the challenges for the economy is that one of the major drivers of growth in recent years, the Canterbury rebuild, is starting to dissipate. In recent years, increases in the amount of reconstruction work completed each quarter provided a significant boost to GDP growth and employment. However, as discussed in our recent report *"Peak or Plateau: Update on the Canterbury rebuild"*[1], reconstruction spending is starting to level off around nine months earlier than we had expected. There is still a large amount of reconstruction work to be completed. But we will no longer see the very large increases in construction spending that we saw in recent years. Instead, we expect that rebuild activity will continue around current strong levels over the next year or so, before it starts to gradually wind down from about mid-2016. This will dampen nationwide GDP growth over the coming year, and will pass through to softer employment and spending in the economy through the latter part of the decade.

Putting all this together, we think that economy will need a significant shot in the arm to get inflation back to levels that the RBNZ is comfortable with on a sustained basis. We're projecting a 25bp cut at next week's OCR review, a 50bp cut in September, and two more 25bp cuts in October and December.

The key reason we think the RBNZ will wait until September to cut by 50bp instead of next week is the continued strength in the housing market. Last week's figures showed that house price inflation has accelerated to 15% on an annual basis. The RBNZ will be mindful about pouring more fuel on an already hot market. However, by the time September rolls around, it's likely that momentum in the housing market will have slowed in response to softening economic confidence, as well as changes in regulations around lending and home sales. This will make the RBNZ more comfortable about cutting rates. It would also coincide with the RBNZ's September Monetary Policy Statement, giving them the change to fully explain their thinking.

[1] Available here: http://www.westpac.co.nz/assets/Business/Economic-Updates/2015/Bulletins-2015/Update-on-the-Canterbury-Rebuild-July-2015.pdf

Round-up of local data released over the last week

Date	Release	Previous	Actual	Mkt f/c
13 July	Jun REINZ house sales	1.4%	0.7%	–
	Jun REINZ house price index %yr	11.8%	14.8%	–
	Jun food price index	0.4%	0.5%	–
16 July	GlobalDairyTrade auction	–5.9%	–10.7%	–
	Jun manufacturing PMI	52.0	55.2	–
	Q2 Consumer Price Index	–0.3%	0.4%	0.5%
	Jul ANZ consumer confidence	119.9	113.9	–

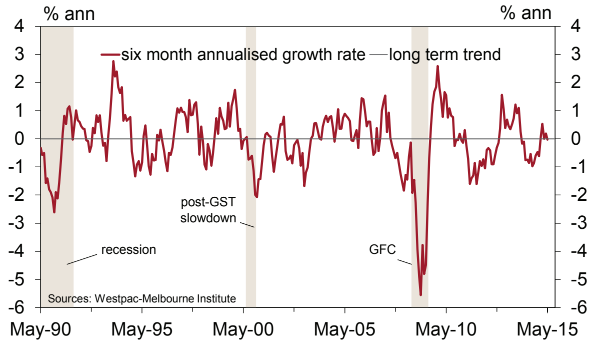
Data previews

Aus Jun Westpac–MI Leading Index

Jul 22, Last: –0.02%

- The 6mth annualised growth rate of the Index fell back from +0.19% in April to –0.02% in May, a disappointing result after four above trend monthly reads.
- The June update looks likely to show a further easing in the growth pulse. Component updates will incorporate a sharp fall in the ASX (–5.6% vs a flat May) and a further decline in the Westpac-MI Consumer Expectations Index (–2.3% after an 11% fall last month). Other components should provide a material offset with dwelling approvals up 3.7%, hours worked up 0.3%, commodity prices posting a decent 2.9% rise in AUD terms in June (ahead of the rout in July), US industrial production rose 0.3% and the yield spread widening slightly (usually a more positive sign for growth prospects).

Westpac-MI Leading Index

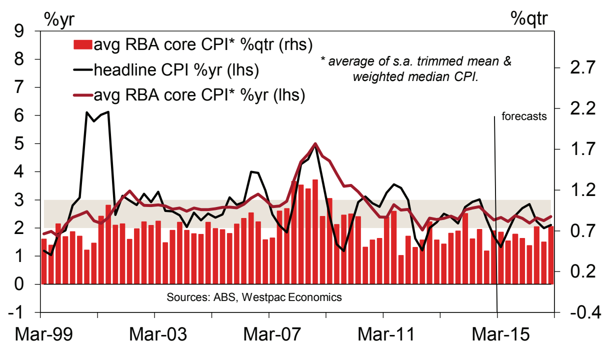


Aus Q2 Consumer Price Index

Jul 22, Last: 0.2%, WBC f/c: 1.0%
Mkt f/c: 0.8%, Range: 0.3% to 1.0%

- The headline CPI lifted 0.2% in Q1 compared to Westpac's, and the market's, expectation of 0.1%. The annual rate is now 1.3%yr compared to 1.7%yr in Q4 and 2.3%yr in Q3.
- For the core measures, the trimmed mean gained 0.64% while the weighted median lifted 0.62%. The annual pace of the average of the core inflation measures is now 2.4%yr, a slight lift from 2.3%yr in Q4 but well below the 2.8%yr pace of 2014Q3.
- Westpac is forecasting a robust 1.0%qtr rise (1.9%yr) in the headline CPI for Q2. Behind this is a rebound in petrol, a solid bounce in fruit & vegetable prices and solid gains in medical & hospital services. Housing costs continue to rise.
- The average of the core measures is forecast to rise 0.5%qtr/2.2%yr. These key policy sensitive rates are not presenting a threat to the RBA's inflation target.

We are seeing the quick bounce in petrol prices

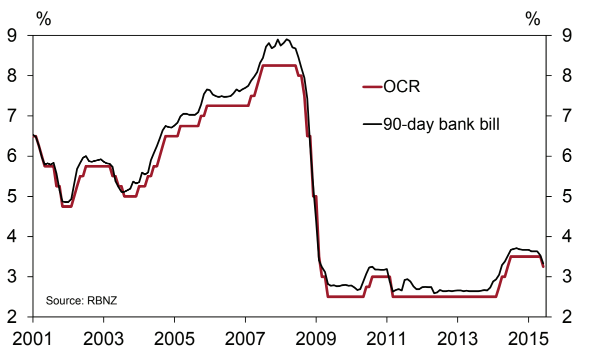


NZ Jul RBNZ OCR review

Jul 23, Last: 3.25%, Westpac f/c: 3.00%, Mkt f/c: 3.00%

- When the RBNZ cut the OCR 25bp in June, it dismissed the strong housing market and emphasised the terms of trade, inflation, and the output gap.
- Since June, data relating to these factors has been horrible: Q1 GDP growth was just 0.2%, dairy auction prices have slumped 17%, consumer and business confidence have fallen sharply, and inflation has once again proven soft.
- At least a 25bp reduction at the July review is a sure bet, and there is a possibility of a 50bp reduction. Markets themselves could be the deciding factor. Should market pricing move to price a significant chance of a 50bp reduction, the RBNZ may be obliged to deliver. Otherwise, 25bp is more likely.

NZ OCR and 90-day rate



Key data & event risk for the week ahead

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
NZ	Jun performance of Services Index	58.0	–	–	Services survey has been consistently strong this year.
Twn	Jun export orders %yr	–5.9%	–8.2%	–	Regional demand highly variable in scale but direction the same: down.
Eur	May current account, £bn	22.3	–	–	Trade balance narrowed slightly in May to €21.2bn.
UK	Jul house prices	3.0%	–	–	Rightmove index; up 4.5%yr in June.
Can	May wholesale trade	1.9%	–	–	After two strong months, pull-back likely given aggregate growth lacking.
Tue 21					
Aus	RBA Minutes July Board meeting	–	–	–	Any firming of the RBA's mild easing bias ahead of their August f/c review.
NZ	Jun net immigration	5,140	–	4,900	Migration still very high but off the RBNZ's radar for now.
UK	Jun public sector net borrowing, £bn	10.1	8.9	–	Ex banking group measure; May was 8 year low on better tax receipts.
Wed 22					
Aus	Jun Westpac–MI Leading Index %dvt	–0.02	–	–	Component update for June likely to show a further easing, see textbox.
	Q2 CPI	0.2%	0.8%	1.0%	Fuel & fresh fruit spiking higher but supported by steady housing gains.
	Q2 avg RBA core CPI	0.7%	0.6%	0.5%	With extremes trimmed out core inflation eases to 2.2%yr from 2.4%yr.
	RBA Governor Stevens	–	–	–	Speech to the Anika Foundation, topic tba, Sydney, 1:05pm.
Chn	Jul MNI business indicator	53.5	–	–	Survey of listed firms only, so equity turmoil highly relevant.
UK	Bank of England Minutes	–	–	–	Any signs that the BOE might follow in FOMC's footsteps in 2016?
US	Jun existing home sales	5.1%	0.9%	1.2%	May saw strong bounce; June to pull back but see uptrend persist.
Thu 23					
Aus	Q2 NAB business survey	–	–	–	Q2 incl detail on capex plans. Conditions up 5pts to +11 in mnth of June.
NZ	RBNZ OCR review	3.25%	3.00%	3.00%	25bp cut most likely, but 50bp cut is possible.
Krw	Q2 GDP %yr	2.5%	2.3%	–	Weakness in domestic demand and exports an inauspicious combo.
Twn	Jun industrial production %yr	–3.18%	–3.45%	–	PMI fell disconcertingly in June, upstream tech struggling.
Eur	Jul consumer confidence	–5.6	–5.8	–	Unchanged in June; but July likely impacted by Greece malaise.
UK	Jun retail sales, incl fuel	0.2%	0.4%	–	Core also up 0.2.% in May, 4.4%yr. Industry data positive for June.
US	Jun Chicago Fed activity index	–0.17	–	–	Continues to point to sluggish growth in aggregate demand.
	Jun leading index	0.7%	0.1%	–	Apr/May gave support to idea growth to strengthen into H2.
	Jul Kansas city Fed manufacturing index	–9	–	–	Energy sector has had a material impact; but stabilisation expected.
	initial jobless claims, '000	281	–	–	Fell 15k last week to be in line with the 4 week moving average.
Fri 24					
NZ	Jun merchandise trade NZDmn	350	100	300	Dairy in decline again, meat exports strong.
Eur	Jul Markit manufacturing PMI - flash	52.5	52.5	–	Services measure also due, at 54.4 in Jun. Composite at 54.2.
Ger	Jul Markit/BME manuf PMI - flash	51.9	51.9	–	Has firmed over past two months; new export orders positive in Jun.
Chn	Jul Caixin manufacturing PMI - flash	49.4	49.8	–	Sponsorship taken over from HSBC by onshore news agency.
Jpn	Jul Nikkei PMI manufacturing - flash	50.1	–	–	Tankan was encouraging but global trade backdrop unsupportive.
Sing	Jun industrial production %yr	–2.3%	–0.5%	–	GDP advance had manufacturing activity at -4.0%yr.
US	Jun new home sales	2.2%	–1.1%	–1.0%	Strength concentrated in south; little traction elsewhere.

Economic & financial forecasts

Interest rate forecasts

	Latest (17 Jul)	Sep 15	Dec 15	Mar 16	Jun 16	Sep 16
Cash	2.00	2.00	2.00	2.00	2.00	2.00
90 Day Bill	2.14	2.20	2.20	2.20	2.20	2.20
3 Year Swap	2.27	2.50	2.60	2.70	2.75	3.00
10 Year Bond	2.97	3.00	3.10	3.25	3.40	3.55
10 Year Spread to US (bps)	61	40	30	25	20	25
International						
Fed Funds	0.125	0.375	0.625	0.875	1.125	1.375
US 10 Year Bond	2.36	2.60	2.80	3.00	3.20	3.30
US Fed balance sheet USDtrn	4.5	4.5	4.5	4.5	4.5	4.5
ECB Repo Rate	0.05	0.05	0.05	0.05	0.05	0.05
New Zealand						
Cash	3.25	2.50	2.00	2.00	2.00	2.00
90 day bill	3.07	2.40	2.10	2.10	2.10	2.10
2 year swap	2.87	2.60	2.20	2.20	2.30	2.40
10 Year Bond	3.46	3.30	3.20	3.30	3.50	3.70
10 Year spread to US	110	70	40	30	30	40

Exchange rate forecasts

	Latest (17 Jul)	Sep 15	Dec 15	Mar 16	Jun 16	Sep 16
AUD/USD	0.7410	0.73	0.72	0.72	0.72	0.73
NZD/USD	0.6527	0.63	0.62	0.62	0.63	0.64
USD/JPY	124.10	121	123	123	124	125
EUR/USD	1.0880	1.08	1.07	1.07	1.07	1.08
AUD/NZD	1.1366	1.16	1.16	1.16	1.14	1.14

Australian economic growth forecasts

	2014			2015				Calendar years			
	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	2013	2014	2015f	2016f
GDP % qtr	0.6	0.3	0.5	0.9	0.4	0.6	0.7	2.1	2.7	2.4	3.0
annual change	2.8	2.7	2.4	2.3	2.1	2.4	2.6	-	-	-	-
Unemployment rate %	5.9	6.2	6.2	6.2	6.0	6.2	6.5	5.8	6.2	6.5	6.3
CPI % qtr	0.5	0.5	0.2	0.2	1.0	0.8	0.4	–	–	–	–
annual change	3.0	2.3	1.7	1.3	1.9	2.2	2.5	2.7	1.7	2.5	2.5
CPI underlying % qtr	0.7	0.4	0.6	0.6	0.5	0.5	0.6	–	–	–	–
annual change	2.8	2.5	2.3	2.4	2.2	2.4	2.3	2.6	2.3	2.3	2.5

New Zealand economic growth forecasts

	2014			2015				Calendar years			
	Q2	Q3	Q4	Q1	Q2f	Q3f	Q4f	2013	2014	2015f	2016f
GDP % qtr	0.7	1.0	0.7	0.2	0.7	0.6	0.6	–	–	–	–
Annual avg change	2.8	3.0	3.3	3.2	3.0	2.7	2.4	2.2	3.3	2.4	3.1
Unemployment rate %	5.7	5.5	5.8	5.8	5.7	5.4	5.2	6.1	5.8	5.2	4.3
CPI % qtr	0.3	0.3	-0.2	-0.3	0.4	0.5	0.2	–	–	–	–
Annual change	1.6	1.0	0.8	0.1	0.3	0.4	0.8	1.6	0.8	0.8	2.2

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