Weekly Commentary

6 November 2017

How far to full employment?

Last week's September labour market report painted a slightly stronger picture than expected. Employment jumped by 2.2%, although we recommend treating that number with caution. It followed a 0.1% fall in the June quarter, which didn't jibe with other labour market indicators at the time. And the labour force participation rate followed a similar pattern, falling to 70.1% in the June quarter before rebounding to an all-time high of 71.1% in September. We suspect that changes to the Household Labour Force Survey in June 2016 may have disrupted the seasonal pattern of the employment and participation series.

The unemployment rate is probably a more reliable measure of how the jobs market is performing, and it too surprised on the positive side, though only slightly – unemployment fell from 4.8% to 4.6%, beating market forecasts of a fall to 4.7%. This is the lowest rate since December 2008, when the Global Financial Crisis was reaching full force.

Despite the improving trend in unemployment, wage growth remains subdued. The Labour Cost Index (LCI) rose by 1.9% in the year to September. However, about 0.3% of that increase was due to the pay equity settlement for aged and disability care workers. Excluding that impact, annual labour cost inflation actually slowed a little, from 1.7% in the June quarter to 1.6% today.

That leads us to a crucial question: how tight is the labour market? That is, how close is the economy to 'full' employment, which is generally taken to mean the lowest rate that can be sustained over the long term (and might soon be a target of the Reserve Bank's).

The unemployment rate has improved substantially over the last couple of years, but history suggests that it can go further. Unemployment was below 5% for much of the 2000s, and even below 4% for a stretch. Wage growth picked up in that time, but it didn't really take off until unemployment was below 4%.

Ultimately, the test of whether the labour market is 'tight' is whether (real) wage growth is accelerating. Real wage growth has actually been reasonably strong compared to last decade, largely because inflation has been persistently and surprisingly low (whereas it was persistently and surprisingly high for much of the 2000s). But now that inflation is picking up from its lows, we have yet to see a matching lift in wage growth. And that provides at least circumstantial evidence that the labour market still has some slack left in it.

The other key development last week was the ANZ Business Outlook survey. Confidence in the economy fell to into negative territory (-10.1) in October, while firms' confidence in their own activity eased to the lowest level since the 2015 "dairy downturn." While confidence may have been dampened by lingering uncertainty around the election, this fall was not a response to the change in Government – the survey was conducted after the election but before coalition negotiations were complete. Instead, firms appear to be registering the same general slowdown in the economy that we have been observing in recent months.

This week the Reserve Bank will release its first Monetary Policy Statement under Acting Governor Grant Spencer. We expect no change to the OCR forecast, which in August was for the OCR to remain unchanged until 2019 and to rise

How far to full employment? cont.

very gradually thereafter. We also expect the RBNZ to retain exactly the same policy guidance paragraph that it has used more-or-less unchanged since February this year:

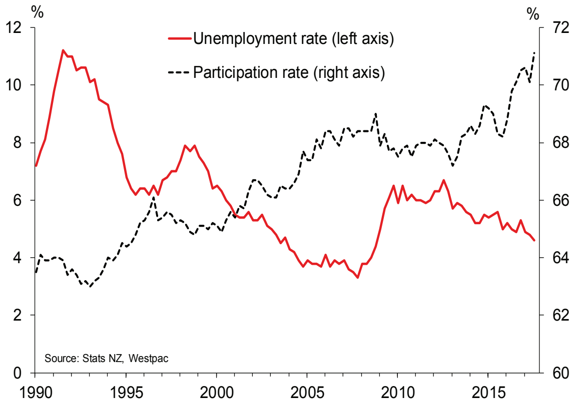
"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."

To be sure, the details of the MPS will be different to past missives. The RBNZ needs to downgrade its GDP and house price forecasts to reflect the reality of recent data. The construction sector seemed to stall for much of this year; GDP growth has been below expectations; businesses' confidence in their trading outlook has fallen; the house price boom came to a halt; and consumer spending has flat lined since April.

At the time of the September OCR Review we argued that the run of weak data recently could prompt the Reserve Bank to issue a more dovish statement in November. However, there was always an important caveat to that – we said "The remaining determinant of the overall tone in November will be the exchange rate. If it falls by enough to provide some prospective stimulus to inflation, the RBNZ would be able to leave its OCR guidance unchanged."

That is exactly what has happened. The exchange rate has fallen sharply and unexpectedly in recent weeks, mainly due to the election outcome. The Trade Weighted Index is now 6% lower than the RBNZ forecast in the August MPS. This will provide some much-needed stimulus to the RBNZ's inflation forecast, and will allow the RBNZ to run with the same OCR forecast as previously.

Labour force participation and unemployment



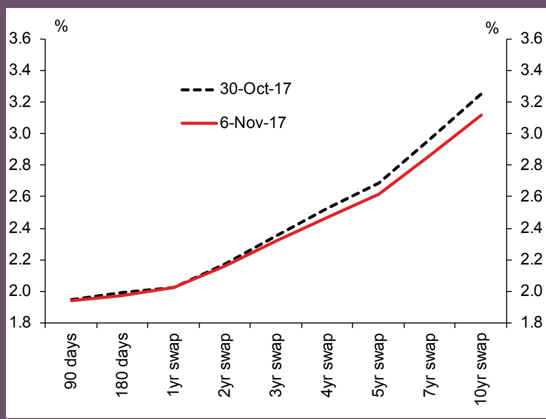
The other reason to expect a "straight bat" from the RBNZ at this week's Monetary Policy Statement is that the election result has made the economic outlook so much more uncertain. The new Government's housing policies will have a difficult-to-determine negative impact on house prices over 2018. The Government plans to cancel next year's tax cuts, but to spend more over time – it won't be easy to anticipate the net impact on inflation until the exact policies are published. And so on and so forth. At this stage, the Reserve Bank is better off waiting and seeing what happens with Government policy, rather than reacting prematurely to policy changes that may or may not eventuate.

Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term 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.

NZ interest rates



The week ahead

NZ Q4 survey of inflation expectations

Nov 6, Two years ahead, last: 2.09%, Westpac f/c: 2.1%

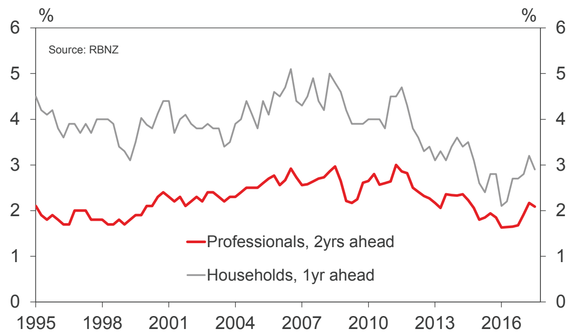
- The importance of the Reserve Bank's survey of inflation expectations has dimmed in recent times, with the RBNZ suggesting that price-setting behaviour has become more backward-looking.
- That said, the survey itself has probably become more backward-looking as well. A change in the schedule means that the survey is now held immediately after the CPI release. CPI inflation rose from 1.7% to 1.9% in the September quarter, a little above market expectations. Consequently, we would expect a small uptick in the survey result, but with the 2% midpoint of the inflation target still providing an effective anchor.

RBNZ Monetary Policy Statement

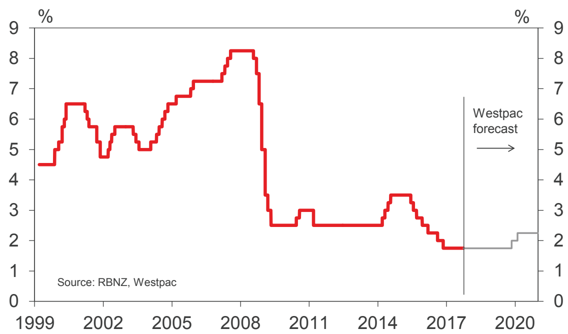
Nov 9, Last: 1.75%, Market: 1.75% , Westpac: 1.75%

- We expect the RBNZ to keep the OCR on hold and give the same neutral policy guidance that it has given all year. We also expect the OCR forecast to be the same as the August MPS – flat until late 2019 and slowly rising beyond that.
- The economic outlook has deteriorated, and the housing market is weaker than the RBNZ anticipated. But the exchange rate has fallen sharply, meaning the overall outlook for medium term inflation is broadly unchanged. Furthermore, the change of Government makes the economic outlook more uncertain. The RBNZ is better off waiting and seeing how Government policy evolves, rather than making bold changes at this point.
- There would be very little financial market reaction to a neutral MPS along these lines.

RBNZ survey of inflation expectations



Westpac OCR forecast



NZ Oct retail card spending

Nov 10, Last: +0.1%, WBC f/c: 0.6%

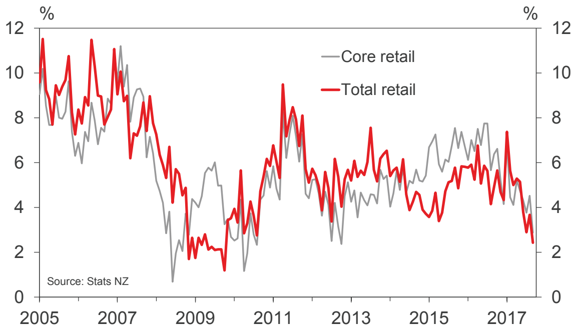
- Retail spending rose just 0.1% in September. While some of this was due to lower than expected spending on fuel, spending on durable goods, clothing and hospitality was down.
- Spending levels have been broadly flat for several months now. In part, this is because of the softness in prices, particularly for imported consumer goods. However, it's likely that the softening in the housing market is also dampening household spending, particularly for items such as household furnishings. We expect that these same factors will again result in only moderate spending growth of 0.6% in September.

RBA November policy meeting

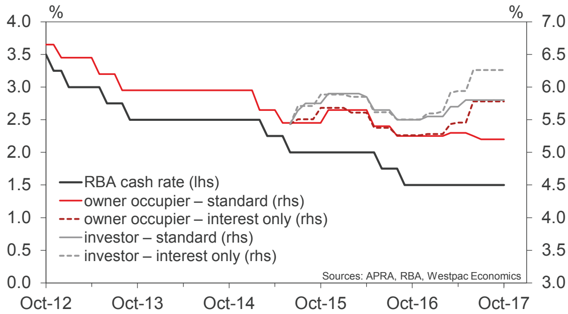
Nov 7, cash rate, last 1.50%, WBC 1.50%

- The RBA is set to meet on 7 November ahead of the Melbourne Cup.
- Since the last meeting in October, momentum in the labour market has remained strong, but household consumption has disappointed materially. This is despite an improvement in consumers' expectations of the economic outlook. Instead, persistent concerns over family finances are limiting discretionary spending. On the housing market, there has been a clear deceleration in Sydney, but Melbourne has held up. Arguably it is still too early to assess the full effect of March's regulatory reforms.
- Poignant in the October minutes was the clear message that the RBA is not beholden to policy developments (rate hikes) abroad. To our mind, below trend GDP growth and benign inflation will keep them on hold in 2018 and 2019.

Card transactions, annual % change



RBA cash rate and mortgage interest rates



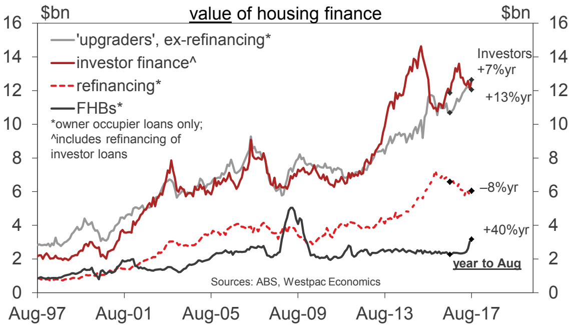
The week ahead

Aus Sep housing finance (no.)

Nov 9, Last: 1.0%, WBC f/c: 3.0%
Mkt f/c: 2.0%, Range: 0.0% to 4.5%

- The number of owner occupier loans rose 1% in Aug, holding flat ex refinance. The value of approvals to investors posted a surprisingly strong 4.3% gain although that is likely being bolstered by investor refinancing activity following macro prudential tightening in late March and associated increases in rates for 'interest only' loans (the ABS does not split out 'refi' for investor loans).
- Industry data suggests owner occupier loans posted a solid 3% rise in Sep, again suggesting the wider market slowdown evident in other measures is primarily due to a pull back in investor segments. Within the owner-occupier group, first home buyers have also been a notably strong driver in recent months, responding to increased state government assistance.

Value of finance approvals by segment



Data calendar

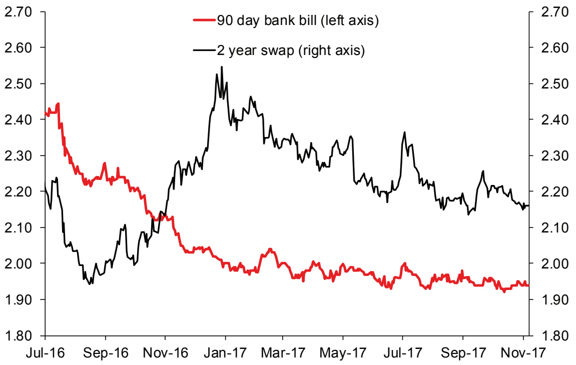
		Last	Market median	Westpac forecast	Risk/Comment
Mon 6					
NZ	Oct ANZ commodity price index	0.8%	–	–	Downside risks emerging with commodity prices.
	Q4 RBNZ 2–year inflation expctns	2.09%	–	2.1%	Small uptick in CPI inflation before the survey was held.
Aus	ABS 17th CPI series re–weight	–	–	–	Will have a meaningful impact on inflation momentum.
	Oct MI inflation gauge	2.5%	–	–	Continues to run ahead of the official inflation measure.
	Oct ANZ job ads	0.0%	–	–	Following a soft month the trend has eased but still robust.
Chn	Q3 current account balance	50.9	–	–	Dated, but offers further detail on trade/ financing.
Eur	Oct Markit services PMI final	54.9	54.9	–	Domestic demand robust, and set to remain that way.
	Nov Sentix investor confidence	29.7	31.0	–	Very positive on outlook.
US	Fedspeak	–	–	–	NY Fed's Potter on Policy and Balance Sheet.
	Fedspeak	–	–	–	Dudley Speaks on Lessons from the Financial Crisis.
Tue 7					
Aus	RBA policy decision	1.50%	1.50%	1.50%	On hold, focus on Statement, quarterly forecasts.
	Melbourne Cup	–	–	–	Almandin to win again; Humidor unreliable.
Chn	Oct foreign reserves $bn	3108.5	3118.5	–	Authorities controls have seen reserves trend higher.
UK	Oct Halifax house prices (3m avg)	0.8%	–	–	Shortage helping to offset effects of economic uncertainty.
US	Sep JOLTS job openings	6082	–	–	Hires; fires; quits; and job openings.
	Fedspeak	–	–	–	Quarles on financial regulation at Clearing House Conference.
Wed 8					
NZ	GlobalDairyTrade auction	–	–	–	Low supply unlikely to boost prices given demand concerns.
Chn	Oct trade balance USDbn	28.61	39.45	–	Growth in X'pts and M'pts jumped in Sep.
	Oct foreign direct investment %yr	17.3%	–	–	Has strengthened in recent months.
US	Sep consumer credit	13.065	17.500	–	Autos and student loans drive this series.
Thu 9					
NZ	RBNZ Official Cash Rate decision	1.75%	1.75%	1.75%	NZD down, but housing cooling, govt change clouds outlook.
Aus	Sep housing finance	1.0%	2.0%	3.0%	Own–occ loans boosted by FHBs, less affected by IO measures.
Chn	Oct CPI %yr	1.6%	1.7%	–	Consumer inflation remains weak on food prices...
	Oct PPI %yr	6.9%	6.6%	–	... commodities continue to support PPI, but will fade.
UK	Oct RICS house price balance	6%	–	–	Housing market sentiment remains subdued, esp. in London.
	Sep industrial production	0.2%	–	–	Low GBP and firmer ext. demand, but dom. demand still soft.
	Sep construction output	0.6%	–	–	Construction softening, dampened by Brexit uncertainty.
	Sep trade balance, £m	–5,626	–	–	Rising import prices adding to pressure on the trade deficit.
US	Initial jobless claims	229k	–	–	Historically low level.
	Sep wholesale inventories final	0.3%	0.3%	–	Inventories surprised to upside in first Q3 GDP estimate.
Fri 10					
NZ	Oct electronic card spending	0.1%	–	0.6%	Slowing housing & low inflation weighing on spending growth.
Aus	RBA Statement on Monetary Policy	–	–	–	Growth and inflation forecasts to be updated.
Chn	Oct M2 money supply %yr	9.2%	9.2%	–	Tentative date.
	Oct new loans, CNYbn	1270.0	775.0	–	Tentative date.
	Oct aggregate financing, CNYbn	1819.9	1152.5	–	Tentative date.
US	Nov Uni. of Mich. sentiment prelim.	100.7	100.0	–	Continues to print at elevated level.
	Oct monthly budget statement $bn	8.0	–	–	Focus for budget on cost of tax reform.

New Zealand forecasts

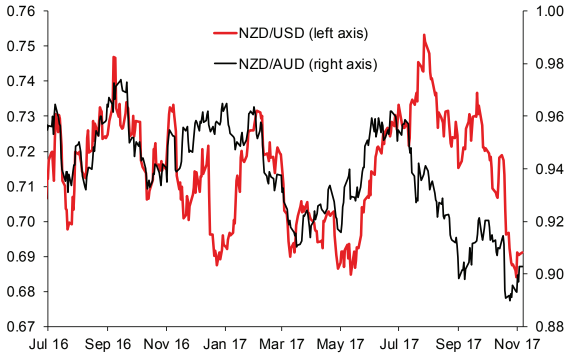
Economic Forecasts	2017				Calendar years			
% change	Jun	Sep	Dec	Mar	2015	2016	2017f	2018f
GDP (Production) ann avg	0.8	0.7	0.6	0.8	2.5	3.0	2.6	2.9
Employment	-0.1	1.1	0.4	0.6	1.4	5.8	2.6	1.8
Unemployment Rate % s.a.	4.8	4.6	4.7	4.7	4.9	5.2	4.7	4.6
CPI	0.0	0.5	0.3	0.3	0.1	1.3	1.8	1.3
Current Account Balance % of GDP	-2.8	-2.7	-2.8	-2.5	-3.2	-2.5	-2.8	-3.3

Financial Forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.95	1.95	1.95	1.95	1.95	1.95
2 Year Swap	2.10	2.15	2.20	2.30	2.40	2.50
5 Year Swap	2.70	2.80	2.90	3.00	3.10	3.20
10 Year Bond	2.95	3.10	3.20	3.30	3.40	3.45
NZD/USD	0.70	0.69	0.68	0.67	0.66	0.66
NZD/AUD	0.92	0.92	0.92	0.93	0.94	0.94
NZD/JPY	77.7	77.3	76.8	76.4	75.9	75.4
NZD/EUR	0.60	0.59	0.59	0.59	0.58	0.58
NZD/GBP	0.55	0.54	0.54	0.54	0.54	0.54
TWI	74.5	73.9	73.4	72.9	72.6	72.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 6 November 2017

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.78%	1.81%	1.85%
60 Days	1.86%	1.87%	1.90%
90 Days	1.94%	1.94%	1.95%
2 Year Swap	2.16%	2.18%	2.21%
5 Year Swap	2.61%	2.68%	2.74%

NZ foreign currency mid-rates as at 6 November 2017

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6912	0.6965	0.7057
NZD/EUR	0.5949	0.5927	0.6014
NZD/GBP	0.5286	0.5277	0.5394
NZD/JPY	78.83	79.00	79.50
NZD/AUD	0.9028	0.8922	0.9098
TWI	73.60	73.76	75.12

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.8	2.4	2.5	2.3	3.0	2.5
CPI inflation % annual	1.7	1.7	1.5	2.1	2.5	2.8
Unemployment %	6.2	5.8	5.7	5.7	6.1	6.0
Current Account % GDP	-3.0	-4.7	-2.7	-1.6	-2.6	-2.7
United States						
Real GDP %yr	2.6	2.9	1.5	2.1	2.1	1.8
Consumer Prices %yr	1.6	0.1	1.3	2.0	1.8	1.8
Unemployment Rate %	6.2	5.3	4.9	4.4	4.2	4.3
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.3	1.1	1.0	1.3	0.8	0.7
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.1	1.8	1.6
United Kingdom						
Real GDP %yr	3.1	2.2	1.8	1.6	1.6	1.5
China						
Real GDP %yr	7.3	6.9	6.7	6.7	6.2	5.9
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.1	4.1	4.2
World						
Real GDP %yr	3.6	3.4	3.2	3.6	3.6	3.5
Forecasts finalised 13 October 2017						

Interest Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.70	1.80	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.58	2.75	2.85	2.85	2.95	3.00	3.00	3.00
International								
Fed Funds	1.125	1.375	1.375	1.625	1.625	1.875	1.875	1.875
US 10 Year Bond	2.35	2.40	2.60	2.75	2.90	3.00	3.00	3.00
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.40	−0.40	−0.30	−0.30

Exchange Rate Forecasts	Latest	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
AUD/USD	0.7689	0.76	0.75	0.74	0.72	0.70	0.70	0.70
USD/JPY	113.95	113	114	114	115	115	116	116
EUR/USD	1.1661	1.17	1.16	1.15	1.14	1.13	1.13	1.13
AUD/NZD	1.1114	1.09	1.09	1.09	1.07	1.06	1.06	1.07

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(ii) physical separation of various Business/Support Units;

(iii) and well defined wall/cell crossing procedures;

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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