Confidence down, prices up

NZIER *Quarterly Survey of Business Opinion*, December quarter 2017

16 January 2018

- Business confidence fell in the December quarter. Some of the decline is likely to be a reaction to the formation of a left-of-centre government.
- But there are also signs of a genuine slowdown in the rate of economic growth, which began even before the election.
- Strong growth in past years means that the economy is now operating closer to full capacity. Measures of costs and prices continue to rise from their lows, though they remain below levels that would suggest a risk of inflation breaking higher.

Key results – forward looking (seasonally adjusted)

	Sep-17	Dec-17
General business sentiment, next 6 mths	5	-11
Trading activity, next 3 mths	26	18
Pricing intentions, next 3 mths	26	30
Cost expectations, next 3 mths	25	40
Profitability, next 3 mths	9	-3
Employment intentions, next 3 mths	14	11
Building investment intentions, next 12 mths	18	2
Plant investment intentions, next 12 mths	17	12

Key results – backward looking (seasonally adjusted)

	Sep-17	Dec-17
Trading activity, past 3 mths	13	10
Pricing, past 3 mths	18	18
Costs, past 3 mths	29	30
Profitability, past 3 mths	-3	-9
Employment, past 3 mths	18	10
Ease of finding skilled labour, past 3 mths	-47	-49
Ease of finding unskilled labour, past 3 mths	-28	-30
Capacity utilisation	91.3%	92.8%

The NZIER *Quarterly Survey of Business Opinion* showed a drop in business confidence in the December quarter, in the wake of the recently formed Labour-led Government. General business sentiment fell from +5 to -11, which was the first negative reading in more than two years. Firms' own reported and expected trading activity saw more modest declines.

These results were in line with monthly business confidence surveys, which had shown an initial sharp drop in confidence in November after the Government was formed, but with some rebound in December after the initial dummy-spitting.

However, we can't write this off entirely as a protest against the new Government. We find that general sentiment in the QSBO tends to be around 10 points lower under Labour governments than under National governments, so a 16-point drop is within the range of plausible outcomes. However, we find no such bias in the firms' own-activity measures. Bear in mind that confidence also fell in September, ahead of the election itself; the combined fall over the last two surveys has been greater than we would expect from just a change of government.

Instead, there does seem to have been some genuine deterioration in economic conditions in the last few quarters – at least, compared to what we had experienced previously. The revised GDP figures published late last year show that the economy powered ahead to 4% growth in 2016, with about half of that coming from population growth. But things were relatively more subdued in 2017, with annual growth slowing to around 3% by the September quarter. The latest *QSBO* results are consistent with our view that growth will continue to slow in the near term.

One of the reasons we downgraded our growth forecasts for 2018 is that we expect a temporary hiatus in business investment, as firms get to grips with the new government's policies. The *QSBO* provides some support for that view: firms' intentions to invest in plant and machinery fell from 17 to 12, the lowest in two years. Building investment intentions fell sharply, but that was coming off a curious spike to record highs in the September quarter.

A drop-off in new investment would be particularly poorly timed, when there are growing signs that the economy is running short of spare capacity to grow. This is particularly evident in the labour market. As the economy has grown strongly in recent years, the unemployment rate has dropped to 4.6%, which is in the range of what many forecasters would consider to be the long-run sustainable rate. The latest *QSBO* found that firms' difficulty in finding skilled workers and employee turnover are at their highest since 2005.

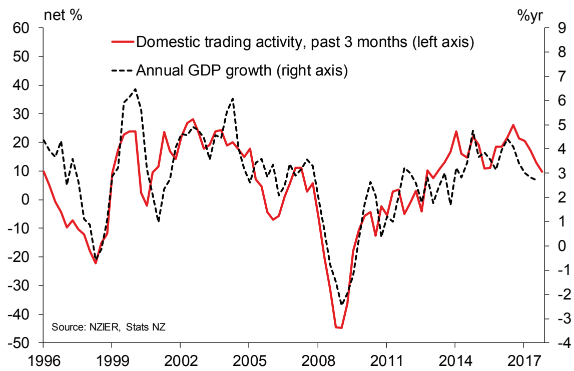
As the economy's spare capacity has been used up over recent years, the price measures in the *QSBO* have moved off their lows. By and large, these measures are not suggesting a risk of a break higher in inflation; rather, the era of stubbornly low inflation in the wake of the global financial crisis appears to have passed.

There was one notable exception: a net 40% of firms expect their average costs to rise over the next three months, a substantial increase from the September survey and the highest level since 2011. However, expectations of prices are less informative than past price changes, and it's possible that this result could be another form of protest against the new government. We agree that government policies are likely to add to the costs of doing business over time – but not within the next three months.

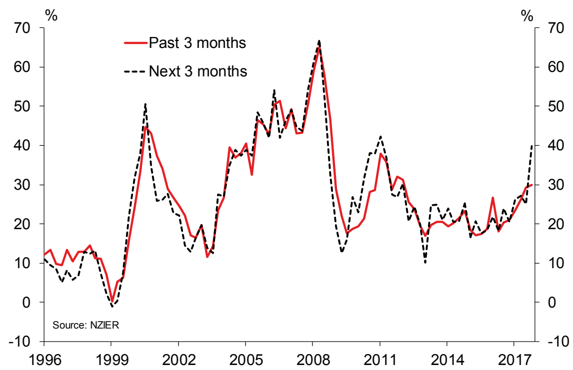
Overall, the *QSBO* results were consistent with our outlook for the economy this year. We expect some slowing in GDP growth over the next few quarters, before increased government spending starts to kick in and boosts GDP growth over 2019. We expect inflation to hold near the 2% target midpoint this year (some government policies, such as free tertiary education, will actually depress CPI inflation over this year). But without evidence that inflation is at risk of breaking higher, we think the Reserve Bank will hold off on OCR hikes this year.

Michael Gordon
Senior Economist

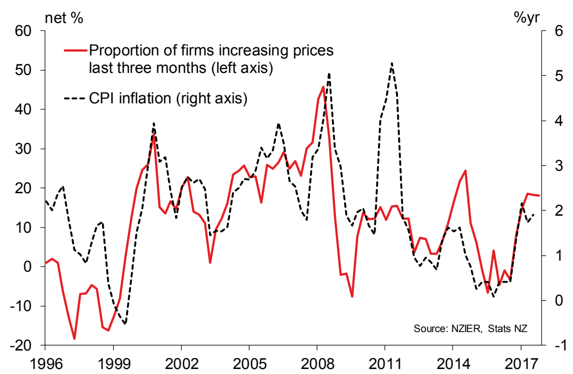
QSBO domestic trading activity and GDP growth



Businesses' average costs



Businesses' prices and CPI inflation



Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

Past performance is not a reliable indicator of future performance. The forecasts given in this document are predictive in character. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Disclaimer

Things you should know

Westpac Institutional Bank is a division of Westpac Banking Corporation ABN 33 007 457 141 ('Westpac').

Disclaimer

This material contains general commentary, and market colour. The material does not constitute investment advice. Certain types of transactions, including those involving futures, options and high yield securities give rise to substantial risk and are not suitable for all investors. We recommend that you seek your own independent legal or financial advice before proceeding with any investment decision. This information has been prepared without taking account of your objectives, financial situation or needs. This material may contain material provided by third parties. While such material is published with the necessary permission none of Westpac or its related entities accepts any responsibility for the accuracy or completeness of any such material. Although we have made every effort to ensure the information is free from error, none of Westpac or its related entities warrants the accuracy, adequacy or completeness of the information, or otherwise endorses it in any way. Except where contrary to law, Westpac and its related entities intend by this notice to exclude liability for the information. The information is subject to change without notice and none of Westpac or its related entities is under any obligation to update the information or correct any inaccuracy which may become apparent at a later date. The information contained in this material does not constitute an offer, a solicitation of an offer, or an inducement to subscribe for, purchase or sell any financial instrument or to enter a legally binding contract. Past performance is not a reliable indicator of future performance. Whilst every effort has been taken to ensure that the assumptions on which the forecasts are based are reasonable, the forecasts may be affected by incorrect assumptions or by known or unknown risks and uncertainties. The ultimate outcomes may differ substantially from these forecasts.

Country disclosures

Australia: Westpac holds an Australian Financial Services Licence (No. 233714). This material is provided to you solely for your own use and in your capacity as a wholesale client of Westpac.

New Zealand: In New Zealand, Westpac Institutional Bank refers to the brand under which products and services are provided by either Westpac or Westpac New Zealand Limited ("WNZL"). Any product or service made available by WNZL does not represent an offer from Westpac or any of its subsidiaries (other than WNZL). Neither Westpac nor its other subsidiaries guarantee or otherwise support the performance of WNZL in respect of any such product. The current disclosure statements for the New Zealand branch of Westpac and WNZL can be obtained at the internet address www.westpac.co.nz. For further information please refer to the Product Disclosure Statement (available from your Relationship Manager) for any product for which a Product Disclosure Statement is required, or applicable customer agreement. Download the Westpac NZ QFE Group Financial Advisers Act 2008 Disclosure Statement at www.westpac.co.nz.

China, Hong Kong, Singapore and India: This material has been prepared and issued for distribution in Singapore to institutional investors, accredited investors and expert investors (as defined in the applicable Singapore laws and regulations) only. Recipients in Singapore of this material should contact Westpac Singapore Branch in respect of any matters arising from, or in connection with, this material. Westpac Singapore Branch holds a wholesale banking licence and is subject to supervision by the Monetary Authority of Singapore. Westpac Hong Kong Branch holds a banking license and is subject to supervision by the Hong Kong Monetary Authority. Westpac Hong Kong branch also holds a license issued by the Hong Kong Securities and Futures Commission (SFC) for Type 1 and Type 4 regulated activities. This material is intended only to "professional investors" as defined in the Securities and Futures Ordinance and any rules made under that Ordinance. Westpac Shanghai and Beijing Branches hold banking licenses and are subject to supervision by the China Banking Regulatory Commission (CBRC). Westpac Mumbai Branch holds a banking license from Reserve Bank of India (RBI) and subject to regulation and supervision by the RBI.

UK: The contents of this communication, which have been prepared by and are the sole responsibility of Westpac Banking Corporation London and Westpac Europe Limited. Westpac (a) has its principal place of business in the United Kingdom at Camomile Court, 23 Camomile Street, London EC3A 7LL, and is registered at Cardiff in the UK (as Branch No. BR00106), and (b) authorised and regulated by the Australian Prudential Regulation Authority in Australia. Westpac is authorised in the United Kingdom by the Prudential Regulation Authority. Westpac is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the Prudential Regulation Authority are available from us on request.

Disclaimer continued

Westpac Europe Limited is a company registered in England (number 05660023) and is authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority.

This communication is being made only to and is directed at (a) persons who have professional experience in matters relating to investments who fall within Article 19(5) of the Financial Services and Markets Act 2000 (Financial Promotion) Order 2005 (the "Order") or (b) high net worth entities, and other persons to whom it may otherwise lawfully be communicated, falling within Article 49(2)(a) to (d) of the Order (all such persons together being referred to as "relevant persons"). Any person who is not a relevant person should not act or rely on this communication or any of its contents. The investments to which this communication relates are only available to and any invitation, offer or agreement to subscribe, purchase or otherwise acquire such investments will be engaged in only with, relevant persons. Any person who is not a relevant person should not act or rely upon this communication or any of its contents. In the same way, the information contained in this communication is intended for "eligible counterparties" and "professional clients" as defined by the rules of the Financial Conduct Authority and is not intended for "retail clients". With this in mind, Westpac expressly prohibits you from passing on the information in this communication to any third party. In particular this communication and, in each case, any copies thereof may not be taken, transmitted or distributed, directly or indirectly into any restricted jurisdiction. This communication is made in compliance with the Market Abuse Regulation (Regulation(EU) 596/2014).

Investment Recommendations Disclosure

The material may contain investment recommendations, including information recommending an investment strategy. Reasonable steps have been taken to ensure that the material is presented in a clear, accurate and objective manner. Investment Recommendations for Financial Instruments covered by MAR are made in compliance with Article 20 MAR. Westpac does not apply MAR Investment Recommendation requirements to Spot Foreign Exchange which is out of scope for MAR.

Unless otherwise indicated, there are no planned updates to this Investment Recommendation at the time of publication. Westpac has no obligation to update, modify or amend this Investment Recommendation or to notify the recipients of this Investment Recommendation should any information, including opinion, forecast or estimate set out in this Investment Recommendation change or subsequently become inaccurate.

Westpac will from time to time dispose of and acquire financial instruments of companies covered in this Investment Recommendation as principal and act as a market maker or liquidity provider in such financial instruments.

Westpac does not have any proprietary positions in equity shares of issuers that are the subject of an investment recommendation.

Westpac may have provided investment banking services to the issuer in the course of the past 12 months.

Westpac does not permit any issuer to see or comment on any investment recommendation prior to its completion and distribution.

Individuals who produce investment recommendations are not permitted to undertake any transactions in any financial instruments or derivatives in relation to the issuers covered by the investment recommendations they produce.

Westpac has implemented policies and procedures, which are designed to ensure conflicts of interests are managed consistently and appropriately, and to treat clients fairly.

The following arrangements have been adopted for the avoidance and prevention of conflicts in interests associated with the provision of investment recommendations.

(i) Chinese Wall/Cell arrangements;

(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.

U.S.: Westpac operates in the United States of America as a federally licensed branch, regulated by the Office of the Comptroller of the Currency. Westpac is also registered with the US Commodity Futures Trading Commission ("CFTC") as a Swap Dealer, but is neither registered as, or affiliated with, a Futures Commission Merchant registered with the US CFTC. Westpac Capital Markets, LLC ('WCM'), a wholly-owned subsidiary of Westpac, is a broker-dealer registered under the U.S. Securities Exchange Act of 1934 ('the Exchange Act') and member of the Financial Industry Regulatory Authority ('FINRA'). This communication is provided for distribution to U.S. institutional investors in reliance on the exemption from registration provided by Rule 15a-6 under the Exchange Act and is not subject to all of the independence and disclosure standards applicable to debt research reports prepared for retail investors in the United States. WCM is the U.S. distributor of this communication and accepts responsibility for the contents of this communication. All disclaimers set out with respect to Westpac apply equally to WCM. If you would like to speak to someone regarding any security mentioned herein, please contact WCM on +1 212 389 1269. All disclaimers set out with respect to Westpac apply equally to WCM.

Investing in any non-U.S. securities or related financial instruments mentioned in this communication may present certain risks. The securities of non-U.S. issuers may not be registered with, or be subject to the regulations of, the SEC in the United States. Information on such non-U.S. securities or related financial instruments may be limited. Non-U.S. companies may not subject to audit and reporting standards and regulatory requirements comparable to those in effect in the United States. The value of any investment or income from any securities or related derivative instruments denominated in a currency other than U.S. dollars is subject to exchange rate fluctuations that may have a positive or adverse effect on the value of or income from such securities or related derivative instruments.

The author of this communication is employed by Westpac and is not registered or qualified as a research analyst, representative, or associated person under the rules of FINRA, any other U.S. self-regulatory organisation, or the laws, rules or regulations of any State. Unless otherwise specifically stated, the views expressed herein are solely those of the author and may differ from the information, views or analysis expressed by Westpac and/or its affiliates.