Weekly Commentary

5 February 2018

Great moderation

Last week was fairly quiet, but the week ahead will be huge with a labour market update from Stats NZ, a dairy auction, and a Reserve Bank Monetary Policy Statement on the calendar.

The economy lost momentum over 2017, with GDP growth slowing and business confidence tanking. But this growth slowdown has not yet affected the labour market. The unemployment rate has fallen steadily over the past year. Job advertisements, benefit numbers and business opinion surveys have all continued to improve steadily, and firms are now reporting the greatest difficulty finding labour since 2005. Given these indicators, we expect this week's Household Labour Force survey to report that unemployment fell from 4.6% to 4.5% in December 2017.

Although the labour market is unambiguously firm, we expect data volatility will lead to a weak-looking employment number this quarter. In September employment rose a whopping 2.2%, and the labour force participation rate experienced a matching jump. This was incongruous with other data and may have partly reflected sampling error. We've assumed some pullback in the participation rate, and a relatively small 0.2% rise in employment for the December quarter.

After several years of falling unemployment, one could be forgiven for wondering whether wage growth is about to accelerate. There are no signs that wage growth did accelerate in the December quarter – we expect the Labour Cost Index will register another 0.4% quarterly rise in private sector salaries and wages. What happens to wage growth next year is a more open question, but in our view it will accelerate only slightly. We expect the economy to continue losing momentum, which could stall or reverse the trend of falling unemployment, and forestall any significant market pressure for rising wages. Wage increases are more likely to come about via government policies that tip the balance of power more towards workers, such as changes to employment laws, higher minimum wages and a shift towards collective agreements.

The Reserve Bank will watch the labour data with interest, given the Government's plans to include employment as well as price stability in the Reserve Bank's monetary policy goals. This probably wouldn't have made much difference to the RBNZ's actions in years past – employment and inflation both argued for keeping interest rates low. But with the unemployment rate now around neutral while inflation is below target, there is more scope for conflict between the two mandates. That said, the RBNZ won't be able to take this quarter's labour data into account for its *Monetary Policy Statement*, which is due the following day.

We are expecting very much a steady-as-she-goes MPS on Thursday. We anticipate no material change from the RBNZ's previous OCR forecasts, and no change to the policy guidance paragraph, which for a year now has remained more-or-less unchanged:

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

Great moderation continued

The RBNZ's press release, and the detail of the *Monetary Policy Statement*, will no doubt allude to the key developments and surprises since November, of which we count five:

Inflation was substantially lower than forecast in December 2017.

The exchange rate has risen unexpectedly. The RBNZ may return to its previous rhetoric that "a lower exchange rate is needed," which could cause the exchange rate to fall on the day.

The housing market has a new lease of life, which will reinforce the RBNZ's apprehension about keeping interest rates too low for too long.

Revisions to historical GDP data from Stats NZ have shown that the economy grew more over 2015 and 2016 than previously estimated. This implies that the output gap is higher and the economy is closer to experiencing inflation pressure than previously thought.

Global economic data has been strong and global equity prices have risen rapidly. This will rate a mention from the RBNZ, but probably won't affect their overall assessment much.

Some of these developments are positive for inflation and others are negative, but we judge the overall balance to be roughly neutral from the RBNZ's perspective.

We have long argued that the RBNZ's forecasts of GDP growth, house prices and inflation are too high. The Government may be planning something of a fiscal boost to the economy, but it also plans a range of measures specifically designed to cool the housing market and slow net migration. We think these measures will have a more marked effect on house prices than the RBNZ anticipates, and a slower housing market would in turn impact GDP growth. Moreover, the recent sharp decline in business confidence portends weaker GDP growth in the short run. Hence our GDP forecast is markedly lower than the RBNZ's previously published forecasts. Slower GDP growth naturally leads us to fret less about inflation accelerating. But there is another leg to our lower inflation view. A range of factors including new technology have also been supressing inflation for years, and we expect this trend will continue – we doubt that inflation would accelerate in the fashion the RBNZ expects, even if GDP growth did accelerate.

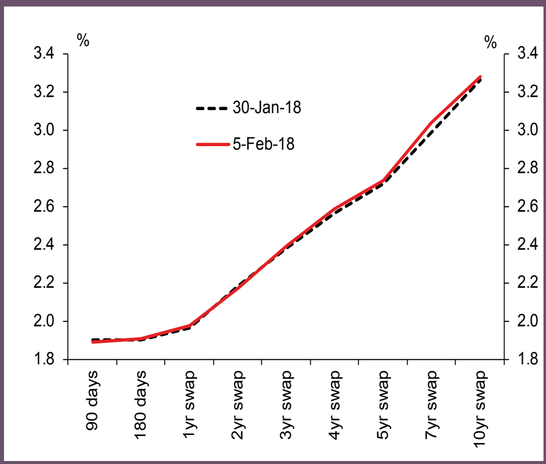
Our low-inflation view leads us to expect that any OCR hike will be delayed until late-2019 (and we have even occasionally warned that there is still a chance of further OCR cuts). Our view stands in stark contrast to financial markets, where pricing is consistent with the OCR rising in late-2018 or early-2019. We doubt that market pricing will shift following the Reserve Bank's statement, but we do expect market pricing for OCR hikes to drift later over the course of this year.

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 fixed 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 Household Labour Force Survey

Feb 7, Employment last: 2.2%, WBC f/c: 0.2%, Mkt f/c: 0.3%
Unemployment last: 4.6%, WBC f/c: 4.5%, Mkt f/c: 4.7%

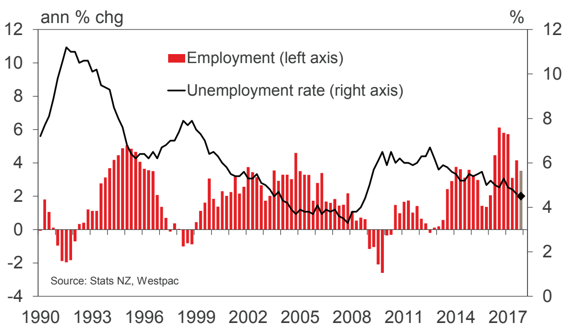
- We expect a small decline in the unemployment rate from 4.6% to 4.5%, which would be a new nine-year low. Job advertisements, benefit numbers and business opinion surveys all point to steady rather than rapid improvement in the jobs market over the quarter.
- Both employment and labour force participation have been very volatile recently. We expect some payback from their sharp gains in the September quarter, without affecting the broader picture of a stronger jobs market.
- The employment figures will undoubtedly come under more scrutiny this year, with diminishing slack in the labour market and a new Government focused on tipping the balance of power more towards workers.

NZ Q4 Labour Cost Index

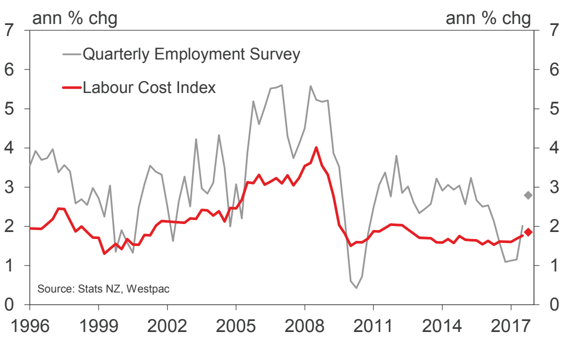
Feb 7, Private sector Last: 0.7%, WBC f/c: 0.4%, Mkt f/c: 0.5%

- We expect a 0.4% rise in the private sector Labour Cost Index for the December quarter. Wage growth has been running at the same quarterly pace for the last couple of years, aside from the 0.7% rise last quarter, which included the equal pay settlement for aged and disability care workers.
- We have no evidence to suggest there was a stirring of wage pressures in the December quarter. Indeed, the latest Westpac-McDermott Miller employment confidence survey found fewer workers reporting a rise in earnings over the last year.
- The Quarterly Employment Survey (QES) suggests a stronger rate of growth in hourly earnings. However, this measure is affected by changes in the composition of jobs.

Household Labour Force Survey



LCI and QES wages



NZ RBNZ Monetary Policy Statement

Feb 8, Last: 1.75%, Market: 1.75%, Westpac 1.75%

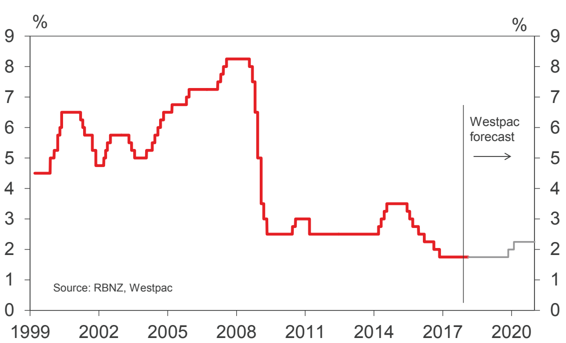
- We expect the RBNZ to continue with its firmly neutral OCR outlook and repeat its long-held guidance that "Monetary policy will remain accommodative for a considerable period".
- Recent developments have been roughly neutral, with low inflation and the high exchange rate counterbalanced by a resurgent housing market and upwardly revised GDP.
- Foreign exchange markets may react to any comment about the exchange rate being too high, but interest rate markets are unlikely to be perturbed by a steady-as-she-goes MPS.

Aus Dec retail trade

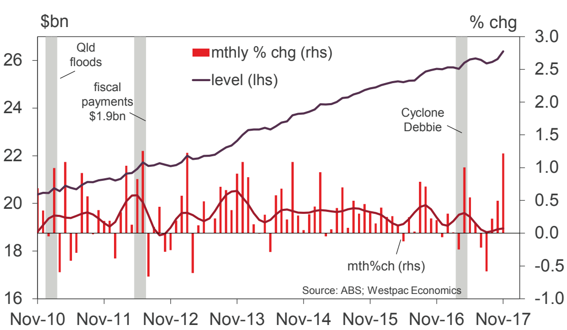
Feb 6, Last: 1.2%, WBC f/c: –0.3%
Mkt f/c: -0.2%, Range: -1.2% to 0.4%

- Retail sales surged 1.2% in Nov, a surprisingly strong result that was the biggest monthly gain since Feb 2013. The ABS cited the launch of Apple's iPhone X and the increased popularity of 'Black Friday' sales as major factors with electrical and electronic goods retailers recording a 9.3%mth surge and sales for 'other retail n.e.c', which includes non store retailers, up 3.9%mth. Sales excluding these two sub-categories were up a milder 0.4%mth. While there were clearly extenuating circumstances in Nov, 'underlying' sales look to have recovered somewhat from the weakness in Q3 with consumer sentiment improving steadily through Oct-Jan. That said, family finances are still under pressure with spending intentions subdued and private sector business surveys indicating retailers continued to struggle with soft conditions in Dec. On balance we expect sales to retrace 0.3% in Dec as one-off factors drop out but leaving a modest gain over the last 3mths.

RBNZ Official Cash Rate



Monthly retail sales



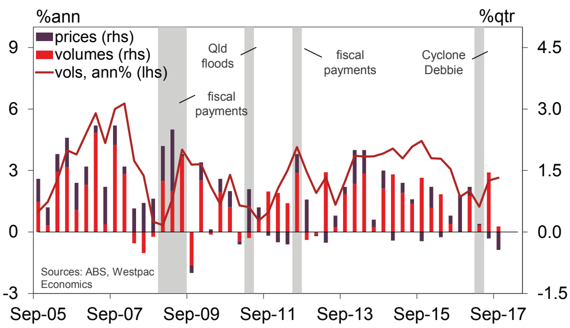
The week ahead

Aus Q4 real retail sales

Feb 6, Last: 0.1%, WBC f/c: 0.6%
Mkt f/c: 1.0%, Range: -1.4% to 1.2%

- Retail volumes stalled in Q3, rising just 0.1% vs a 1.5% gain in Q2, a weather-affected 0.2% gain in Q1 and a 0.9% gain in Q4. The quarterly profile is choppy but has been tracking a weak underlying trend. The Q4 update will show a significant improvement. Even with a pull back in the Dec month, nominal sales are on track to be up over 1% for the quarter. The Q4 CPI detail showed mixed results for retail prices. Intense competition saw increased discounting in categories such as household contents and clothing. However, food, which makes up over 40% of retail sales, posted a stronger than expected 1% rise in the quarter vs a 0.9% fall in Q3. The mix suggests about half of the gain in nominal sales in Q4 is due to prices. We expect real retail sales to be up 0.6% for the quarter. With price moves mixed across categories, there is some upside risk to the quarter particularly if spending patterns have responded to relative price shifts.

Quarterly retail volumes and prices

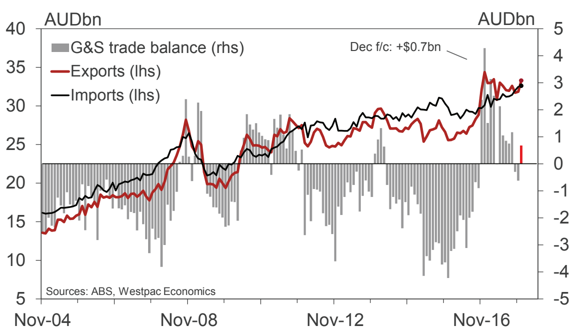


Aus Dec trade balance, AUDbn

Feb 6, Last: –0.6, WBC f/c: 0.7
Mkt f/c: 0.2, Range: -0.9 to 0.7

- Australia's trade balance slipped into deficit in October and November on a dip in exports.
- For December, we anticipate a return to surplus, a forecast $0.7bn, a $1.3bn turnaround on November, led by a rebound in exports.
- Export earnings in December increased by a forecast 4.5%, $1.4bn, centred on iron ore, coal and LNG, reflecting a rebound in volumes and higher prices.
- Imports are expected to edge higher, 0.4% (+$0.1bn), on rising volumes. Prices are likely little changed, with the currency consolidating in the month, so too global energy prices.

Australia's trade balance

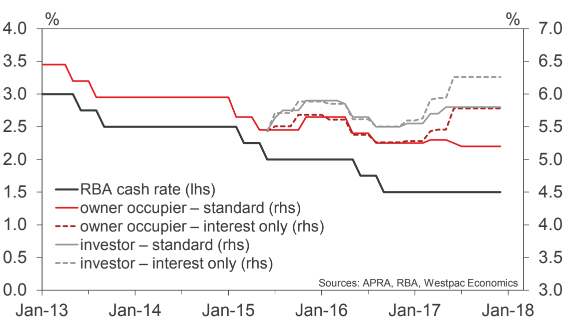


Aus RBA policy decision

Feb 6, Last: 1.50%, WBC f/c: 1.50%
Mkt f/c: 1.50%, Range: 1.50% to 1.50%

- The RBA left interest rates unchanged throughout calendar 2017, Governor Lowe noting in his final speech of the year that: "the continuing spare capacity in the economy and the subdued outlook for inflation mean that there is not a strong case for a near-term adjustment in monetary policy". We expect the RBA to leave rates unchanged at its Feb meeting. Developments over the summer hiatus have been mixed with the Q3 national accounts disappointing but more positive news around global conditions, labour markets and confidence. Inflation remains subdued, with latest figures showing core inflation running at a 1.6% annual pace over the second half of 2017. There is also no new information around the Bank's key areas of uncertainty – the impact of lacklustre consumer demand; the extent to which weak labour income growth continues; and the risks around household debt. We expect consumer weakness to persist in 2018, leading the RBA to again leave rates on hold all year.

RBA cash rate and mortgage interest rates

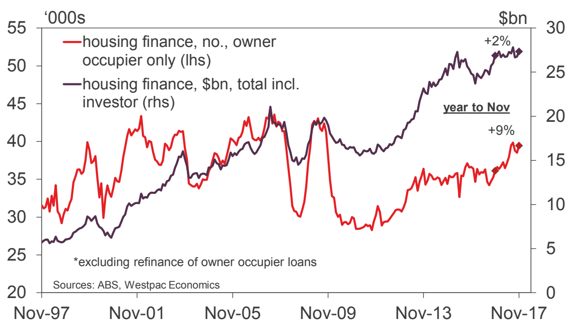


Aus Dec housing finance (no.)

Feb 9, Last: 2.1%, WBC f/c: –1.5%
Mkt f/c: -1.0%, Range: -1.9% to 0.5%

- Finance approvals have held up much better than expected through 2017, the most recent figures showing a 2.1% rise in the number of new owner occupier loans in Nov and a 1.5% rise in the value of investor loans. The latter are down –8.3%yr but the total value of finance approvals is up 4%yr despite auction activity, turnover and price growth all showing a material slowdown in the major eastern markets. Industry figures point to a softer month for owner occupier approvals some – Dec is expected to show a 1.5% decline. However, the general picture is still better than might have been expected given macro-prudential measures and a similar sized slowdown in 2015, which saw the total value of loans fall 13% peak to trough. It may indicate that weaker foreign buyer demand had a bigger hand in the 2017 slowdown.

New finance approvals*



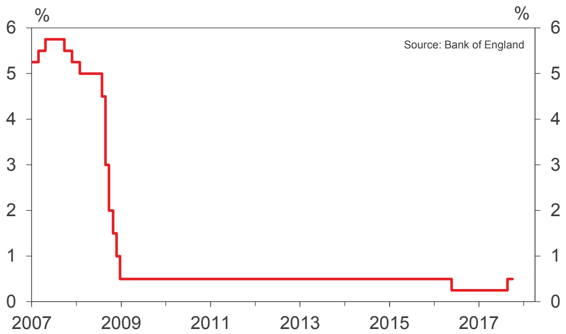
The week ahead

UK Bank of England Bank Rate decision

Feb 8, Last: 0.5%, Mkt: 0.5%, WBC f/c: 0.5%

– Inflation is sitting at the top of the BOE's target band and while growth remains sluggish, spare capacity has been eroded and there are positive signs in parts of the economy. Against this back drop, BOE Governor Carney recently noted that "we've moved into a more conventional area for monetary policy where the focus is increasingly on returning inflation sustainably to target over an appropriate horizon." We expect the BOE will keep the Bank Rate on hold at 0.5% at its February meeting. In addition, the BOE is expected to maintain the very gradual tightening bias it adopted late last year, when it noted that some modest interest rate increases were likely over the next few years. The Governor's recent comments suggest some risk that the MPC strengthens its rhetoric around the rates outlook. However, given the lingering downside risks for activity stemming from Brexit, we continue to see the risk that any tightening comes later, rather than sooner.

Bank of England Bank Rate



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 5					
NZ	Jan ANZ commodity prices	–2.2%	–	–	Likely to benefit from higher dairy prices in January.
Aus	Jan AiG PSI	52.0	–	–	Services expanding, led by business-oriented segments.
	Jan MI inflation gauge	2.3%	–	–	Continues to overshoot ABS measure.
	Jan ANZ job ads	–2.3%	–	–	Monthly volatility eased, but didn't break, the uptrend.
Chn	Jan Caixin China PMI services	53.9	53.5	–	Momentum is softening, slowly.
Eur	Jan Markit services PMI	57.6	–	–	Has continued to trend higher.
	Feb Sentix investor confidence	32.9	34.5	–	Strong, and likely to remain that way.
UK	Jan Markit services PMI (final)	54.2	54.0	–	Conditions steady, but signs of nervousness remain.
US	Jan Markt service PMI	53.3	–	–	Flash estimate reported modest easing from 53.7.
	Jan ISM non-manufacturing	56.0	56.5	–	ISM continues to hold higher level than Markit PMI.
Tue 6					
NZ	Waitangi Day public holiday	–	–	–	Markets closed.
Aus	Dec retail sales	1.2%	–0.2%	–0.3%	iPhone X, Black Friday boost to unwind.
	Q4 real retail sales	0.1%	1.0%	0.6%	Stalled badly in Q3, Q4 looking a little better.
	Dec trade balance, AUDbn	–0.6	0.2	0.7	Exports +4.5%, iron ore, coal & LNG (vols & prices).
	RBA policy decision	1.50%	1.50%	1.50%	A patient RBA continues to remain on hold.
US	Dec trade balance US$bn	–50.5	–52.1	–	To deteriorate again, at the margin.
	Dec JOLTS job openings	5879	–	–	JOLTS also includes hires; fires and quits.
	Fedspeak	–	–	–	Bullard on economy and policy in Kentucky.
Wed 7					
NZ	GlobalDairyTrade auction	4.9%	–	–	Stronger prices in Jan; rain has eased drought concerns.
	Q4 unemployment	4.6%	4.7%	4.5%	Expect the unemploy rate to fall to new post-GFC low...
	Q4 employment change	2.2%	0.4%	0.2%	... but will see payback for Q3 employ/part-rate spike.
	Q4 labour cost index (ex overtime)	0.7%	0.5%	0.4%	No evidence to date of a pickup in wage pressures.
Chn	Jan foreign reserves $bn	3140	3170	–	Uptrend strong evidence of authorities' power.
UK	Jan Halifax house prices	–0.6%	–	–	Dampened by eco uncertainty and real income squeeze.
US	Dec consumer credit	28.0	20.0	–	Credit card use has surged in late 2017.
	Fedspeak	–	–	–	Evans and Dudley speak.
Thu 8					
NZ	RBNZ Monetary Policy Statement	1.75%	1.75%	1.75%	A steady-as-she-goes statement after mixed data.
Aus	RBA Governor Lowe speaking	–	–	–	A50 Economic Forum, topic tba, Sydney, 12pm
	Q4 NAB business survey	7	–	–	Dec monthly survey was released last week.
Chn	Jan trade balance USDbn	54.7	52.4	–	Exports and imports both accelerating.
	Q4 current account balance	–	–	–	Dated, but good for detail on investment flows.
	Jan foreign direct investment %yr	-9.2%	–	–	Highly volatile, of limited use.
UK	Jan RICS house price balance	8%	–	–	Drags from economic uncertainty, especially in London.
	Bank of England policy decision	0.50%	0.50%	0.50%	BOE on hold with cautious tightening bias.
US	Fedspeak	–	–	–	Williams (Sydney morning), Harker & Kashkari.
	Initial jobless claims	230k	–	–	Multi-decade low holding.
Fri 9					
NZ	Jan QVNZ house prices, %yr	6.6%	–	–	House prices have accelerated again in recent months.
Aus	Dec housing finance	2.1%	-1.0%	-1.5%	Held up better than expected through 2017 slowdown.
	RBA Statement on Monetary Policy	–	–	–	Forecasts updated, see page 2 for a discussion.
Chn	Jan PPI %yr	4.9%	4.2%	–	Will weaken as commodity price upswing tops out.
	Jan CPI %yr	1.8%	1.5%	–	Weak of late; CNY likely to create volatility.
UK	Dec industrial production	0.4%	–0.9%	–	Global growth and the low GBP boosting demand.
	Dec construction output	0.4%	–	–	Housing construction up; commercial activity subdued.
	Dec trade balance, £bn	-2804	–	–	Boost to exports from GBP offsetting import costs.
US	Dec wholesale inventories	0.2%	0.2%	–	Remains a key source of volatility for GDP.
	Fedspeak	–	–	–	George, 1pm AESDT.
Sat 10					
Chn	Jan aggregate financing, CNYbn	1140	3500	–	Usual new year strength to be seen...
	Jan new loans, CNYbn	584	2200	–	... despite authorities tighter stance.
	Jan M2 money supply %yr	8.2%	8.2%	–	Financial series tentative, 10–15 Feb.

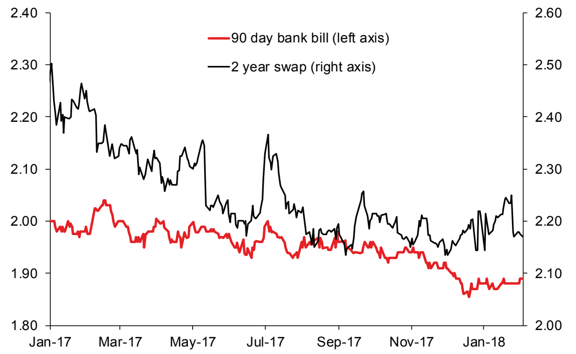
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017		2018		Calendar years			
% change	Sep(a)	Dec	Mar	Jun	2016	2017f	2018f	2019f
GDP (Production)	0.6	0.7	0.5	0.6	4.0	2.9	2.5	3.2
Employment	2.2	0.2	0.6	0.4	5.8	3.5	1.6	1.2
Unemployment Rate % s.a.	4.6	4.5	4.5	4.6	5.3	4.5	4.7	4.6
CPI	0.5	0.1	0.7	0.3	1.3	1.6	1.9	1.7
Current Account Balance % of GDP	-2.6	-2.9	-2.7	-3.0	-2.5	-2.9	-3.4	-2.8

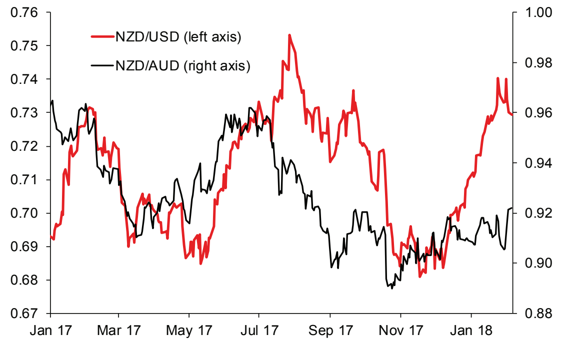
¹ Annual average % change

Financial Forecasts	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.90	1.90	1.90
2 Year Swap	2.20	2.20	2.30	2.40	2.50	2.60
5 Year Swap	2.75	2.80	2.95	3.05	3.15	3.25
10 Year Bond	2.95	3.10	3.30	3.40	3.45	3.50
NZD/USD	0.71	0.69	0.67	0.65	0.63	0.64
NZD/AUD	0.91	0.91	0.91	0.90	0.90	0.90
NZD/JPY	80.2	79.4	78.4	76.1	73.7	74.9
NZD/EUR	0.60	0.59	0.58	0.57	0.55	0.55
NZD/GBP	0.53	0.52	0.52	0.51	0.50	0.51
TWI	74.1	73.0	71.9	70.5	68.7	69.5

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 5 February 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.80%	1.78%	1.79%
60 Days	1.84%	1.83%	1.83%
90 Days	1.89%	1.88%	1.88%
2 Year Swap	2.17%	2.25%	2.18%
5 Year Swap	2.74%	2.78%	2.66%

NZ foreign currency mid-rates as at 5 February 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7296	0.7284	0.7175
NZD/EUR	0.5866	0.5938	0.5977
NZD/GBP	0.5172	0.5244	0.5297
NZD/JPY	80.38	80.61	81.17
NZD/AUD	0.9218	0.9111	0.9153
TWI	74.93	74.98	74.83

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017f	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.3	2.5	2.5
CPI inflation % annual	1.7	1.7	1.5	1.7	2.0	2.0
Unemployment %	6.2	5.8	5.7	5.5	6.1	6.0
Current Account % GDP	-3.0	-4.7	-2.7	-1.6	-2.2	-2.6
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	2.2	2.0
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	4.1	4.1
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	1.4	1.1	0.9
Euroland						
Real GDP %yr	1.3	2.0	1.8	2.4	2.0	1.7
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	6.8	6.2	5.9
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.2	4.2	4.2
World						
Real GDP %yr	3.6	3.4	3.2	3.8	3.7	3.6
Forecasts finalised 14 December 2017						

Interest Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	1.78	1.77	1.80	1.80	1.80	1.80	1.80	1.80
10 Year Bond	2.84	2.70	2.75	2.90	2.85	3.00	3.10	3.05
International								
Fed Funds	1.375	1.625	1.875	2.125	2.125	2.125	2.125	2.125
US 10 Year Bond	2.79	2.60	2.75	3.00	3.00	3.00	2.90	2.75
ECB Deposit Rate	0.00	–0.40	–0.40	–0.40	–0.40	–0.30	–0.30	–0.20

Exchange Rate Forecasts	Latest	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19
AUD/USD	0.8009	0.78	0.76	0.74	0.72	0.70	0.71	0.72
USD/JPY	109.63	113	115	117	117	117	117	118
EUR/USD	1.2497	1.20	1.17	1.15	1.15	1.15	1.17	1.18
AUD/NZD	1.0867	1.10	1.10	1.10	1.11	1.11	1.11	1.11

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