Weekly Commentary

7 May 2018

Work without reward

Last week Stats NZ delivered its battery of labour market data relating to the March quarter. It arguably deepened a key mystery – why is wage growth so low when employment is strong?

The unemployment rate fell to a fresh nine-year low of 4.4%. That was on the back of ongoing employment gains, although the pace of employment growth has slowed over the past year. Despite falling unemployment, wage growth remained muted. The Labour Cost Index (LCI) showed just a 0.3% rise for the quarter. The annual rate was 1.9%, but excluding the impact of last year's pay settlement for aged care workers, the annual increase would have been 1.6% – effectively the same rate of increase that we have seen for the last several years.

In contrast to the subdued wage growth story in the LCI, the QES measure of average hourly earnings has picked up strongly in the latest quarter, and over the last year. However, we would put less weight on this series. It has always been more volatile than the LCI (and was affected more by the aged-care workers' settlement), and the recent growth is arguably a correction from a very weak patch a year earlier.

The labour market surveys came ahead of this week's Monetary Policy Statement (MPS), which will be the first under the Reserve Bank's new mandate to contribute to maintaining maximum sustainable employment and avoid unnecessary volatility in employment. The RBNZ may consider unemployment of 4.4% evidence that employment is currently at, or even beyond, the maximum sustainable level. This is based their assertion that the non-inflationary rate of unemployment is 4.7%, and their forecast that the long-run average rate of unemployment will be 5%.

But there is a great deal of uncertainty about where employment stands relative to the maximum sustainable level. The lack of a pickup in wage growth suggests that employment is still short of the sustainable maximum. The labour underutilisation rate of 11.9% argues in the same direction. Other evidence points in the direction of employment being at or beyond the maximum sustainable level – surveys show that firms' difficulty finding labour is at a cyclical extreme, and the employment to GDP ratio is extremely high.

These issues will be hotly debated at the RBNZ, and will be discussed in detail in the MPS. However, we do not think that the move to considering the labour market will prompt a change in the OCR outlook. The RBNZ may well conclude that the labour market does not need assistance in the same way as inflation needs a boost. In that sense, moving to a dual mandate weakens the case for keeping the OCR low. However, there have long been considerations outside of inflation that have made the RBNZ wary of lowering the OCR too far. Most notably, the RBNZ didn't want to risk inflaming the housing market. Shifting the focus to the labour market probably won't increase or decrease the RBNZ's caution about keeping the OCR low.

In terms of the inflation outlook, recent developments have probably been to the positive side. The exchange rate has dropped sharply below the RBNZ's forecast, the housing market has been stronger than the RBNZ expected, and export commodity prices have risen instead of falling as the

Work without reward... continued

RBNZ anticipated. That is more than enough to offset the fact that GDP growth has probably been weaker than the RBNZ expected in the six months to March.

However, the recent rise in bank bills (the interest rates at which banks lend to one another) relative to the OCR is a spanner in the works. The risk is that this will spark off a round of independent mortgage rate increases. The RBNZ may want to see how this issue pans out before actually changing the OCR outlook.

Bringing all of this together, the RBNZ is likely to leave the OCR unchanged relative to the February MPS, meaning it will continue forecasting no change in the OCR until mid- to late-2019. If there is a change in OCR outlook it will be small, and in the direction of earlier hikes.

More uncertain is how the RBNZ chooses to communicate the OCR outlook. For over a year now it has repeated the same bottom-line: *"Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly."* The new Governor might want to stick with that phrase to emphasise continuity for markets. Or he may want to emphasise the change in regime by changing the wording. We have no way of telling which it will be, but what we can say is that a change in phraseology from the RBNZ will not necessarily be a signal to markets.

The final interesting feature of last week's labour market report was that after years of strong growth, employment in the construction sector has flattened out. This matches a general decline in business confidence in the construction sector observed over the past year and reaffirmed in last week's ANZ business confidence survey. Building consents rose strongly in March, but the strength was restricted to the volatile Auckland apartment building sector. The general trend in consents over the past seven months has been sideways.

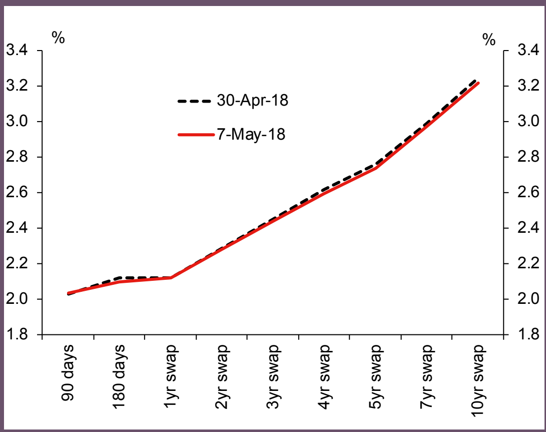
It is hard to tell what has caused this general flattening off in residential construction activity. It may represent a reduction in demand for building, but that would be surprising given the housing shortages that are manifest in Auckland and one or two other parts of the country. The other possibility is that construction is beset with some form of inability to grow, rather than an unwillingness. Labour shortages are probably not the constraint – we have noticed that job ads in construction have also come off. More likely, construction firms and developers are finding it difficult to access finance, and are having difficulty turning a profit with costs rising as they are. We are starting to get the sense that construction activity won't grow in 2018 to the extent that we have been forecasting – and that might bode ill for the economy overall.

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 Q2 RBNZ survey of inflation expectations

May 8, Two years ahead, last: 2.11%

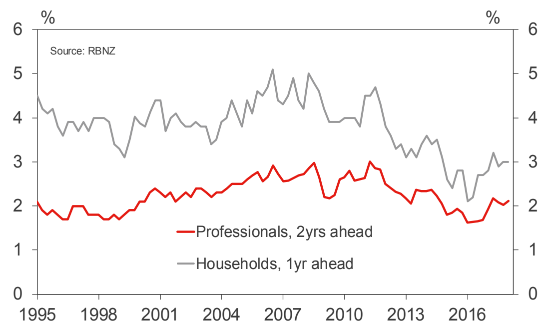
- The latest RBNZ expectations survey was held soon after the March quarter inflation result, which saw annual inflation dropping from 1.6% to 1.1%. However, it's not clear that expectations will follow the CPI downwards. Some of the March quarter softening in inflation was due to special factors, such as the partial removal of tertiary study fees. In addition, there have been some well publicised price increases (e.g. petrol), as well as growing concern about Government policy and wage costs.
- Inflation expectations in this and other surveys have lifted from the lows we saw in 2016/17 and have now flattened off at levels around the RBNZ's 2% target mid-point.

NZ Apr retail card spending

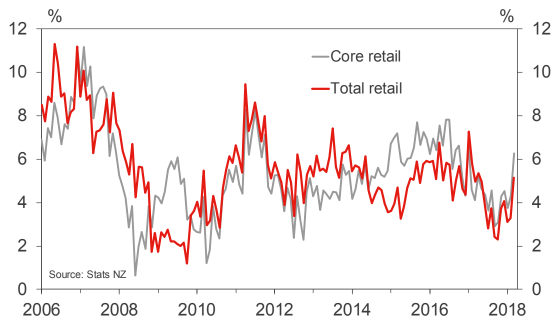
May 9 Last 1.0%, WBC f/c: -0.1%

- Retail card spending was stronger than expected in March, rising by 1% over the month. In part, that strong result was a rebound from earlier weather related weakness. Spending also appears to have received a boost from Easter holiday leisure activities and the recent firming in the housing market (which tends to affect spending on durable items).
- With weather and holiday related volatility dissipating, we expect to see a modest 0.1% easing in retail spending in April. However, given the solid gains earlier in the year and low level of retail price inflation, we wouldn't describe that as weak. Spending continues to be supported by strong population growth, low interest rates, and the recent firming in the housing market.

RBNZ survey of inflation expectations



Card transactions, annual % change



RBNZ OCR and Monetary Policy Statement

May 10 Last 1.75% WBC f/c: 1.75%, Mkt f/c: 1.75%

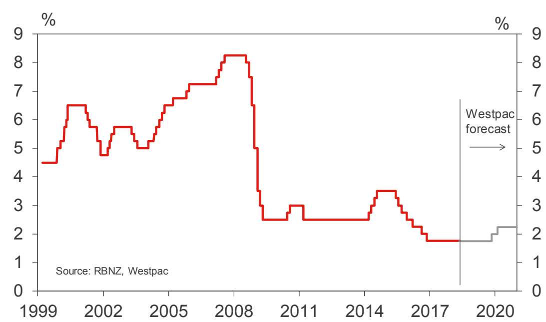
- This will be the Reserve Bank's first policy announcement under its new Policy Targets Agreement and under Governor Adrian Orr. We don't expect a change in the OCR outlook. But if there is a change, it will be in the direction of slightly earlier hikes than previously signalled. Recent economic developments have been, on balance, slightly positive for inflation.
- The wording of the MPS and the press release will be different from previous announcements, but markets shouldn't necessarily take that as a signal – it might just reflect the new Governor's communication style.
- The RBNZ's new labour market directives probably won't cause a change in the OCR outlook this time. However, the labour market target might matter at other points in time.

NZ Apr REINZ house sales and prices

May 11 (tbc), Sales last: -4.5%, Prices last: 4.2%yr

- New Zealand house prices have been more buoyant in recent months, although Auckland and Canterbury have remained relatively subdued. Market turnover has also picked up, albeit less emphatically. A drop in mortgage rates and a slight easing of loan-to-value restrictions have given some support to the market.
- We expect the housing market to lose momentum again over the rest of this year, as the new Government introduces a range of policies aimed at cooling housing speculation. The first step came at the end of March, when the bright-line test for taxing capital gains on investment properties was extended from two to five years.
- There is no set date for the release of the April house sales figures; we expect them to be released towards the end of the week, but they could be pushed into the following week.

RBNZ Official Cash Rate



REINZ house prices and sales

The week ahead

Aus Mar retail trade

May 8, Last: 0.6%, WBC f/c: 0.2%
Mkt f/c: 0.2%, Range: -0.1% to 0.6%

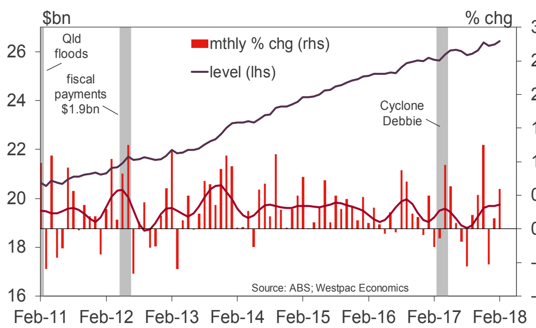
- Retail sales improved in Jan and Feb (+0.2% and +0.6% respectively) after a 0.5% fall in Dec that had followed a patchy second half to 2017. The detail was also mostly positive with the Feb gain led by solid rises in 'discretionary' store types. Notably, online sales continue to see strong growth, albeit from a low starting point.
- Indicators are more mixed for March. Consumer sentiment softened after a sharemarket sell-off and increased concerns about the outlook for the economy and jobs. Retail responses to private sector business surveys also point to a softening in sales although these have provided conflicting guidance in recent months. On balance we expect March to show renewed headwinds with a sub-par 0.2% gain.

Aus Q1 real retail sales

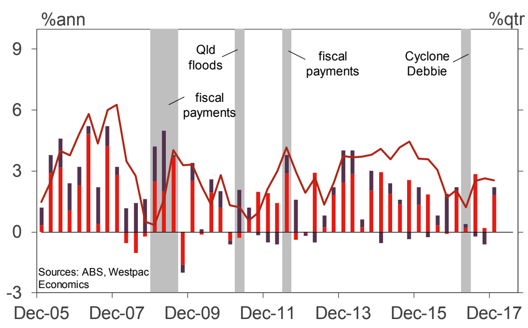
May 8, Last: 0.9%, WBC f/c: 0.8%
Mkt f/c: 0.5%, Range: -0.5% to 1.3%

- After stalling in Q3, retail volumes rebounded 0.9% in Q4, rounding off a stop start year for retail. Volume gains have also been alongside aggressive price discounting – non food retail prices down 0.9%qtr, and 2%yr, 2017 marking the biggest annual price decline since the early 2000s when a rising AUD was generating significant falls in imported goods prices.
- The Q1 update should show a further rise but at a slower pace. Nominal sales are on track to be up about 0.7% for the quarter vs 1.1% in Q4. Retail prices have again moved lower, the Q1 CPI detail pointing to a decline of around 0.2% (although this understated price weakness in Q4). Overall the mix points to a 0.8% rise in real retail sales.

Monthly retail sales



Quarterly retail volumes and prices



Aus 2018 Federal Budget, AUDbn

May 8, Last: -15.6(e), WBC f/c: -15.0
Mkt f/c: -15.0, Range: -23.0 to -7.5

- Federal Budget 2018 will reveal an improved budget position relative to the December MYEFO largely reflecting upside on jobs growth and commodity prices in 2017/18. For 2017/18, the deficit is expected to improve by $8bn relative to MYEFO, upgraded to $15.6bn from $23.6bn. For 2018/19, after factoring in the potential impact of new spending and personal income tax cuts, the deficit is some $5.5bn lower than in MYEFO, at $15.0bn (0.8% of GDP). As to the timing of the return to surplus, this is likely to remain in 2020/21, to the tune of $9.0bn, broadly in line with the MYEFO forecast of $10.2bn. Net debt levels remain manageable at an expected $351bn (18.4% of GDP) at June 2019. For more detail, see our preview bulletin.

Aus Mar housing finance (no.)

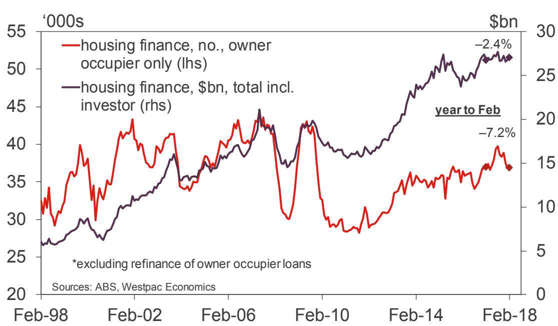
May 11, Last: 0.2%, WBC f/c: –3.0%
Mkt f/c: -1.5%, Range: -3.0% to 2.5%

- Australian housing finance approvals were essentially steady in Feb, the number of owner occupier approvals dipping 0.2% and the value of investor finance up 0.5%.
- Industry figures point to a sharp fall in owner occupier approvals in March – we expect the official figures to show a 3% drop. Housing markets remained soft through the month with auction clearance rates around long run average levels in Sydney and Melbourne and prices continuing to slip lower. Buyer sentiment has steadied having lifted off its 2017 lows but remains downbeat by historical standards. Some tightening in lending criteria may also be impacting new finance activity.

Underlying cash balance, $bn

Region	'17/18	'18/19	'19/20	'20/21
MYEFO	–23.6	–20.5	–2.6	+10.2
% GDP	–1.3	–1.1	–0.1	0.5
Improved starting position	8.0	9.5	9.5	9.5
Medicare levy, scrapped		–0.4	–3.6	–4.3
Spending, net		–0.9	–1.0	–0.7
Tax cuts		–2.7	–5.7	–5.7
Net improvement	**8.0**	**5.5**	**–0.8**	**–1.2**
Budget position	-15.6	-15.0	-3.4	+9.0
% GDP	-0.9	-0.8	-0.2	0.4

New finance approvals*



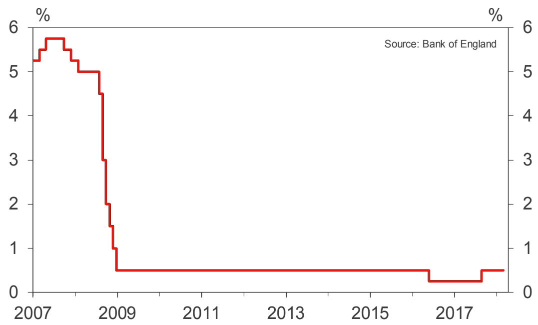
The week ahead

UK Bank of England Bank Rate decision

May 10, Last: 0.5%, Mkt: 0.5%, WBC f/c: 0.5%

- We expect the BOE will keep the Bank Rate on hold at 0.5% at its May meeting, and that they will maintain their gradual tightening bias. The pace of activity has been easing off, including a step down in GDP growth to a lower than expected 1.2% in March (vs. 1.4% in December). Although some of this is due to earlier inclement weather, lingering uncertainty around the economic outlook and headwinds in the household sector are also a drag. Inflation remains above 2%, but has been easing back, and some further softening is expected over the coming months.
- Reinforcing expectations for an on hold decision in May are recent comments from BOE Governor Carney. While he did note that rates are likely to rise over the coming years, he highlighted the continued uncertainty associated with Brexit and mixed tone of recent economic activity.

Bank of England Bank Rate

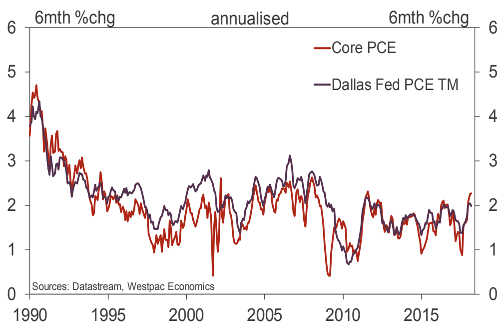


US Apr CPI

May 10, last –0.1%, WBC 0.3%

- US consumer inflation is in the process of accelerating, as base effects from March–May 2017 drop out. These weak outcomes of 2017 were due to a number of 'one-off' or 'transitory' shocks related to the pricing of mobile phone plans and physician services. These factors were responsible for the lift in annual core inflation from 1.9% in February to 2.1% in March, and further gains are expected.
- From March to April, no change is expected in the growth rate, with another 0.2% increase forecast. This is the pace that inflation has averaged since August 2017.
- Headline inflation will however be whipped around on a month to month basis, with March's –0.1% result followed by a 0.3% gain as energy prices jump. It remains our expectation that inflation will settle near 2.0% on a core basis in the second half of 2018.

Core inflation near target; to remain there



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 07					
Aus	Apr NAB business survey	14	-	-	Conditions above LR avg, despite pull-back in March.
	Apr ANZ job ads	0.0%	-	-	Growth momentum in job ads remains robust.
Chn	Apr foreign reserves $bn	3142.8	3132.0	-	Fairly stable of late.
Eur	May Sentix investor confidence	19.6	22.4	-	Still strong.
US	Mar consumer credit $bn	10.6	16.0	-	Higher rate to crimp demand in time.
	Fedspeak	-	-	-	Quarles, Bostic, Evans & Kaplan at Financial Markets Conf.
	Fedspeak	-	-	-	Barkin in moderated Q&A.
Tue 08					
NZ	Q2 RBNZ 2y inflation expectations	2.11%	-	-	The earlier rise in expectations has levelled off recently.
Aus	RBA Deputy Head International Boge	-	-	-	An update on the FX Global Code, 9.00AM AEST.
	Q1 real retail sales	0.9%	0.5%	0.8%	Another solid gain for vols but coming via fierce price ...
	Mar retail sales	0.6%	0.2%	0.2%	... competition. Monthly sales look to be softer in Mar.
	2018 Federal Budget, AUDbn	-15.6(e)	-15	-15	Deficit narrowing on improved starting position, see textbox.
Chn	Apr trade balance CNYbn	-29.8	150.6	-	Focus remains on rhetoric more than hard numbers.
	Apr foreign direct investment %yr	0.4%	-	-	Tentative date 8-15.
UK	Apr Halifax house prices	1.5%	-	-	Economic uncertainty weighing on house price growth.
US	Apr NFIB small business optimism	104.7	105.0	-	Small bus. very positive on outlook. Spending to follow?
	Mar JOLTS job openings	6052	-	-	Hires; fires; quits; and openings.
	Fed Chair Powell speaks	-	-	-	Mon. policy influences on global conditions & capital flows.
Wed 09					
NZ	Apr retail card spending	1.0%	-	-0.1%	Modest easing following volatility. Trend this year is firm.
US	Apr PPI	0.3%	0.2%	-	Oil price rise having an effect.
	Mar wholesale inventories final	0.5%	0.6%	-	A positive in Q1.
	Fedspeak	-	-	-	Bostic speaks on economic outlook and policy.
	State primaries	-	-	-	Indiana, North Carolina, Ohio and West Virginia.
Thu 10					
NZ	RBNZ Official Cash Rate	1.75%	1.75%	1.75%	First decision since RBNZ's policy targets were expanded.
	Minister of Finance Robertson	-	-	-	Pre-Budget speech.
Aus	May MI inflation expectations	3.6%	-		Inflation remains subdued.
Chn	Apr PPI %yr	3.1%	3.4%	-	Commodity prices have buoyed.
	Apr CPI %yr	2.1%	1.9%	-	Consumer inflation benign.
	Apr M2 money supply %yr	8.2%	8.5%	-	Affected by tighter credit.
	Apr aggregate financing, CNYbn	1330.0	1350.0	-	Bank credit to remain the driver of credit growth....
	Apr new loans, CNYbn	1120.0	1100.0	-	... as activities of shadow sector curbed.
UK	Apr RICS house price balance	0%	-	-	Demand remains weak, esp. in London.
	Mar industrial production	0.1%	0.3%	-	Manufacturing conditions have cooled in early 2018...
	Mar trade balance, £bn	-965	-2000	-	... though firm external demand is providing some offset.
	Mar construction output	-1.6%	-2.0%	-	Construction sector conditions remain soft.
	Bank of England Bank Rate	0.5%	0.5%	0.5%	Slowing growth & easing inflation keeps BOE on hold.
US	Apr CPI	-0.1%	0.3%	0.3%	Energy a big support in Apr.
	Initial jobless claims	211k	-	-	Low and will remain so.
	Apr monthly budget statement $bn	-208.7	-	-	Growing interest, but highly volatile month to month.
Fri 11					
NZ	Apr BusinessNZ PMI	52.2	-	-	Business conditions, incl. orders, have cooled in early 2018.
	Apr food prices	1.0%	-	-0.3%	Vege prices last month were boosted by wet weather.
	Apr REINZ house prices, %yr	4.2%	-	-	Date TBC. Easing in mort. rates and lending restrictions...
	Apr REINZ house sales	-4.5%	-	-	... are providing a temporary boost to the housing market.
US	Apr import price index	0.0%	0.5%	-	Sedate despite 2017 depreciation in US dollar.
	May Uni. of Michigan sentiment	98.8	98.0	-	Consumer comfortable and hopeful over outlook.

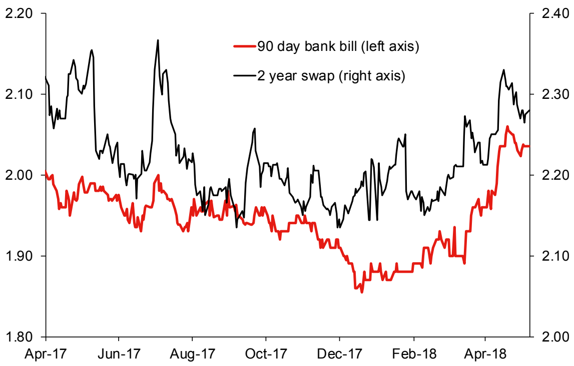
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017	2018			Calendar years			
% change	Dec(a)	Mar	Jun	Sep	2016	2017	2018f	2019f
GDP (Production)	0.6	0.6	0.6	0.7	4.0	2.9	2.7	3.0
Employment	0.5	0.3	0.4	0.4	5.8	3.7	1.4	1.0
Unemployment Rate % s.a.	4.5	4.5	4.4	4.4	5.3	4.5	4.5	4.7
CPI	0.1	0.5	0.4	0.6	1.3	1.6	1.7	1.5
Current Account Balance % of GDP	-2.7	-2.6	-3.0	-3.3	-2.2	-2.7	-3.4	-3.1

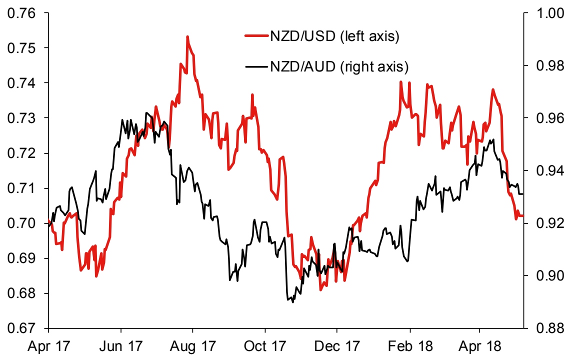
[1] Annual average % change

Financial Forecasts	Jun-18	Sep-18	Dec-18	Mar-18	Jun-19	Sep-19
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	2.00	2.00	2.00	2.00	2.00	2.10
2 Year Swap	2.20	2.20	2.30	2.40	2.55	2.70
5 Year Swap	2.70	2.75	2.90	3.05	3.15	3.25
10 Year Bond	2.90	3.00	3.20	3.30	3.35	3.40
NZD/USD	0.72	0.70	0.68	0.66	0.65	0.64
NZD/AUD	0.94	0.92	0.92	0.92	0.92	0.91
NZD/JPY	77.8	76.3	75.5	73.3	72.2	70.4
NZD/EUR	0.59	0.57	0.56	0.55	0.54	0.52
NZD/GBP	0.53	0.53	0.54	0.54	0.53	0.52
TWI	74.5	73.0	71.7	70.3	69.6	68.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 7 May 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.88%	1.88%
60 Days	1.94%	1.97%	1.92%
90 Days	2.04%	2.06%	1.98%
2 Year Swap	2.28%	2.32%	2.25%
5 Year Swap	2.74%	2.77%	2.69%

NZ foreign currency mid-rates as at 7 May 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7021	0.7217	0.7275
NZD/EUR	0.5867	0.5883	0.5919
NZD/GBP	0.5188	0.5154	0.5160
NZD/JPY	76.64	77.83	77.79
NZD/AUD	0.9312	0.9406	0.9468
TWI	73.55	74.61	75.09

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.3	2.7	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	2.1	1.9
Unemployment %	6.2	5.8	5.7	5.5	5.5	5.6
Current Account % GDP	-3.0	-4.7	-3.1	-2.3	-2.7	-3.8
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	2.8	2.5
Consumer Prices %yr	1.6	0.1	1.3	2.1	2.6	2.0
Unemployment Rate %	6.2	5.3	4.9	4.4	4.0	3.8
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.4	1.4	0.9	1.7	1.3	1.0
Euroland						
Real GDP %yr	1.3	2.1	1.8	2.3	2.1	1.6
United Kingdom						
Real GDP %yr	3.1	2.3	1.9	1.8	1.2	1.5
China						
Real GDP %yr	7.3	6.9	6.7	6.9	6.3	6.1
East Asia ex China						
Real GDP %yr	4.2	3.8	3.9	4.5	4.3	4.3
World						
Real GDP %yr	3.6	3.5	3.2	3.8	3.8	3.7
Forecasts finalised 4 May 2018						

Interest Rate Forecasts	Latest	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	2.02	2.02	1.98	1.94	1.90	1.88	1.86	1.85
10 Year Bond	2.79	2.75	2.95	3.15	3.20	3.10	3.10	3.10
International								
Fed Funds	1.625	1.875	2.125	2.125	2.375	2.625	2.625	2.625
US 10 Year Bond	2.95	2.90	3.10	3.35	3.50	3.50	3.40	3.30
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.20	0.00	0.00	0.00

Exchange Rate Forecasts	Latest	Jun-18	Sep-18	Dec-18	Mar-18	Jun-19	Sep-19	Dec-19
AUD/USD	0.7557	0.77	0.76	0.74	0.72	0.71	0.70	0.70
USD/JPY	109.05	108	109	111	111	111	110	110
EUR/USD	1.1992	1.22	1.22	1.21	1.19	1.21	1.23	1.26
AUD/NZD	1.0752	1.07	1.09	1.09	1.09	1.09	1.09	1.08

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