Weekly Commentary

12 November 2018

Glow Worm (Arachnocampa Luminosa)

Not on target

Unemployment has plumbed new lows and that could spark some wage inflation, but we still think general inflation is contained. The RBNZ shifted to a slightly less dovish stance, which was expected. Extraordinarily, the RBNZ is forecasting that both inflation and employment will exceed target in the medium term, yet it plans no response to that with the OCR. This underscores that the new RBNZ is less hawkish than the old.

Last week's excitement started with the September quarter Household Labour Force Survey, which registered a ten-year low in the unemployment rate of 3.9%. That was a lot lower than we were expecting, given that jobseeker benefit numbers are on the rise.

We are wary of the inherent noise in the HLFS survey. On this occasion the drop in unemployment was heavily concentrated among very young people, which may be a sign that sampling error was a factor. One-quarter moves of this size are often followed by at least a partial reversal in the next quarter, and that's what we expect on this occasion.

That said, a broad sweep of all relevant data does suggest that the labour market is more positive than we gave it credit for. The HLFS probably overstates the case, but the fact remains that unemployment is trending down despite the economic slowdown of 2017 and early-2018. Evidently, low business confidence has not stopped firms from hiring.

Given this evidence of improving employment conditions, the lack of wage growth looks all the more mysterious. The September Labour Cost Index rose by 0.5%, with annual growth slowing a little to 1.9%. The drop in the annual growth rate is not surprising, as the aged care workers' pay equity settlement had boosted the numbers previously. Private sector wage growth has arguably started to pick up on a quarterly basis, and other measures of wage growth are a little stronger. But it's been a very incremental lift in wage growth so far.

Our view is that wage growth will gradually strengthen as the labour market continues to tighten. Wage growth is also going to be boosted by the rising minimum wage, pay settlements for nurses and teachers, and moves towards more collective wage bargaining. But this acceleration in wage growth will be too slow to generate much inflation, particularly considering other forces will be acting to keep inflation contained, such extending free tertiary education beyond one year and competition in the retail sector.

The Reserve Bank's November *Monetary Policy Statement* came hot on the heels of the super-strong labour market report, and followed similar massive upside surprises on GDP and inflation. We were expecting a slightly hawkish shift, and that's exactly what we got. The Reserve Bank removed the phrase that the next move in the OCR could be "*up or down*", issued evenly balanced alternative scenarios (rather than skewing them to the downside), and lifted its inflation forecast.

At the same time however, the RBNZ remained adamant that the OCR is not going to rise any time soon. They retained the phrase that the OCR is expected to remain "at this level through 2019 and into 2020", and the OCR forecast was unchanged from August.

Not on target continued

Given the sheer scale of the data surprises over the past three months, this really was a tiny shift in position. This underscores just how much less hawkish the Reserve Bank has become since the change to a dual mandate and a new Governor. We suspect that last week's events will become a theme. Over the coming year, we expect the economy to strengthen and inflation to rise. Yet we remain very comfortable forecasting no OCR hike until mid-2020.

The most extraordinary aspect of last week's *Monetary Policy Statement* related to the Reserve Bank's medium-term forecasts. The Reserve Bank is actually forecasting that inflation will rise above the 2% mid-point of their inflation target bank, on a sustained basis, over the medium term. At the same time, they predict that employment will rise above its maximum sustainable level. In other words, the Reserve Bank is saying that it is going to overshoot its targets. Yet it is not planning to adjust the OCR to avert that miss.

Usually, the Reserve Bank forecasts shows inflation settling at 2% over a horizon of, say, three years. After all, if inflation was in danger of heading higher three years in the future, the Reserve Bank would still have time to lift the OCR and avert the rise in inflation. On this occasion, rather than forecasting a rise in the OCR it is simply saying that it is not going to hit its inflation target, although admittedly the margin is small.

The situation has become more complex now that the RBNZ must target both employment and an inflation. One could imagine the RBNZ forecasting one variable above target and one below, in a sort of balancing act. But that is not the case here – the RBNZ is saying it expects both employment and inflation to be above target.

Perhaps the RBNZ has been burned by many years of below-target inflation, and is prepared to take a small risk on the other side. Or perhaps it is interpreting differently the requirement to keep inflation "near the 2% mid-point" of its target range, and regards 2.2% as close enough. Whatever the explanation, this is a small but significant departure from the approach that the previous Governor would have taken.

Financial markets have taken the recent strong data and slight shift in tone from the RBNZ as licence to mark swap rates and the NZD much higher. That may prove to be a mistake. Our prediction is that the Reserve Bank will remain very dovish even if the data remains strong. If we are right, two-year swap rates above 2.2% are not tenable.

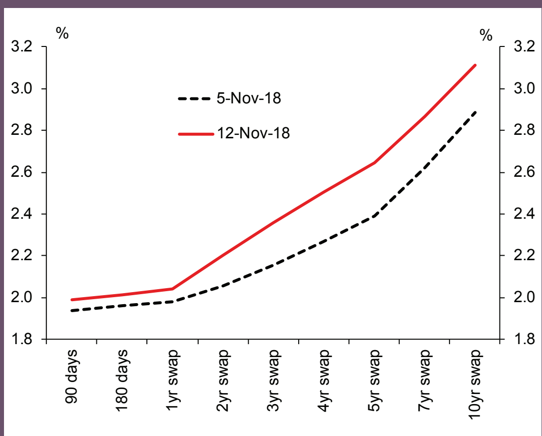
Fixed vs Floating for mortgages

Fixed-term mortgage rates have fallen as the market has adjusted to the Reserve Bank's softer stance. Looking further ahead, we expect floating and short-term fixed rates to rise gradually over the next few years, so taking a fixed rate may prove worthwhile once they have settled down.

One-year fixed rates are currently the lowest on offer, and appear to offer good value for borrowers. Longer-term fixed rates are high relative to where we think one-year fixed rates are going to go. However, longer-term rates offer security against the possibility of mortgage rates rising more rapidly than expected in the future.

Floating mortgage rates usually work out to be more expensive for borrowers than fixed rates. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



The week ahead

NZ Oct house sales and prices

Nov 10 (tbc), Sales last: -2.5%, Prices last: +5.4%yr

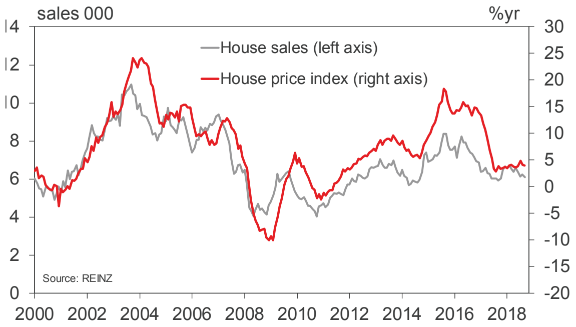
- House price inflation has slowly strengthened in recent months, although there is stark regional variation. Auckland and Canterbury prices are flat to falling, others are rising rapidly.
- Going forward the market will be influenced by the recently-introduced foreign buyer ban and a recent sharp drop in mortgage rates. We expect the balance to be positive, but less so in Auckland.
- We have already seen stronger listings and strong sales from one agency, the October REINZ data may show a modest pickup in sales.

NZ Oct retail card spending

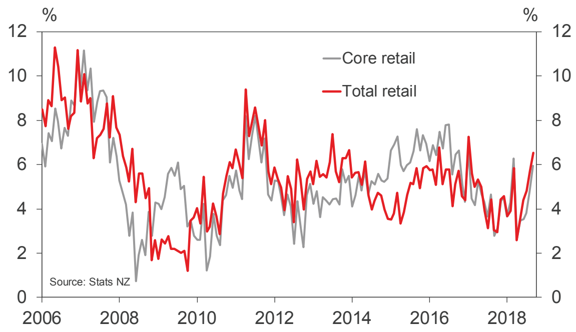
Nov 12, Last: +1.1%, WBC f/c: +0.5%

- Retail spending levels rose by a solid 1.1% in September, following a similar sized gain in August. Those gains were underpinned by increased spending on consumables (e.g. groceries), as well as firm spending on durables. Spending levels have been boosted by the Government's Families Package, which has added to the disposable incomes of many households.
- We expect more modest spending growth in October and are forecasting a 0.5% gain in the month. While the lift in disposable incomes has added to the level of spending, higher fuel prices are limiting increases in discretionary expenditure in core categories.

NZ REINZ house prices and sales



NZ card transactions, annual % change



Aus Q3 Wage Price Index - %qtr

Nov 14, Last: 0.6%, WBC f/c: 0.6%
Mkt f/c: 0.6%, Range: 0.4% to 0.7%

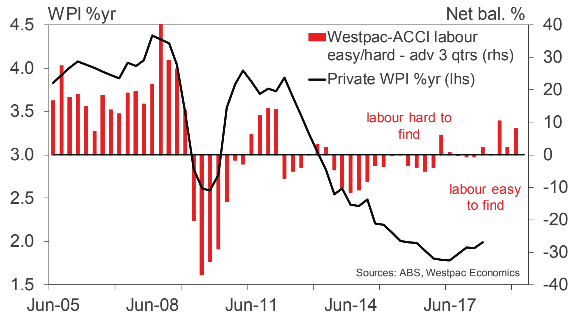
- There has been some removal of excess slack in the labour market, yet we are still waiting for a meaningful pickup in wage inflation.
- Total hourly wages ex bonuses increased 0.6% in Q2, in line with market and Westpac expectations; lifting the annual rate to 2.1%yr from 2.0%yr (was 2.1%yr). Private sector wages grew 0.5% lifting the annual rate slightly to 2.1%yr. Public sector wages grew 0.6% holding the annual rate at 2.4%yr - a pace maintained since 2017 Q1.
- This year the lift in the minimum wage was 3.5%yr, a small increase on the 3.3%yr granted in 2017. However, in 2017 the minimum wage increase did not have a meaningful impact on aggregate wages. Will we see a larger impact in 2018?

Aus Nov Westpac-MI Consumer Sentiment

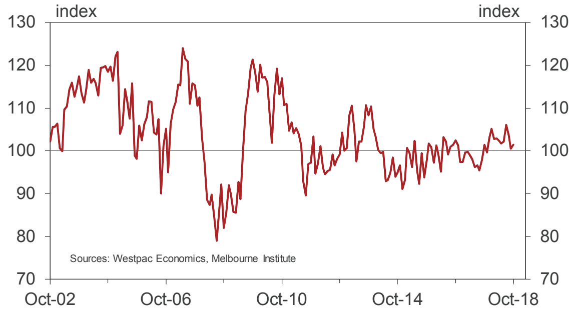
Nov 14 Last: 101.5

- The Westpac Melbourne Institute Index of Consumer Sentiment rose 1% to 101.5 in October from 100.5 in September. The small gain follows a 5.2% decline over the previous two months as an earlier boost from tax cuts announced in the May budget faded and negatives around the political backdrop; mortgage rate increases; declining house prices and rising petrol prices weighed on confidence. The October gain suggests some of the drag from these negatives has eased while positives around economic growth and the labour market have provided some support.
- The November survey was in the field from November 5-10. The backdrop has again been a little more settled although global trade tensions, declining house prices in Sydney and Melbourne and sluggish income growth remain clear headwinds.

Aus wage growth and difficulty finding labour



Aus Consumer Sentiment Index



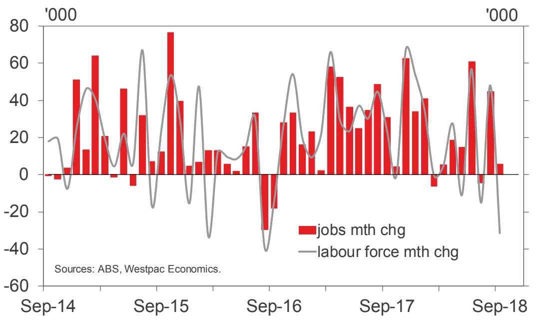
The week ahead

Aus Oct Labour Force Survey - Employment '000

Nov 15, Last: 5.6k, WBC f/c: 20k
Mkt f/c: 20k, Range: 10k to 30k

- The Sep Labour Force Survey was full of surprises. The first was that employment came in less than expected rising just 5.6k in the month with a more positive 20.3k gain in full-time employment vs. a –14.7k decline in part-time employment.
- At the same time there was a drop in participation to 65.4% from 65.6% resulting in a –31.6k decline in the labour force. Our holistic view of the survey is that some of the monthly volatility is associated with the rolling of the groups in the survey sample. In original terms, the ABS notes that the incoming rotation group had a lower employment to population ratio (61.9%) than the entire sample (62.1%).
- Given this, we are looking for a slightly above trend bounce in employment, up 20k with an associated rise in the labour force.

Aus employment & labour force

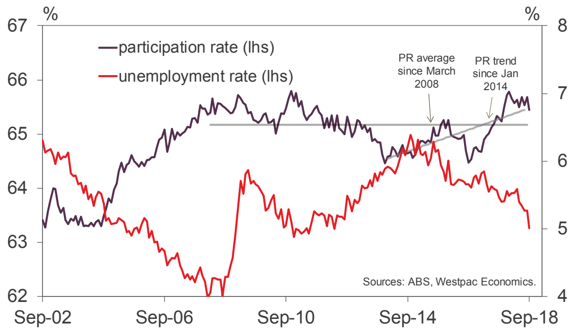


Aus Oct Labour Force Survey - Unemployment %

Nov 15, Last: 5.0%, WBC f/c: 5.1%
Mkt f/c: 5.1%, Range: 4.9% to 5.2%

- The other big surprise in the Oct Labour Force was the fall in unemployment to 5.0% which has historically been argued to be the level for the natural rate of unemployment.
- As the fall was associated with a fall in participation, some may be tempted to argue that were it not for the fall in participation then the unemployment rate would have been higher. We don't give countenance to such a statement as we believe you should take a holistic view of the labour market and not just look at one factor (say employment) and ignoring others (unemployment, participation, and hours worked).
- With our forecast 20k rise in employment and a lift in participation to 65.5% this will see the unemployment rate lift to 5.1%.

Aus unemployment and participation rates

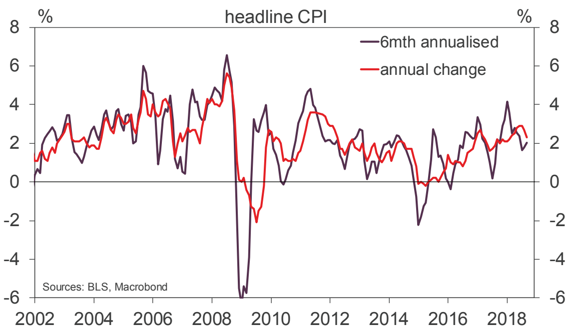


US Oct CPI and retail sales

Nov 14, CPI, last 0.1%, WBC 0.3%
Nov 15, retail sales, last 0.1%, WBC 0.7%

- CPI inflation has held above the FOMC's 2.0%yr target for much of 2018, the headline measure averaging 2.6%yr over the 7 months to Sep. The core measure (excludes food and energy) has averaged 2.2%yr over the same period.
- October looks set to continue this trend, respective 0.3% and 0.2% monthly gains to see annual inflation at 2.5%yr for headline and 2.2%yr for core.
- On retail sales, monthly volatility has been considerable, both with respect to initial outcomes and revisions. Looking through this however, the trend remains robust. After a weak September, we are due a bounce come October. Furthermore, the risks are skewed upward, given the need to replace auto purchases following Hurricane season.

US CPI

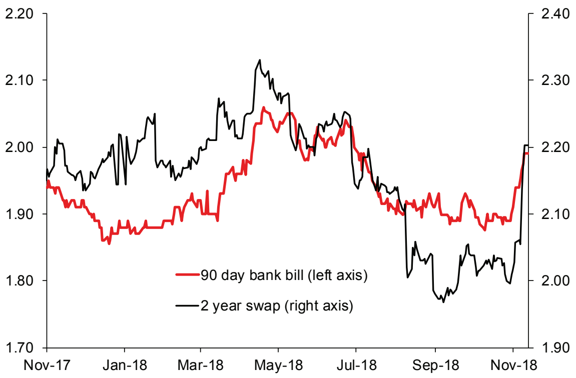


New Zealand forecasts

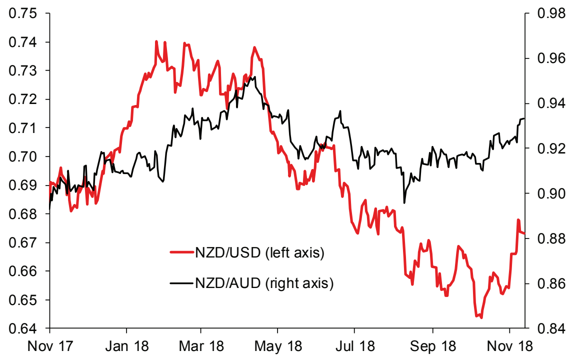
Economic Forecasts	Quarterly				Annual			
	2018			2019				
% change	Jun (a)	Sep	Dec	Mar	2017	2018f	2019f	2020f
GDP (Production)	1.0	0.7	0.7	0.7	2.8	2.8	3.1	2.9
Employment	0.6	1.1	0.1	0.2	3.7	2.4	1.2	1.7
Unemployment Rate % s.a.	4.4	3.9	4.3	4.4	4.5	4.3	4.2	4.0
CPI	0.4	0.7	0.5	0.4	1.6	2.1	1.4	1.8
Current Account Balance % of GDP	-3.3	-3.5	-3.5	-3.2	-2.9	-3.5	-3.4	-2.9

Financial Forecasts	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.95	2.00	2.10
2 Year Swap	2.10	2.20	2.30	2.45	2.60	2.75
5 Year Swap	2.50	2.70	2.90	3.05	3.15	3.25
10 Year Bond	2.70	2.90	3.10	3.25	3.35	3.40
NZD/USD	0.66	0.64	0.63	0.61	0.62	0.63
NZD/AUD	0.92	0.90	0.90	0.90	0.89	0.88
NZD/JPY	75.2	73.0	72.5	69.5	69.4	69.3
NZD/EUR	0.58	0.58	0.57	0.56	0.56	0.56
NZD/GBP	0.52	0.52	0.51	0.49	0.49	0.49
TWI	72.6	70.9	70.2	68.3	68.5	68.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 12 November 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.90%	1.83%	1.82%
60 Days	1.95%	1.86%	1.86%
90 Days	1.99%	1.89%	1.89%
2 Year Swap	2.20%	2.01%	2.04%
5 Year Swap	2.65%	2.32%	2.41%

NZ foreign currency mid-rates as at 12 November 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6733	0.6525	0.6507
NZD/EUR	0.5949	0.5723	0.5630
NZD/GBP	0.5212	0.5093	0.4946
NZD/JPY	76.63	72.92	72.98
NZD/AUD	0.9331	0.9184	0.9149
TWI	74.00	71.83	71.36

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 12					
NZ	Oct REINZ house prices, %yr	4.0%	–	–	Due this week. Balance between foreign buyer ban and a recent…
	Oct REINZ house sales	–2.5	–	–	…drop in mortgage rates should be positive for now.
	Oct retail card spending	1.1%	–	0.5%	Rising fuel prices restraining broader spending growth.
Chn	Oct money supply M2 %yr	8.3%	8.4%	–	Tentative date 10-15. New loans and financing also released.
Eur	EC President Juncker speaks	–	–	–	Opening speech at conf. "Where is Europe Headed?"
US	Veterans Day	–	–	–	Public holiday.
	Fedspeak	–	–	–	Daly speaks on the economic outlook in Idaho.
Tue 13					
NZ	Oct food prices	–0.1%	–	–0.5%	Produce prices easing; annual food price inflation near zero.
Aus	Oct NAB business survey	15	–	–	Conditions index elevated but off highs of late 2017, H1 2018.
Eur	Nov ZEW survey of expectations	-19.4	–	–	Eased back to below average
UK	Sep ILO unemployment rate	4.0%	–	–	Low unemployment has been boosting wage growth.
US	Oct NFIB small business optimism	107.9	108.0	–	Small businesses believe strongly in the outlook.
	Oct monthly budget $bn	119.1	-116.5	–	Deficit yet to become a concern.
	Fedspeak	–	–	–	Kashkari speaks at regional economic conference on immigration.
Wed 14					
Aus	Nov WBC-MI Consumer Sentiment	101.5	–	–	Important read in the lead in to Christmas.
	Q3 wage price index	0.6%	0.6%	0.6%	Waiting to see if the min wage increase will bump the WPI.
UK	Oct CPI	0.1%	–	–	Core inflation contained with imported inflation easing.
	Sep house price index, %yr	3.2%	–	–	Economic uncertainty continues to weigh on price growth.
Chn	Oct retail sales ytd %yr	9.3%	9.3%	–	Consumer has been a key driver of growth in 2018.
	Oct industrial production ytd %yr	6.4%	6.3%	–	Manufacturing momentum remains solid.
	Oct fixed asset invest. ytd %yr	5.4%	5.5%	–	Investment looks to be building a base.
Eur	Sep industrial production	1.0%	-0.4%	–	Trend is moderate.
	Q3 GDP 2nd estimate	0.2%	0.2%	–	National detail and revisions.
US	Oct CPI	0.1%	0.3%	0.3%	Energy a positive in Oct.
	Oct CPI ex food and energy	0.1%	0.2%	0.2%	Core inflation remains near target.
	Fedspeak	–	–	–	Quarles speaking to House financial services panel on banking.
Thu 15					
Aus	Oct employment	5.6k	20k	20k	Falling employment & participation in Sep suggests we can…
	Oct unemployment rate	5.0%	5.1%	5.1%	… get a bump in both employment & unemployment in Oct.
	Nov MI inflation expectations	4.0%	–	–	Petrol prices have started to ease back
	RBA Deputy Gov Debelle speaks	–	–	–	FINSIA Signature Event: The Regulators, Melb 12:30 pm.
Eur	Sep trade balance €bn	16.6	–	–	Surplus has eased back over 2018.
US	Nov Fed Empire state index	21.1	19.5	–	Regional surveys coming off highs.
	Oct retail sales	0.1%	0.5%	0.7%	Oct to see a bounce in sales; durables upside risk.
	Nov Phily Fed index	22.2	21.0	–	Regional surveys coming off highs.
	Oct import price index	0.5%	0.0%	–	Higher US dollar an offset to commodity prices.
	Initial jobless claims	214k	–	–	Very low.
	Sep business inventories	0.5%	0.3%	–	Pull forward of imports a positive for inventories.
	Fed Chair Powell speaks	–	–	–	To discuss economy at Dallas Fed event.
	Fedspeak	–	–	–	Quarles speaking to Senate panel on banking supervision.
	Fedspeak	–	–	–	Kashkari speaking in moderated Q+A in Minnesota.
Fri 16					
NZ	Oct BusinessNZ manufacturing PMI	51.7	–	–	Businesses have reported softening activity in recent months.
Eur	Oct core CPI %yr final	1.1%	1.1%	–	Has remained sticky around 1%.
US	Oct industrial production	0.3%	0.2%	–	Quite a constrast to PMI strength.
	Nov Kansas City Fed index	8	–	–	Regional surveys coming off highs.
	Sep total net TIC flows $bn	108.2	–	–	Detail on US government bond purchasers.
	Fedspeak	–	–	–	Evans speaks at fixed income roundtable in Chicago.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
Real GDP % yr	2.5	2.6	2.2	3.3	2.7	2.8
CPI inflation % annual	1.7	1.5	1.9	2.0	1.7	1.7
Unemployment %	5.8	5.7	5.5	5.1	5.0	4.8
Current Account % GDP	-4.7	-3.1	-2.6	-2.4	-2.5	-3.3
United States						
Real GDP %yr	2.9	1.5	2.3	2.9	2.5	1.7
Consumer Prices %yr	0.1	1.4	2.1	2.4	2.0	1.9
Unemployment Rate %	5.3	4.9	4.4	3.9	3.6	3.6
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	1.4	0.9	1.7	0.9	0.8	0.7
Euro zone						
Real GDP %yr	2.1	1.8	2.5	1.9	1.5	1.5
United Kingdom						
Real GDP %yr	2.3	1.9	1.8	1.2	1.2	1.4
China						
Real GDP %yr	6.9	6.7	6.9	6.4	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	3.9	4.5	4.3	4.1	4.1
World						
Real GDP %yr	3.5	3.2	3.8	3.8	3.6	3.5
Forecasts finalised 9 November 2018						

Interest Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day BBSW	1.94	1.98	1.93	1.91	1.90	1.90	1.85	1.83
10 Year Bond	2.77	2.70	2.80	2.80	2.90	2.80	2.70	2.60
International								
Fed Funds	2.125	2.375	2.625	2.875	3.125	3.125	3.125	3.125
US 10 Year Bond	3.22	3.25	3.40	3.50	3.60	3.30	3.10	3.00
ECB Deposit Rate	-0.40	–0.40	–0.40	–0.40	–0.30	–0.20	0.00	0.20

Exchange Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
AUD/USD	0.7243	0.72	0.71	0.70	0.68	0.70	0.74	0.74
USD/JPY	113.93	114	114	115	114	112	109	106
EUR/USD	1.1343	1.13	1.11	1.10	1.09	1.10	1.16	1.22
AUD/NZD	1.0750	1.09	1.11	1.11	1.11	1.13	1.14	1.11

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