

Weekly Commentary

14 May 2018



In with the new

The Reserve Bank served up a refreshing Monetary Policy Statement (MPS) under new Governor Adrian Orr, with straightforward language and an infographic. Beneath those cosmetic changes the outlook for the OCR was very similar to the outlook given in February – the OCR is on hold for a considerable period.

There was perhaps the slightest hint of a shift in a dovish direction. The reminder that the next move in the OCR could be either “up or down” was brought right up front in the document. And the actual OCR forecast was the barest shade lower (a tenth of a percent lower in a single quarter). Markets reacted strongly to that, and the New Zealand dollar fell nearly a cent over the day.

The RBNZ and financial markets are continuing to move incrementally closer to our view that a slowing economy might make it very difficult to boost inflation, and consequently the OCR will not need to rise until the end of 2019.

The most interesting aspect of the MPS was the RBNZ’s treatment of its new employment mandate. The RBNZ came right out and stated that employment is currently roughly at its maximum sustainable level. That took guts – the Government will be displeased at the implication that its goal of 4% unemployment is currently viewed as unsustainable.

The RBNZ went through a range of ways to measure where employment is relative to the sustainable maximum, but sounded most enthusiastic about the most obvious one – the unemployment rate. The RBNZ also placed a lot of weight on wage growth as an indicator of where the labour market is in the cycle. Wage growth has undershot forecasts for years, and if it continues to do so the RBNZ might conclude that employment has not reached its maximum sustainable level after all. Low wage growth

would also portend low inflation, so the outlook for wage growth now has double significance for the RBNZ.

The other interesting feature of the MPS was the lack of discussion around the exchange rate and the housing market. We view that as an improvement, particularly with regards to the exchange rate. The RBNZ has a long history of obsessing over the exchange rate and engaging in fruitless attempts to jawbone it lower. At best this has diverted attention from issues monetary policy can actually influence, and at worst it has led to serious monetary policy errors.

The other key development over the past week has been a rash of weak household-related data for April. Electronic card transactions and car registrations fell very sharply, and housing market data was weak.

The New Zealand housing market cooled over the first half of 2017, but enjoyed something of a comeback from September last year. The latest data have confirmed that the brief resurgence is over, and the New Zealand housing market is cooling once more. Market turnover is down, house prices are now falling in Northern New Zealand, and the rate of house price inflation has slowed elsewhere, most notably in Wellington.

This is bang on what we were expecting. We have long been forecasting a modest decline in house prices due to a raft of expected law changes. The first of these was the extension of the Bright Line Test, introduced at the end of March.

In with the new... continued

Property investors must now hold a property for five years before selling if they want to avoid being taxed on capital gains. Later this year we will see a foreign buyer ban come into force, and next year property investors' ability to claim tax deductions on rental property losses will be phased out. Finally, later this year the Tax Working Group will report back, and will probably recommend further taxes on property. We would be stunned if these changes failed to dent house prices.

If the housing market does weaken in the way we anticipate, there will be two main consequences. First, the Reserve Bank will become more willing to loosen its mortgage lending restrictions, which were already loosened slightly in January. We are looking for a second loosening in November this year, but an earlier move cannot be ruled out. We may get more guidance when the next Financial Stability Review is released on 31 May. And second, a weaker housing market will shift the balance of monetary policy in a dovish direction.

This week, the new coalition Government will release its first Budget. The Budget will probably be fairly mundane

in terms of new policy announcements, at least compared to the half-year update last December. We expect the Government will stick to its forecasts for a gradual decline in the net debt to GDP ratio, and therefore the forecasts for the bond programme will also stay the same. Our Budget Preview, released today, contains more detail.

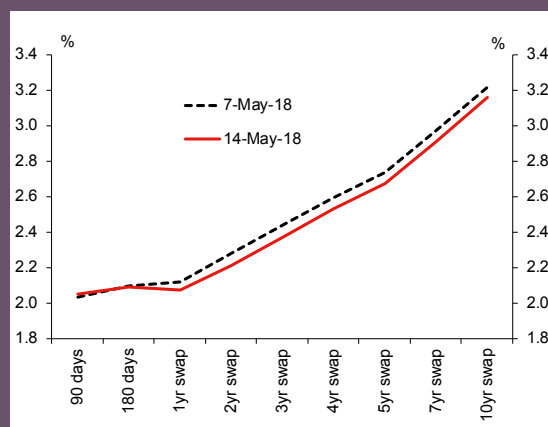
The Government may well forecast a reduction in debt relative to GDP below 20%, but there has been much discussion about whether this goal will actually be achieved in reality. Last week we published a bulletin explaining why we think the answer is a resounding yes. First of all, with the tax take exceeding forecasts recently, 20% net debt to GDP is not going to be all that difficult to achieve. But more importantly, even if the Government overspends on operational spending, it is highly likely to underspend its capital budget. The Government is forecasting a near-doubling of capital spending within two years. We seriously doubt they will be able to get that much investment done, given how capacity constrained the construction sector is. Less investment would also mean less debt. We have concluded that the Government will easily meet its debt target, but it might be for the wrong reasons.

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



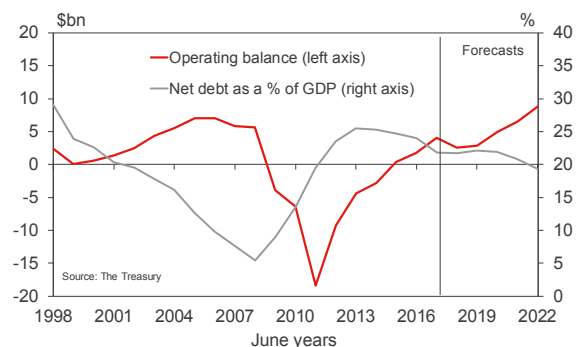
The week ahead

NZ Budget 2018

May 17

- When the Government delivers its first Budget next week it will walk the tightrope between increased spending and keeping within its Budget Responsibility Rules. While operational spending is likely to increase, thanks to a higher than expected tax take in recent months, the Budget projections will be constrained by reducing net core crown debt below 20% of GDP by 2021, and continuing to project operating surpluses.
- It will have been helped by a strong starting point, with the tax take currently running around \$1.1 billion ahead of forecast.
- The Government has signalled net capital spending plans over the next five years are broadly unchanged from those presented in December's Half Year Fiscal Update.

NZ fiscal projections (half-year update)



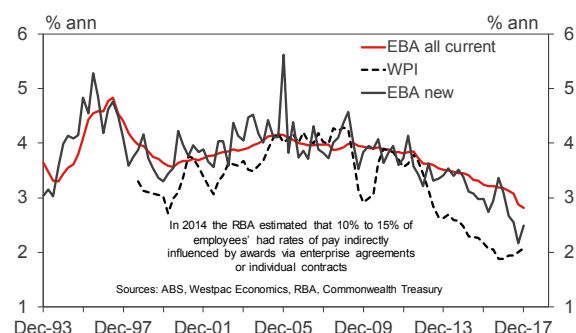
Aus Q1 Wage Price Index

May 16, Last 0.6%, WBC f/c: 0.6%

Mkt f/c: 0.6%, Range: 0.5% to 0.7%

- There has been some tightening in the Australian labour market, as measured by the broader measures of labour utilisation, but we still observe ongoing weakness in wage outcomes. Total hourly wages ex bonuses increased 0.6% in the December quarter, just slightly above market and Westpac expectations for 0.5% lifting the annual pace modestly from 2.0%/yr to 2.1%/yr. Private sector wages grew 0.5% holding the annual rate at 1.9%/yr. Public sector wages grew 0.6% with the boost coming from professional & technical (1.0%), education (0.8%) and health care (0.9%). Public sector wage inflation is holding an annual pace of 2.4%/yr which is just up on the 2016 record low of 2.3%/yr. The December quarter reported a modest uptick in new Enterprise Bargaining Agreements wage outcomes, but they are still less than the average of existing agreements.

As WPI stabilises, EBA wages moderate



Aus May Westpac-MI Consumer Sentiment

May 16, Last: 102.4

- After a promising start to the year, sentiment has drifted lower over the last three months, the index slipping to 102.4 in April. While still over the 'gain line' - reads above 100 indicate optimists still outnumber pessimists - and more encouraging than through most of 2017, the index remains well below the 105-115 levels typically associated with a robust consumer. The May survey is delayed a week in order to capture reactions to the Federal budget. Aside from this, sentiment may also be affected by financial market moves, the ASX200 rebounding strongly to be up 5.5% since the April survey but the AUD sliding nearly 2½¢ USD. Petrol prices have also shown a notable lift, average pump prices up over 7¢ a litre nationally since the last survey and over 13¢ since early March. Continued slippage in Sydney and Melbourne house prices is also likely to be weighing on sentiment.

Consumer Sentiment Index



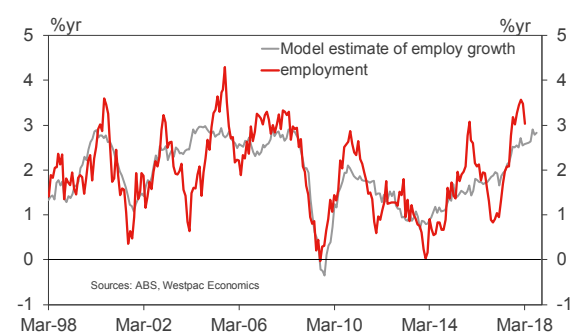
Aus April Labour Force - total employment '000

May 17, Last 4.9k, WBC f/c: 17

Mkt f/c: 20, Range: 10 to 30

- Australian employment grew just 4.9k in March but just as significant, the 17.5k gain in February was revised to -6.3k. The ABS now tells us that February was the first negative print in a record breaking run of 16 consecutive monthly gains. This was a bit of an anti-climax for what should have been a quite momentous occasion. A run of weak numbers were to be expected. After all the upswing in employment through the second half of 2017 was well above what our broader leading indicators were suggesting. The three month average gain has fallen from 45.7k in January to 12.0k in March while the annual pace of growth has eased back to 3.0% from 3.6% in January. Our analysis of the various business surveys suggests employment growth of something closer to 2¾%/yr. Our 17k forecast for April will see the annual rate ease back to 2.8%.

Jobs Index model of employment



The week ahead

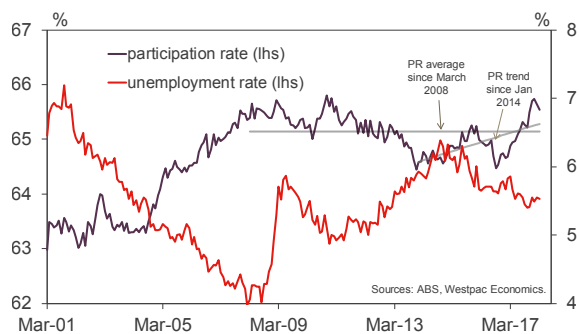
Aus April Labour Force - unemployment rate %

May 17, Last 5.5%, WBC f/c: 5.5%

Mkt f/c: 5.5%, Range: 5.3% to 5.6%

- Despite weak employment the unemployment rate was flat at 5.5%, which had been revised down from 5.6%. The participation rate was 65.5% down from February's figure of 65.6%. It appears that the unemployment rate has at least flattened so far in 2018, or can even be described as rising a little with a March quarter average of 5.52% vs. 5.45% in the December quarter. We also noted that the participation rate has drifted down a little but it is not far off the recent record high. We estimate the participation rate will round up from 65.5% in March to 65.6% in April resulting in a 17k lift in the labour force. As this matches our 17k forecast gain in total employment, the unemployment rate holds flat at 5.5. We should note given just how high the participation rate is, it is possible we will see a lower unemployment rate due to a further fall in participation.

Unemployment and participation rates



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 14					
NZ	Apr BusinessNZ perf. of services index	58.8	-	-	March's surge higher likely overstates the pace of activity.
US	Fedspeak	-	-	-	Mester at Bank of France conference.
	Fedspeak	-	-	-	Bullard at blockchain technology conference in NY.
Tue 15					
Aus	RBA Deputy Gov Debelle speaking	-	-	-	'Outlook for the Australian Economy', Sydney, 9.10 am AEST.
	RBA minutes	-	-	-	Additional colour around the Board deliberations.
	RBA Deputy Gov Debelle speaking	-	-	-	'Interest Rate Benchmark Reform' Hong Kong 11.40 am AEST.
Chn	Apr retail sales ytd %yr	9.8%	9.8%	-	Consumer remains robust.
	Apr industrial production ytd %yr	6.8%	6.7%	-	PMI's remain positive.
	Apr fixed asset investment ytd %yr	7.5%	7.4%	-	Subdued growth to continue.
Eur	Mar industrial production	-0.8%	0.6%	-	Rebound expected.
	Q1 GDP 2nd estimate	0.4%	0.4%	-	No change in second estimate; more detail released.
	May ZEW survey of expectations	1.9	-	-	Investors remain positive.
UK	Mar ILO unemployment rate	4.2%	0.4%	-	Weather and softening services activity weighing on hiring.
US	May Fed Empire state index	15.8	15.0	-	Mixed results for regional surveys of late.
	Apr retail sales	0.6%	0.4%	0.5%	Solid but not strong, best description of consumer.
	Mar business inventories	0.6%	0.2%	-	Inventories add to slow?
	May NAHB housing market index	69	70	-	Very positive sentiment towards housing.
	Mar total net TIC flows	44.7	-	-	Trade tensions see greater interest in flows.
	Fed nominee testimony	-	-	-	Clarida and Bowman testify before senate panel.
	Fedspeak	-	-	-	Kaplan on energy outlook and the economy.
	Fedspeak	-	-	-	Williams at Economic Club of Minnesota.
Wed 16					
Aus	May Westpac-MI Consumer Sentiment	102.4	-	-	Any boost from tax cuts announced in Fed budget?
	Q1 wage cost index	0.6%	0.6%	0.6%	Labour market has tightened but wages yet to respond.
Eur	Apr CPI %yr final	1.2%	1.3%	-	Revision expected to see headline down, core unchanged.
US	Apr housing starts	1.9%	0.1%	-	Fickle month to month...
	Apr building permits	4.4%	-1.7%	-	... but trend points to continued modest gains.
	Apr industrial production	0.5%	0.6%	-	Little watched.
	Fedspeak	-	-	-	Bostic gives an economic update.
Thu 17					
NZ	Budget 2018	-	-	-	Spending to increase, but debt target won't be breached.
Aus	Apr employment '000	4.9	20	17	The labour market has slowed from the rapid pace of 2018...
	Apr unemployment rate	5.5%	5.5%	5.5%	... but participation has also eased back from record highs.
Eur	Mar trade balance €bn	21.0	-	-	Is support from global economy fading?
US	Initial jobless claims	211k	-	-	Very low.
	May Philly Fed index	23.2	21.7	-	Mixed results for regional surveys of late.
	Apr leading index	0.3%	0.4%	-	Points to growth a little above trend.
	Fedspeak	-	-	-	Bullard in media interview.
	Fedspeak	-	-	-	Kashkari in moderated Q&A.
	Fedspeak	-	-	-	Kaplan in moderated Q&A.
Fri 18					
US	Fedspeak	-	-	-	Mester at ECB on macroprudential and monetary policy.
	Fedspeak	-	-	-	Kaplan in moderated Q&A.
	Fedspeak	-	-	-	Brainard on the Community Reinvestment Act.

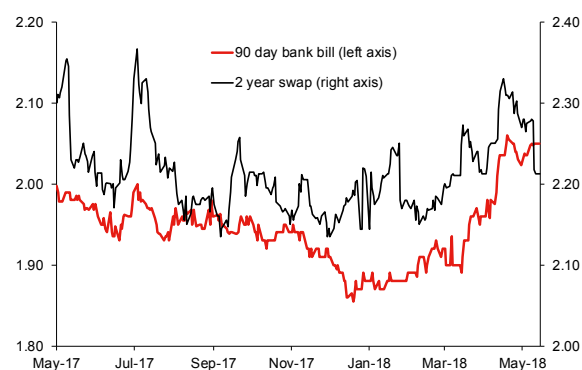
New Zealand forecasts

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

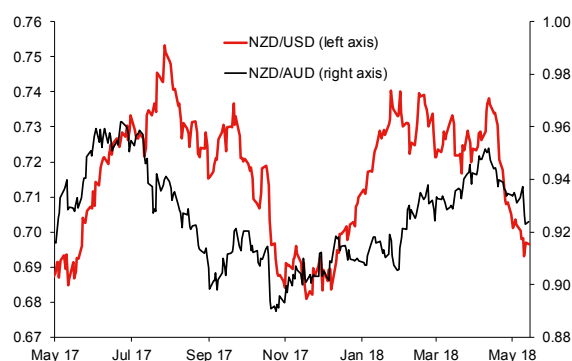
¹ Annual average % change

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 14 May 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.88%	1.88%	1.89%
60 Days	1.96%	1.95%	1.95%
90 Days	2.05%	2.03%	2.04%
2 Year Swap	2.21%	2.29%	2.32%
5 Year Swap	2.67%	2.76%	2.75%

NZ foreign currency mid-rates as at 14 May 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6966	0.7083	0.7357
NZD/EUR	0.5830	0.5843	0.5965
NZD/GBP	0.5142	0.5144	0.5163
NZD/JPY	76.15	77.24	79.09
NZD/AUD	0.9240	0.9348	0.9464
TWI	72.93	73.75	75.63

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	0.7537	0.76	0.75	0.74	0.72	0.71	0.70	0.70
USD/JPY	109.46	110	111	112	114	113	112	110
EUR/USD	1.1920	1.20	1.19	1.18	1.17	1.18	1.20	1.22
AUD/NZD	1.0818	1.07	1.09	1.09	1.09	1.09	1.09	1.08

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