Weekly Commentary

18 June 2018

Slowing momentum

Recent data has reinforced our view that the drivers of New Zealand's economic growth are becoming more mixed. This week's GDP data is likely to show that annual GDP growth slowed to 2.8% in the March quarter – its slowest pace since September 2014 – as momentum in the household and construction sectors has faded. But although New Zealand's economic cycle is maturing, it's certainly not all doom and gloom. The strong terms of trade is one noticeable bright spot, with strong incomes in the export sector set to provide a key role in supporting growth.

Much of the slowdown in economic activity has been centred on the household sector, with the cooling in the housing market a key influence. On that front, May REINZ data showed that seasonally adjusted sales were down 0.7% in the month and the average number of days to sell has increased. Nationwide prices eased 0.2% in May, following a similar decline in April.

But beneath the headline result, there are marked differences across regions. The slowdown in the housing market has been most keenly felt in Auckland (and to a lesser extent Canterbury). In Auckland, house prices are now falling gradually on a monthly basis, are down 2% since February. Average prices in the region are now back at August 2016 levels.

Outside of Auckland, house prices rose a touch in May, and are up 6.8% on a year ago. But even that's still a much more gradual pace of growth than we've seen in recent years. A year ago, annual house price inflation outside of Auckland was running at a rate of 11%, and two years ago it was almost 16%.

The slowdown in the housing market in recent months has matched our expectations that the changing policy backdrop would be a significant drag. In March we saw the holding period for taxing capital gains on investment properties extended from 2 years to 5 years (the so called 'bright line' test). At the margin, this may have prompted some investors to bring their purchase of properties forward ahead of the changes coming into effect. However, moving forward it has made purchasing property less attractive to investors and speculators.

Looking ahead, we expect the housing market to cool further as more of the Government's policies designed to slow the housing market move from the drawing board and into practice. Notably, the ban on foreign buyers looks set to come into effect next month. And with recent data showing offshore buyer activity concentrated in Auckland and the Queenstown Lakes District, it seems likely that this policy change will affect these regions the most. In addition, any lift in buying ahead of the new rules coming into effect could have generated a temporary lift in housing market activity, which we would expect to fade going forward.

The third policy change proposed by the new Government is the graduated removal of the ability of investors to write off losses on their investment property against other incomes. This will further erode the incentives around property investment and dampen house price growth.

Combined, these policy changes, along with a gradual rise in mortgage rates and slowing population growth, are likely to see annual house price inflation fall to 0% by the end of the year.

Slowing momentum ... continued

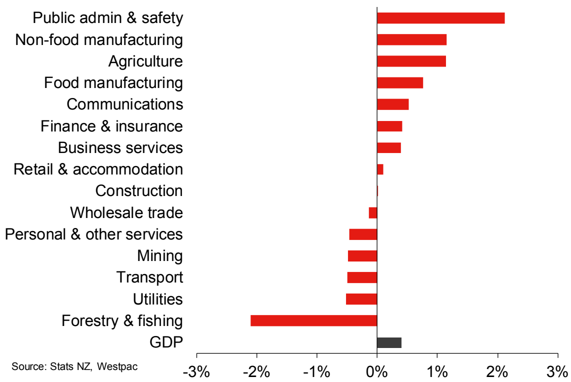
With so much of New Zealanders' wealth tied up in housing assets, developments in the housing market have big implications for household spending. Going forward we expect the cooling housing market, combined with slower net migration, will be a significant drag on household spending. Indeed there are already signs that the pace of growth in retail spending has stalled. Last week's data showed electronic card spending rose just 0.5% in May, with spending levels essentially flat since January (albeit at a high level). And the pressure doesn't look set to ease any time soon. Rising oil prices and forthcoming fuel tax increases mean filling the petrol tank will eat up a greater share of household income, and will likely force households to trim other spending.

Softness in the consumer sector is also likely to feature in this week's March quarter GDP release. We expect 0.4% GDP growth in the quarter, which would mark the third consecutive quarter of subdued growth (GDP expanded by 0.6% in the September and December quarters of 2017).

Sectors that touch on a wide range of economic activity – such as transport, retail, wholesaling and business and personnel services – are all expected to show weak growth or even outright declines. In contrast, the strongest growth is likely to be in the public sector. We should note, however, that the main indicator for this in the national accounts is the Government's personnel expenses – a measure of inputs, which doesn't necessarily translate into more outputs. The support to growth generated by a lift in the delivery of public services is more a story for 2019 and beyond.

But it's certainly not all doom and gloom for the New Zealand economy. Although some of the recent drivers of growth are fading, New Zealand's strong terms of trade remains a bright spot. The terms of trade eased a touch in the March quarter. But that's coming off an all-time high reached at the end of 2017. The strong terms of trade has been helped by broad-based strength in New Zealand's key export commodities. Almost everywhere you look, farmers and growers are benefitting from high international prices for their products thanks to a combination of robust global demand and, in some cases, tight supplies. While we expect international commodity prices to ease over the coming months as growth in China slows, a weaker NZ dollar should buffer the effect at the farm and orchard gate. This should help the export sector take a bigger role in the economy as momentum in household spending fades.

Q1 GDP forecasts by sector



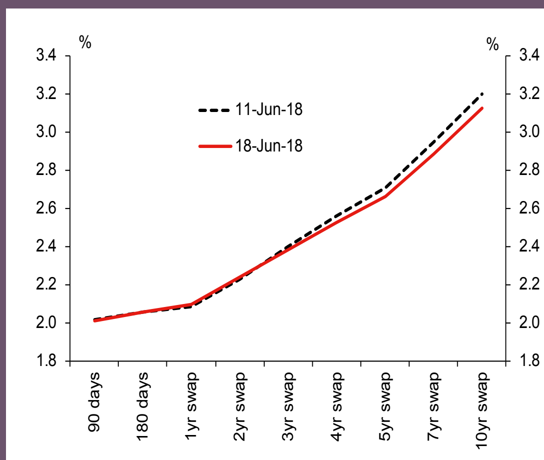
Source: Stats NZ, Westpac

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 Westpac McDermott Miller consumer confidence

Jun 20, Last 111.2

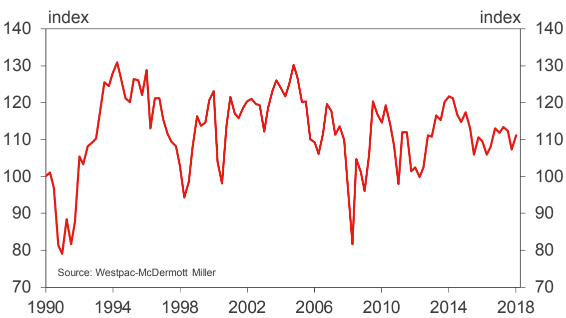
- Households perked up at the start of 2018. The Westpac McDermott Miller Consumer Confidence Index rose 3.8 points in March, taking it to a level of 111.2. That reversed most of the drop seen in the wake of last year's election and took consumer confidence back to around average levels.
- The June survey will provide an update on how consumer confidence has fared in the face of changing conditions in the economy, including the slowdown in the housing market.

NZ Q1 current account, % of GDP

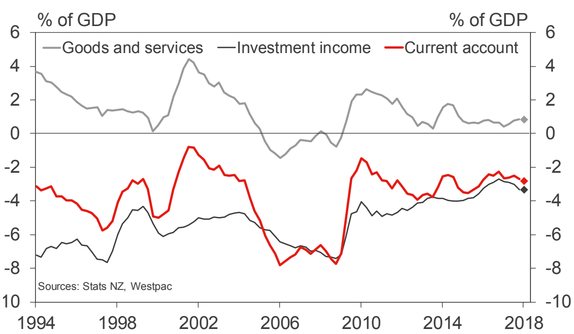
Jun 20, Last: –2.7%, Westpac f/c: –2.8%, Mkt f/c: –2.8%

- We expect the annual current account deficit to widen slightly to 2.8% of GDP. While goods imports remained firm, New Zealand's export performance worsened in the first quarter due to a drop in both prices and volumes. This decline is likely to be short-lived: commodity prices have since improved, and we suspect that the drop in volumes was due to the timing of shipments.
- We expect a slight narrowing of the investment income deficit for the March quarter, with a pullback in profits of overseas–owned firms after a few unusually strong quarters. However, the deficit is still likely to be larger than it was a year ago, contributing to a widening of the annual current account deficit.

Westpac-McDermott Miller consumer confidence



Annual current account balance



NZ Q1 GDP

Jun 21, Last: 0.6%, Westpac f/c: 0.4%, Mkt f/c: 0.5%

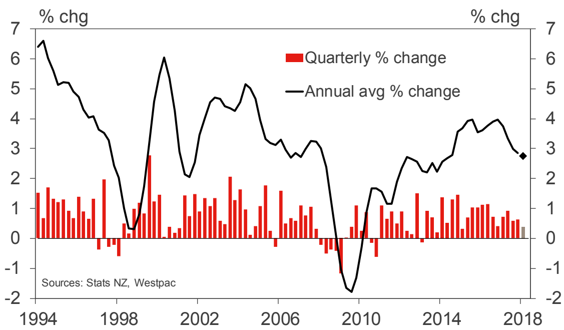
- Following only modest growth in the December quarter, we expect that GDP growth softened again in March. We're forecasting only a 0.4% rise over the quarter. That would pull annual GDP growth down to 2.8%, which would be the slowest pace since 2014.
- We expect the strongest growth to be in the public sector. We also expect a lift in agriculture, and a related lift in food manufacturing.
- However, a wide range of economic activity – such as transport, retail, wholesaling, and business and personal services – are expected to show weak growth at best, or even outright declines.

Aus May Westpac–MI Leading Index

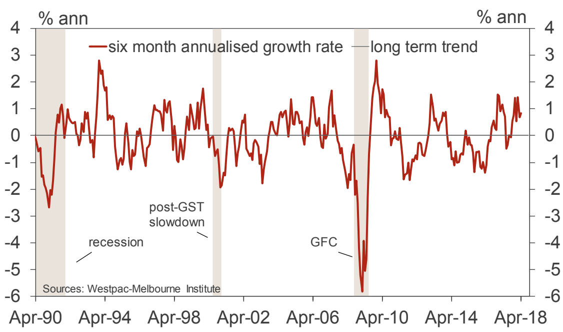
Jun 20, Last: 0.82%

- The six month annualised growth rate in the Leading Index increased slightly from +0.77% in March to +0.82% in April. The above trend signal continues to come mainly from 'offshore' components – commodity prices and US industrial production – with domestic components largely flat.
- The May will include updates on: the ASX200, up 0.5% vs 3.9% last month; the Westpac-MI Consumer Expectations Index, down -1% vs 0.8% last month; commodity prices, up 0.6% (in AUD terms) vs -3.2% last month; dwelling approvals, down -5% vs 3.5% last month; the yield spread, widened 15bps vs a 11bps narrowing last month; the Westpac-MI Unemployment Expectations Index, up 5.7% vs -4.5% last month; and total hours worked, -1.4% vs 1.2% last month.

Production-based GDP



Westpac-MI Leading Index



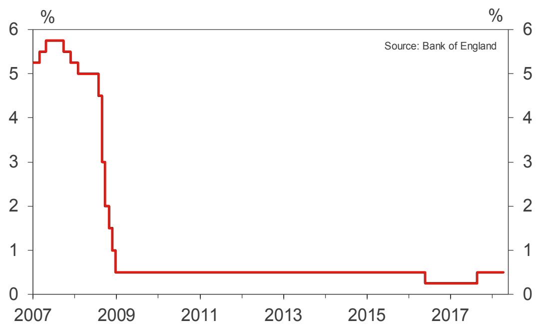
The week ahead

UK Bank of England Bank Rate Decision

Jun 21, Last: 0.5%, Westpac f/c: 0.5%, Mkt f/c: 0.5%

- We expect the Bank of England to keep the Bank Rate on hold at its June policy meeting.
- Despite a sharp rise in fuel prices, annual headline inflation remained at 2.4% in May. In addition, core inflation is sitting at 2.1%yr – only just above the Bank of England's 2.0%yr target.
- The BOE is still expected to signal that gradual, limited rate increases will eventually be required. However, with the combination of fairly well contained core inflation, subdued economic growth, and lingering downside risks associated with Brexit, rate hikes are still some way off.

Bank of England Bank Rate



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	May BusinessNZ PSI	55.9	-	-	Service sector conditions have cooled over the past year.
Eur	ECB President Draghi speaks	-	-	-	Giving opening remarks at ECB Sintra conference.
UK	Jun Rightmove house prices	0.8%	-	-	Housing market turnover low. Weakness in London prices.
US	Jun NAHB housing market index	70	70	-	Remains at high level.
	Fedspeak	-	-	-	Dudley & Williams at banking culture conference.
	Fedspeak	-	-	-	Bostic on economic and monetary policy in Georgia.
Tue 19					
Aus	RBA minutes	-	-	-	Additional colour around the Board deliberations.
Eur	ECB President Draghi speaks	-	-	-	Again at Sintra conference.
	ECB Praet speaks	-	-	-	Chairs price and wage setting panel at Sintra.
US	May housing starts	-3.7%	1.9%	-	Volatility continuing month to month...
	May building permits	-0.9%	-1.0%	-	... but modest uptrend still intact.
	Fedspeak	-	-	-	Bullard on wage and price setting panel at Sintra.
Wed 20					
NZ	Q2 Westpac MM consumer confidence	111.2	-	-	Picked up in Q1 as post election nervousness eased.
	GlobalDairyTrade auction	-1.3%	-	-	Prices likely to remain stable.
	Q1 current account (% of GDP)	-2.7%	-2.8%	-2.8%	Q1 softness in export prices and vols. Imports remain firm.
Aus	May Westpac-MI Leading Index	0.82%	-	-	Offshore components driving above trend pulse.
	Governor Lowe on central bank panel	-	-	-	Sintra with Fed's Powell, ECB's Draghi and BOJ's Kuroda.
US	May existing home sales	-2.5%	1.7%	-	Limited by supply.
Thu 21					
NZ	Q1 GDP	0.6%	0.5%	0.4%	Economy lost momentum, softness in a range of sectors.
Eur	Jun consumer confidence	0.2	-0.1	-	Politics and trade uncertainty v's job/ income gains.
	ECB speak	-	-	-	Bundesbank Weidmann & Banque de France Villeroy.
UK	May public sector net borrowing, £b	6.2	-	-	Brexit/soft activity will challenge debt reduction goals.
	BOE policy decision	0.5%	-	0.5%	Inflation is contained, headwinds for growth remain.
	BOE Governor Carney speaks	-	-	-	Speech at Lord Mayor's bankers and merchants dinner.
US	Initial jobless claims	218k	-	-	Very low.
	Jun Phily Fed index	34.4	27.8	-	Regional surveys buoyant.
	Apr FHFA house prices	0.1%	-	-	House price growth remains robust.
	May leading index	0.4%	0.4%	-	Pointing to above-trend growth.
Fri 22					
NZ	May net migration	4930	-	5200	Small bounce after falls, annual rate still trending down.
Eur	Jun Markit manufacturing PMI flash	55.5	55.0	-	A further deterioration in momentum...
	Jun Markit services PMI flash	53.8	53.7	-	... would be of significant concern.
US	Jun Markit manufacturing PMI flash	56.4	56.3	-	Markit and ISMs both very positive on...
	Jun Markit services PMI flash	56.8	56.8	-	... mid-2018 outlook.

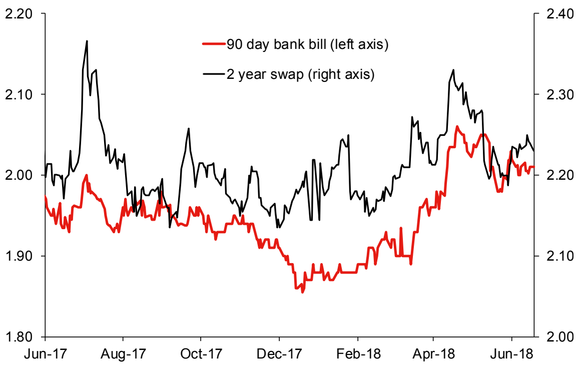
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2017	2018			Calendar years			
% change	Dec(a)	Mar	Jun	Sep	2016	2017	2018f	2019f
GDP (Production)	0.6	0.4	0.7	0.8	4.0	2.9	2.5	3.2
Employment	0.4	0.6	0.2	0.3	5.8	3.7	1.4	1.4
Unemployment Rate % s.a.	4.5	4.4	4.4	4.5	5.3	4.5	4.6	4.6
CPI	0.1	0.5	0.6	0.7	1.3	1.6	2.1	1.4
Current Account Balance % of GDP	-2.7	-2.8	-3.3	-3.7	-2.2	-2.7	-3.9	-3.8

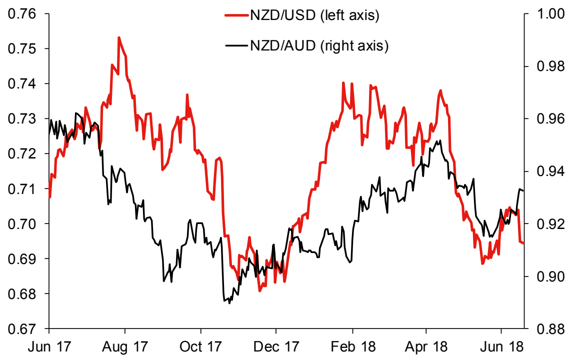
[1] Annual average % change

Financial Forecasts	Sep-18	Dec-18	Mar-18	Jun-18	Sep-19	Dec-19
Cash	1.75	1.75	1.75	1.75	1.75	2.00
90 Day bill	2.00	2.00	2.00	2.00	2.10	2.20
2 Year Swap	2.20	2.30	2.40	2.55	2.70	2.80
5 Year Swap	2.75	2.90	3.05	3.15	3.25	3.30
10 Year Bond	3.00	3.20	3.30	3.35	3.40	3.45
NZD/USD	0.68	0.67	0.65	0.65	0.64	0.65
NZD/AUD	0.91	0.91	0.90	0.90	0.91	0.93
NZD/JPY	75.5	75.0	74.1	73.5	71.7	71.5
NZD/EUR	0.58	0.58	0.57	0.56	0.54	0.54
NZD/GBP	0.52	0.53	0.53	0.53	0.52	0.53
TWI	72.0	71.6	70.2	70.0	69.1	70.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 18 June 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.90%	1.89%	1.88%
60 Days	1.94%	1.95%	1.94%
90 Days	2.01%	2.01%	2.00%
2 Year Swap	2.24%	2.25%	2.23%
5 Year Swap	2.66%	2.68%	2.73%

NZ foreign currency mid-rates as at 18 June 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.7028	0.7027	0.6921
NZD/EUR	0.5967	0.6009	0.5879
NZD/GBP	0.5239	0.5277	0.5138
NZD/JPY	76.77	77.16	76.78
NZD/AUD	0.9259	0.9189	0.9201
TWI	73.88	73.81	73.05

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.2	2.7	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	2.2	1.9
Unemployment %	6.2	5.8	5.7	5.4	5.5	5.6
Current Account % GDP	-3.0	-4.7	-3.1	-2.5	-3.0	-4.2
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	3.9	3.7
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 14 Jun 2018						

Interest Rate Forecasts	Latest	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	2.07	1.98	1.94	1.90	1.88	1.86	1.85	1.83
10 Year Bond	2.69	2.90	3.05	3.20	3.10	3.10	3.00	3.00
International								
Fed Funds	1.875	2.125	2.125	2.375	2.625	2.625	2.625	2.625
US 10 Year Bond	2.93	3.10	3.35	3.50	3.50	3.40	3.20	3.10
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.30	−0.30	−0.20	−0.10

Exchange Rate Forecasts	Latest	Sep-18	Dec-18	Mar-18	Jun-19	Sep-19	Dec-19	Mar-20
AUD/USD	0.746	0.75	0.74	0.72	0.72	0.70	0.70	0.72
USD/JPY	110.75	111	112	114	113	112	110	109
EUR/USD	1.157	1.17	1.16	1.15	1.16	1.18	1.20	1.21
AUD/NZD	1.073	1.10	1.10	1.11	1.11	1.09	1.08	1.09

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

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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