Weekly Commentary

20 August 2018

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Low for longer

After digesting the latest Monetary Policy Statement from the Reserve Bank, we have concluded that the OCR will now remain on hold for longer than we had previously assumed. That's not to say we've been surprised by unexpected weakness in the economy. On the contrary, the economic slowdown currently in train is something we have consistently warned about over the past year. Rather, it's the RBNZ's behaviour under new Government Adrian Orr that has changed.

Last week we changed our view on when we think the RBNZ is most likely to raise rates. Previously we had the first rate hike pencilled in for November 2019. We now think the OCR will remain on hold until May 2020, rising slowly thereafter. What's more, there's a decent chance that the RBNZ will cut rates in the next twelve months (we put the odds at one in three).

Importantly, this change in view has little to do with the state of the economy. We have long warned of a slowdown in growth in 2018 and predicted that the RBNZ would become more dovish as its more upbeat view converged with our own more pessimistic outlook. Indeed that is broadly what's happened (though, as is often the case, the RBNZ lurched even further than we expected).

Instead, the main reason for our change in call is the RBNZ's apparent change in behaviour with new Governor at the helm. Recent RBNZ communications have consistently surprised on the dovish side of the spectrum, with the biggest shift in last week's Monetary Policy Statement – a move that was bigger than can be explained by data surprises alone. We strongly suspect that the new regime will be keener to shore up GDP growth when it flags, and more willing to take a risk when inflation is rising. Essentially, the Reserve Bank has become more dovish.

Given this backdrop, the key question is whether or not the Reserve Bank will go so far as to cut the OCR, having already warned it is "nearer the trigger point". While we think such a move is possible, it would require the data to disappoint relative to the RBNZ's expectations. And our view is that that is unlikely. In particular, June quarter GDP will probably print closer to 1% than the 0.5% the RBNZ is forecasting, and we think September quarter inflation will be 1.7% in contrast to the RBNZ's 1.4% pick. What's more, the surprisingly dovish RBNZ statement has seen the NZ dollar plunge and it now sits well below the RBNZ's assumption.

These data surprises are likely to coincide with signs of more broad-based improvements in the economy. The Government's Families Package has boosted the incomes of some households and is expected to support spending in the coming months, government consumption is ramping up, and the falling exchange rate will boost the incomes of exporters. Consequently, we expect GDP growth to temporarily accelerate to 3.1% over 2019.

The expectation of lower interest rates will filter through other aspects of our economic forecasts. The New Zealand dollar has fallen sharply to just under 66 cents against the US dollar and momentum is still downward at present. However, later this quarter we expect a rash of positive data to arrest this decline or even cause a temporary pop higher. Over a longer horizon, we retain our view that the NZD/USD will depreciate further. We expect the NZD/USD to fall to 64 cents by September this year, lingering at these levels for a time before gradually moving higher as interest rate

Low for longer... continued

differentials once again start moving in favour of a firmer NZD/USD.

Lower interest rates will also impact the housing market, where they will provide something of a counterbalance to the swathe of Government policies aimed at cooling investor activity.

Last week's REINZ data suggested the trend in the housing market remains fairly subdued. It showed July was a solid month for house prices (which were up 0.5% in the month) but a very weak month for sales, which fell almost 6%. The housing market in Auckland remains much weaker than other regions.

But the market reaction to the Monetary Policy Statement has seen wholesale interest rates drop significantly. We estimate this will lead to a 0.2% drop in two year fixed mortgage rates over the next couple of months. And with mortgage rates a crucial determinant of housing market developments, lower mortgage rates should give the housing market temporary a leg up in early 2019. We also expect the Reserve Bank to ease its loan-to-value restrictions in the November Financial Stability Report, with the change to come into effect in January.

While these will be important positive developments, we retain our negative outlook on house prices over the longer term. The foreign buyer ban was passed by Parliament last week and will shortly come into effect. Although this is a watered-down version of the original bill (with foreigners still allowed to buy new apartments in large developments and multi-storey blocks), we still expect it to have a significant impact on the housing market – particularly in Auckland and Queenstown where most foreign purchases take place. And the Tax Working Group is due to issue an interim report next month, which should give some indication of where capital gains or other property taxes sit on the Government's agenda. In addition, interest rates won't remain this low forever. Eventually rising mortgage rates will hit the housing market. We're forecasting a house price decline of almost 3% for 2020.

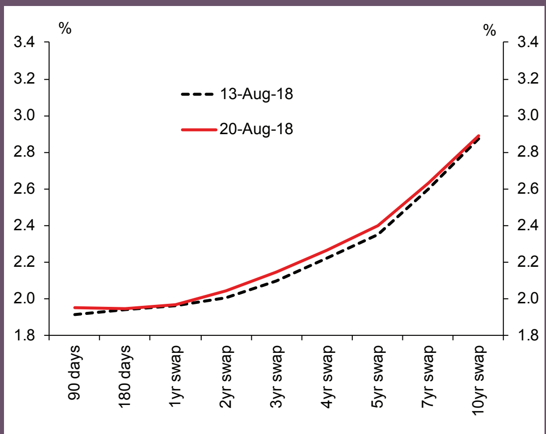
Fixed vs Floating for mortgages

We see scope for fixed-term mortgage rates to fall in the near term, as the market adjusts 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 usually 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



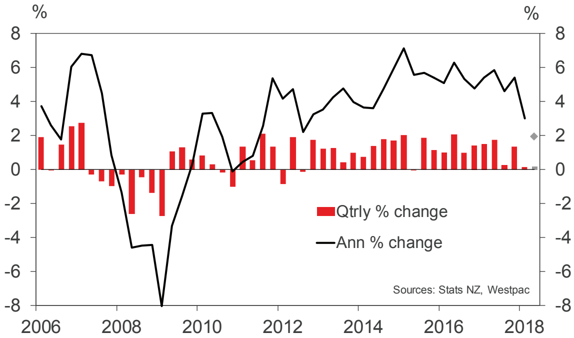
The week ahead

NZ Q2 real retail sales

Aug 22, Last: +0.1%, Westpac f/c: +0.2%, Mkt f/c: +0.4%

- After adjusting for price changes, retail spending was essentially flat over the March quarter. Much of the weakness in spending was concentrated on fuel and vehicle spending (dampened respectively by rising petrol prices and delays with vehicle importation). Spending in core categories rose by 0.6% over the quarter.
- We expect that overall retail spending will rise by 0.2% in the June quarter, including a 0.3% rise in the core categories. This modest pace of growth is consistent with the cooling in the housing market that is weighing on spending appetites.
- The key risk around our forecasts are recent delays with vehicle imports. It is not clear how much of this was captured in the March quarter, and we could see a larger than expected bounce back in this category.

Real retail sales

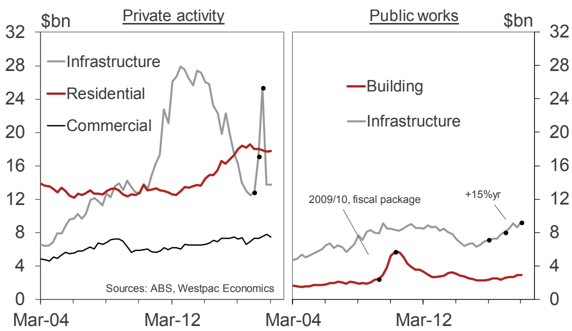


Aus Q2 construction work

Aug 22, Last: 0.2%, WBC f/c: 0.8%
Mkt f/c: 0.8%, Range: -0.3% to 2.9%

- Construction work consolidated in the March quarter, edging 0.2% higher to be 5% above the level of a year ago. Strength in public works in the quarter outweighed a surprise dip in private non-residential building activity.
- For the June quarter, we anticipate a modest gain of 0.8%. The strong upswing in public construction likely extended into the June quarter, with considerable further upside. We expect non-residential building work to rebound, consistent with approvals and the sizeable work pipeline.
- Home building activity is expected to be relatively flat, as work in the sector crests at a high level ahead of a downturn in 2019. An uncertainty is private infrastructure work, we've factored in a modest fall as work on the gas projects is completed.

Construction work: by segment

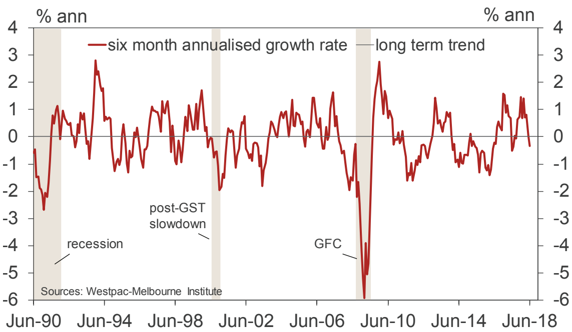


Aus Jul Westpac–MI Leading Index

Aug 22, Last: –0.33%

- The Leading Index has been pointing to a clear slowing in momentum since the start of the year. The six month annualised growth rate came in at –0.33% in June, the first negative since September last year, pointing to a below trend growth pace well below the comfortably above trend reads seen late last year.
- The July reading looks likely to be a little more positive. It will include several components with more positive updates, in particular, dwelling approvals which rose 6.4% vs -2.5% last month; and total hours worked which will incorporate two positive monthly updates since the last leading index release (+0.7% in June and +0.2% in July vs –1.3% in May). Other components have been more mixed: the ASX200, up 1.4% vs 3% last month; but consumer sentiment components softer and the remaining components – US industrial production, AUD commodity prices, and the yield spread unchanged.

Westpac-MI Leading Index



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
UK	Aug Rightmove house prices	–0.1%	–	–	Continuing to fall in London, moderate gains elsewhere.
US	Fedspeak	–	–	–	Bostic speaks on the economic outlook in Tennessee.
Tue 21					
NZ	Jul net migration	4840	–	5000	Annual rate continuing to trend down from high levels.
Aus	RBA minutes	–	–	–	Additional colour around risks to the central view.
	RBA Governor Lowe speaks	–	–	–	Remarks, ASIC's National Financial Capability Strategy, 8am
Chn	Trade delegation meets with US	–	–	–	21–22 meeting between country representatives.
UK	Jul public sector borrowing, $bn	4.5	–2.0	–	Borrowing requirements have been much lower than expected.
Wed 22					
NZ	GlobalDairyTrade auction	0.0%	–	–	After falling in July, prices have been relatively stable lately.
	Q2 retail sales	0.1%	0.4%	0.2%	Spending growth stalled through the first half of the year.
Aus	Jul Westpac–MI Leading Index	–0.33%	–	–	Dropped back below trend in June but July looking better.
	Q2 construction work	0.2%	0.8%	0.8%	Public construction upswing + rebound in non–res building.
	RBA Dep. Governor Debelle speaks	–	–	–	Low inflation, Economic Society, Brisbane, 1:10pm
US	Jul existing home sales	–0.6%	1.3%		Supply remains the key issue for volumes.
Thu 23					
Aus	RBA Asst. Gov. Boulton speaks	–	–	–	Asst. Gov. Bus Services, Business Banking Summit, 12:45pm
Chn	2nd round tariffs	–	–	–	Scheduled 25% tariffs on $16bn of US goods implemented.
Eur	Aug Markit manufacturing PMI flash	55.1	55.3	–	Euro Area PMIs look to be stabilising...
	Aug Markit services PMI flash	54.2	54.5	–	... after coming off highs. Indicative of robust growth.
	Aug consumer confidence prelim.	–0.6	–0.6	–	Softening in GDP and geopolitics to be assessed.
US	Initial jobless claims	212k	–	–	Very low and will remain that way.
	Jun FHFA house prices	0.2%	–	–	Price growth to persist, albeit likely at a lesser pace.
	Aug Markit manufacturing PMI flash	55.3	55.0	–	Effect of higher dollar and trade tensions...
	Aug Markit services PMI flash	56.0	56.0	–	.... to take time to work through.
	Jul new home sales	–5.3%	3.0%	–	Mortgage rates remain accommodative.
	Aug Kansas City Fed index	23	–	–	Remains strong.
	Jackson Hole policy symposium	–	–	–	23–25, focus on impacts of market structure change.
	2nd round tariffs	–	–	–	Scheduled 25% tariffs on $16bn China goods implemented.
Fri 24					
NZ	Jul trade balance, $m	-133	–	–400	Seasonal decline in exports; underlying pulse is improving.
US	Jul durable goods orders	0.8%	0.8%	–	Anecdotes imply investment growth to be subdued in H2.
	Fed Chair Powell speaks	–	–	–	'Monetary Policy in a Changing Economy' at Jackson Hole.

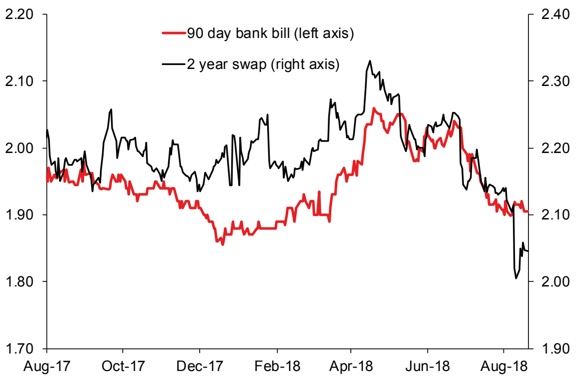
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2018				Calendar years			
% change	Mar (a)	Jun	Sep	Dec	2016	2017	2018f	2019f
GDP (Production)	0.5	1.0	0.6	0.7	4.0	2.8	2.8	3.1
Employment	0.6	0.5	0.4	0.3	5.8	3.7	1.8	1.4
Unemployment Rate % s.a.	4.4	4.5	4.5	4.6	5.3	4.5	4.6	4.6
CPI	0.5	0.4	0.7	0.3	1.3	1.6	1.9	1.3
Current Account Balance % of GDP	-2.8	-2.9	-3.2	-3.3	-2.2	-2.7	-3.3	-3.4

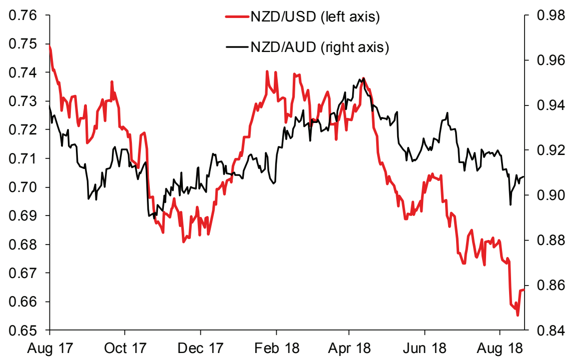
[1] Annual average % change

Financial Forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-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	1.95	2.00
2 Year Swap	2.00	2.10	2.20	2.30	2.45	2.60
5 Year Swap	2.50	2.65	2.80	2.90	3.05	3.15
10 Year Bond	2.70	2.90	3.10	3.15	3.25	3.35
NZD/USD	0.67	0.66	0.65	0.65	0.64	0.64
NZD/AUD	0.91	0.89	0.90	0.90	0.91	0.91
NZD/JPY	74.37	73.9	73.5	73.1	71.7	70.4
NZD/EUR	0.58	0.57	0.57	0.56	0.55	0.53
NZD/GBP	0.52	0.52	0.53	0.53	0.52	0.52
TWI	72.46	71.5	71.0	70.5	69.8	69.4

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 20 August 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.79%	1.81%	1.82%
60 Days	1.84%	1.85%	1.87%
90 Days	1.95%	1.91%	1.92%
2 Year Swap	2.05%	2.12%	2.15%
5 Year Swap	2.40%	2.55%	2.53%

NZ foreign currency mid-rates as at 20 August 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6641	0.6747	0.6791
NZD/EUR	0.5805	0.5830	0.5787
NZD/GBP	0.5209	0.5188	0.5172
NZD/JPY	73.46	75.05	75.57
NZD/AUD	0.9080	0.9120	0.9153
TWI	72.13	73.06	73.23

International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017	2018f	2019f
Australia						
Real GDP % yr	2.6	2.5	2.6	2.2	2.8	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	1.7	1.7
Unemployment %	6.2	5.8	5.7	5.4	5.5	5.6
Current Account % GDP	-3.0	-4.7	-3.1	-2.5	-2.4	-3.4
United States						
Real GDP %yr	2.6	2.9	1.5	2.3	2.9	2.5
Consumer Prices %yr	1.6	0.1	1.4	2.1	2.5	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	1.1	1.0
Euro zone						
Real GDP %yr	1.3	2.1	1.8	2.3	2.0	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	4.4	4.3
World						
Real GDP %yr	3.6	3.5	3.2	3.8	3.8	3.7
Forecasts finalised 13 August 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 BBSW	1.95	2.02	2.00	1.97	1.97	1.92	1.92	1.87
10 Year Bond	2.55	2.75	3.05	3.20	3.10	3.10	3.00	3.00
International								
Fed Funds	1.875	2.125	2.375	2.625	2.875	2.875	2.875	2.875
US 10 Year Bond	2.87	3.00	3.35	3.50	3.50	3.40	3.20	3.10
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.40	−0.30	−0.20	−0.10

Exchange Rate Forecasts	Latest	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
AUD/USD	0.7269	0.74	0.74	0.72	0.72	0.70	0.70	0.72
USD/JPY	110.85	111	112	114	113	112	110	109
EUR/USD	1.1380	1.17	1.16	1.15	1.16	1.18	1.20	1.21
AUD/NZD	1.1021	1.10	1.12	1.11	1.11	1.09	1.09	1.11

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