

Weekly Commentary

21 May 2018



The “patient” Budget

Last week all eyes were on the Labour-led coalition Government’s maiden Budget. In the end it was a rather bland affair. The stronger than expected economy delivered extra tax revenue, but this was promptly gobbled up by increased health spending, leaving the crumbs to be scattered across a range of smaller initiatives in other sectors.

Last week’s Budget followed a similar script to the final few Budgets under the previous Government. The economy has proved stronger than expected, and that has delivered surprisingly strong tax revenue. But the Government has found that delivering the health outcomes people want is more expensive than forecast. So most of the extra money was channelled into health, and there was precious little left over for anything else. Labour kept its coalition partner happy by boosting funding for ministries headed by New Zealand First politicians, and education got most of the remainder.

Initiatives announced in the health sector included extending free GP visits to children under 14 years old, and a \$20-\$30 reduction in the cost of GP visits for community service card holders. In education, the focus shifted toward childhood education from tertiary education, giving much more bang for buck. However, the quantum was disappointingly small. Especially when compared to the money poured into free tertiary education and bigger student allowances at last year’s Half Year Update which will do much less for society as the benefits mostly accrue to people who are already doing relatively well.

The Government stuck to its self-imposed Budget Responsibility Rules. We think that was appropriate. The economy is in a bit of a sweet spot, so now is the time to save for a rainy day. The future might hold a recession or a natural disaster, and we know that the aging population

will be hugely expensive. A line in the sand is also a good way to avoid white-elephant spending by encouraging prioritisation within a spending limit.

One of the responsibility rules, perhaps the only binding one, is to bring net debt below 20% of GDP within five years of taking office. With only slightly smaller accumulated surpluses, and no new capital spending, there was little change in the forecast for net core Crown debt after five years. The latest projections see it drop to 19.1% of GDP by 2022, leaving the government with some wiggle room.

That might prove useful if, as we expect, growth disappoints relative to Treasury’s projections. Although the Treasury’s growth forecasts are a little softer in the near-term, they still have a reasonably strong outlook over the next five years, with GDP assumed to average close to 3% per annum. We expect that both nominal and real GDP growth will undershoot the Treasury’s forecasts. That signals some associated downside risks for tax revenue collections and projected surpluses.

The other place the Government has generated a bit of wiggle room is by plans to increase borrowing by Crown entities. This borrowing is technically not counted as core Crown debt, though it is a bit of a grey area. For example, Housing New Zealand intends to borrow in its own name to fund the building of new state houses, with the trade-off that it may end up paying a higher interest rate than if the investment had been funded by central Government. This

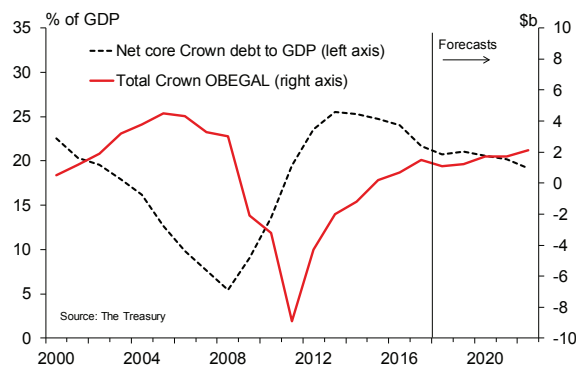
The “patient” Budget continued

switch won't fool investors who lend money to NZ or ratings agencies who will also keep an eye on total borrowings as well as those strictly defined as core Crown debt. The more borrowing these entities do, the more likely it is to appear on the radar, but we're probably not at that point yet.

The ramp up in spending in this Budget will have inflationary consequences for the economy. Treasury thought these would be significant, and forecast OCR hikes early next year. We view any inflationary consequence as more minor, and more likely to take effect in later years, so we won't be changing our own expectation of the first rate hike in November next year.

One of the risks identified in the Budget was the cost of dealing with the Mycoplasma bovis outbreak – a disease recently discovered in New Zealand for the first time which affects the health of cattle. It makes some sense to note this as a risk as neither the extent of the problem, nor the best response, has been determined yet. But it's also worth noting that the situation has deteriorated in the weeks since the Budget was signed off, with evidence that the disease becoming more widespread throughout the country. These developments have probably swung the dial in favour of farmers learning to manage the disease rather than attempting to eradicate it. Yet, whichever way the decision goes, already fragile confidence in the dairy sector has taken yet another knock.

Operating balance ex gains and losses



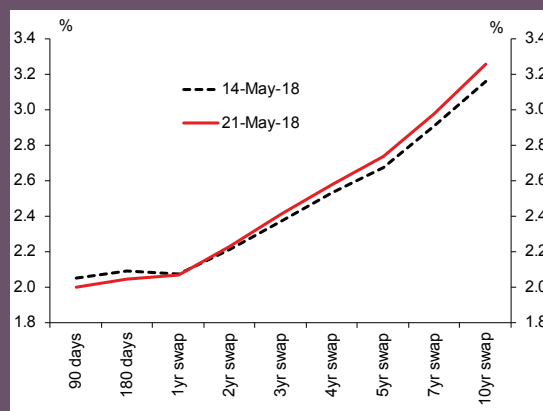
Overall, it was a bland Budget, but we think that was appropriate. New Zealand's economy is in a fairly sweet spot, so now is the time to save for a rainy day. It also leaves the Government with enough tucked up its sleeve for the remainder of its term. So while today's Budget may have been a largely business as usual document, next year's Budget could be a different beast, once the Living Standards Framework is integrated and the working groups on tax, education and social welfare report back with policy ideas.

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



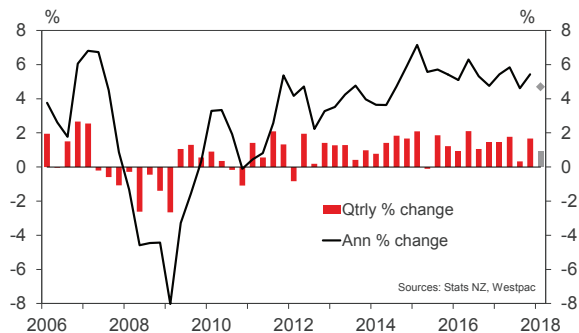
The week ahead

NZ Q1 real retail sales

May 21, Last: +1.7%, Westpac f/c: +0.9%

- Households ended 2017 with a bang. Retail spending rose 1.7% in the December quarter to be up 5.4% over the year. Underpinning the rise in overall spending was a solid 1.8% lift in core categories. That included a 3% increase in spending on hospitality (that was likely encouraged by the hot summer weather), as well as gains in food and grocery sales. There were also solid gains in categories such as clothing and electronics.
- We expect that overall retail spending rose by 0.9% in the March quarter. Spending has been held back by reduced expenditure on fuel and vehicles, with the latter affected by recent delays with importing. Core spending, in contrast, is expected to have risen by a solid 1.7%. That includes a continued lift in durables spending supported by the firming in the housing market in early 2018. Consumables spending is also expected to have been firm.

Real retail sales

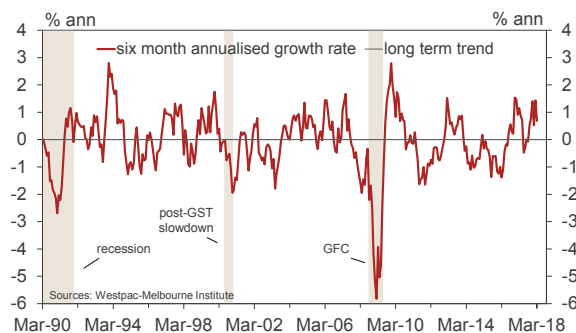


Aus Apr Westpac-MI Leading Index

May 23, Last: +0.69%

- The six month annualised growth rate in the Leading Index fell from +1.43% in February to +0.69% in March. While down, the growth rate is still in positive territory, signalling above trend momentum over much of the remainder of 2018. Drivers of the slowdown were domestic – a slowing labour market; and some weakness in housing while rising short term interest rates have reflected liquidity pressures from global markets. The April read will include mostly positive component updates, including: the ASX200, up 3.9% vs -4.3% last month; the Westpac-MI Consumer Expectations Index, up 0.8% vs -0.9% last month; US industrial production, up 0.7% vs 0.7% last month; dwelling approvals, up 2.6% vs -4.2% last month; the Westpac-MI Unemployment Expectations Index, down -4.5% vs 3.1% last month; and total hours worked, up 1.1% vs 0.2% last month. The drag from narrowing yield spreads has also moderated although global commodity price moves have been less positive (down -3% in AUD terms vs 2% last month).

Westpac-MI Leading Index



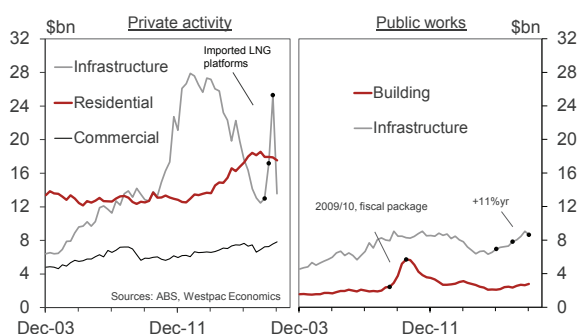
Aus Q1 construction work

May 23, Last: -19.4%, WBC f/c: 0.7%

Mkt f/c: 1.3%, Range: -2.0% to 5.0%

- Recently, the Construction Work survey has been impacted by imported LNG platforms. The survey includes their full value when imported, rather than actual work in the period, as in the national accounts. 'Construction Work' rose 9.8% in Q2 and climbed a further 16.6% in Q3 (boosted by imports of platforms), then reversed 19.4% in Q4.
- For Q1, we expect a small rise of 0.7%, anticipating no further impact from LNG platforms.
- Upswings in public construction and commercial building are likely positives, as well as housing renovations. Potential negatives are: new home building, with approvals off their peaks; and private infrastructure (with a decline in mining as the final gas projects are completed offsetting a lift in non-mining infrastructure).

'Construction work' impacted by LNG platforms



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
NZ	Apr net migration	5480	-	5460	Migration is still elevated, but is gradually easing back.
	Q1 real retail sales	1.7%	1.0%	0.9%	Core to remain firm, supported by a lift in durables spending.
Eur	ECB speak	-	-	-	Nowotny at Czech National Bank event.
UK	May Rightmove house prices	0.4%	-	-	London weak. Prices in other regions firmer, but still soft.
US	Apr Chicago Fed activity index	0.1	-	-	A touch above trend.
	Fedspeak	-	-	-	Bostic speaks on welfare economics at the Atlanta club.
	Fedspeak	-	-	-	Harker speaks at Chief Executives Organisation seminar.
	Fedspeak	-	-	-	Kashkari in moderated Q+A in Michigan.
Tue 22					
UK	Apr public sector net borrowing, £b	-0.3	-	-	Deficit improved. Concerns on spending needs post-Brexit.
US	May Richmond Fed index	-3	-	-	Regional indexes a mixed bag currently.
Wed 23					
Aus	Apr Westpac-MI Leading Index	-0.22%	-	-	Growth pulse has been choppier in 2018 but still above trend.
	Q1 construction work	-19.4%	1.3%	0.7%	Survey recently distorted by LNG platform imports.
	RBA Governor Lowe speaking	-	-	-	Outlook for China (TBC), Sydney 6.00pm AEST.
Eur	May Markit manufacturing PMI flash	56.2	56.1	-	PMI's look to have rolled over on a broad basis...
	May Markit services PMI flash	54.7	54.5	-	... but level still positive.
	May consumer confidence prelim.	0.4	0.5	-	Households remain optimistic.
UK	Apr CPI	0.1%	0.5%	-	Effect of GBP's fall is fading, pulling annual inflation down.
	Mar house prices index, %yr	4.4%	-	-	Uncertainty weighing on prices, especially in London.
US	May Markit manufacturing PMI flash	56.5	56.1	-	Mixed outcomes for regional surveys...
	May Markit services PMI flash	54.6	-	-	... point to a deceleration in Markit and ISMs.
	Apr new home sales	4.0%	-2.2%	-	Very volatile, but rates yet to have material impact.
	FOMC meeting minutes	-	-	-	Detail on risks ahead key.
Thu 24					
NZ	Apr trade balance, NZ\$m	-86	198	100	Meat and dairy exports shaping up stronger.
Aus	RBA Assist Gov Bullock speaking	-	-	-	De Nederlandsche Bank Housing Mkt seminar, Amsterdam.
Eur	EU/EA finance ministers meet	-	-	-	Brussels, 24-25.
UK	Apr retail sales	-1.2%	0.0%	-	Poor weather drag fading, real incomes squeeze a headwind.
US	Initial jobless claims	222k	-	-	Very low.
	Mar FHFA house prices	0.6%	-	-	Showing good momentum still despite rates.
	Apr existing home sales	1.1%	-0.7%	-	Supply low, creating volatility.
	May Kansas City Fed index	26	-	-	Regional indexes a mixed bag currently.
	Fedspeak	-	-	-	Dudley on reference rate reform at BOE event in London.
	Fedspeak	-	-	-	Harker on the labour market and technology in Dallas.
Fri 25					
UK	Q1 GDP 2nd estimate	0.1%	0.1%	0.1%	Poor weather a drag, underlying softness esp. households.
	BoE Carney speaks	-	-	-	At Sweden's Riksbank conference.
US	Apr durable goods orders	2.6%	-1.4%	-	How strong is the investment upswing to be?
	May Uni. of Michigan sentiment final	98.8	98.9	-	Labour market driving optimism.
	Fed Chair Powell speaks	-	-	-	On financial stability and transparency at Riksbank conf.
	Fedspeak	-	-	-	Kaplan, Evans, and Bostic at Dallas Fed labour market conf.
Sun 27					
Chn	Apr industrial profits %yr	3.1	-	-	Profitability an increasing focus of authorities.

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	0.4	0.6	0.4	0.4	5.8	3.7	1.4	1.0
Unemployment Rate % s.a.	4.5	4.4	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

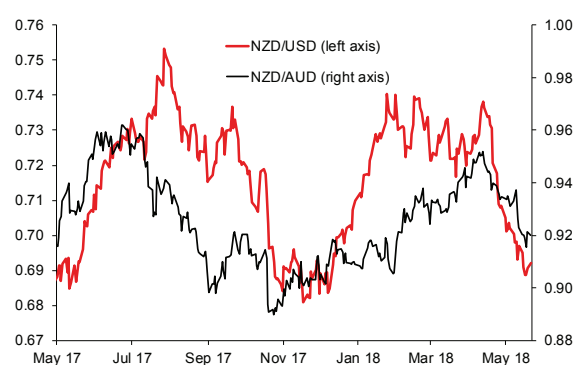
¹ Annual average % change

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	0.71	0.69	0.68	0.66	0.65	0.64
NZD/AUD	0.93	0.92	0.92	0.92	0.92	0.91
NZD/JPY	78.1	76.6	76.2	75.2	73.5	71.7
NZD/EUR	0.59	0.58	0.58	0.56	0.55	0.53
NZD/GBP	0.53	0.52	0.54	0.54	0.53	0.52
TWI	74.0	72.5	72.0	70.6	69.8	68.9

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 21 May 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.88%	1.85%	1.88%
60 Days	1.94%	1.94%	1.97%
90 Days	2.00%	2.04%	2.06%
2 Year Swap	2.23%	2.28%	2.32%
5 Year Swap	2.73%	2.74%	2.77%

NZ foreign currency mid-rates as at 21 May 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6921	0.7021	0.7217
NZD/EUR	0.5879	0.5867	0.5883
NZD/GBP	0.5138	0.5188	0.5154
NZD/JPY	76.78	76.64	77.83
NZD/AUD	0.9201	0.9312	0.9406
TWI	73.05	73.55	74.61

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	1.94	1.98	1.98	1.94	1.90	1.88	1.86	1.85
10 Year Bond	2.92	2.80	2.90	3.10	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	3.12	3.00	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	0.7512	0.76	0.75	0.74	0.72	0.71	0.70	0.70
USD/JPY	110.94	110	111	112	114	113	112	110
EUR/USD	1.1802	1.20	1.19	1.18	1.17	1.18	1.20	1.22
AUD/NZD	1.0905	1.07	1.09	1.09	1.09	1.09	1.09	1.08

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