Weekly Commentary

23 July 2018

Growth finding a floor

Economic news over the past week continued to highlight the flagging momentum in activity through the first half of 2018. However, while the economy has lost some steam, the back half of the year is likely to see a rotation in the drivers of growth, underpinned by a large increase in fiscal spending. This will help to provide a floor under GDP growth over the next year or two. Against this backdrop, we have seen a firming in inflation, with a further lift expected over the next few quarters.

The New Zealand economy slowed through the first half of 2018

The first half of 2018 saw some of the wind coming out of the economy's sails, with annual GDP growth estimated to have slowed to around 2.5% in the year to June. This has broadly matched our expectations for a cooling in private sector demand in the face of a slowing housing market and emergence of capacity constraints. But while GDP growth may have slowed, we certainly wouldn't describe the New Zealand economy as being weak, especially not with unemployment at a ten year low. The economy is now into its eighth year of expansion, and it's normal to see some easing in growth at this late stage of the cycle as spare capacity has been absorbed.

Slowing economic momentum has been seen on several fronts. One of the most important is the housing market. The latest update from REINZ revealed that nationwide house prices fell by 0.1% in June, leaving the level of house prices essentially flat since February. Prices are still 3.8% higher than this time last year. However, that is a far cry from the double-digit rates of increase we saw in recent years.

Softness in house prices has been centred squarely on the Auckland and Canterbury markets, which together account for 40% of sales. Prices in Auckland fell 0.3% in June (their fourth decline in as many months) and have been tracking sideways for close to two years now. Similarly, prices in Canterbury have held steady for an extended period as the region continues its post-earthquake adjustment. Outside of Auckland and Canterbury, we're still seeing reasonable price gains, though the rate of increase has taken a noticeable step down from the frantic pace seen in previous years.

The slowdown in the housing market comes against a backdrop of significant policy changes. The 'Bright Line Test' for taxing capital gains has already been extended. Restrictions on foreign buyers of property are expected to come into force some time next month. Then from early next year, the use of negative gearing by property investors will start to be phased out. Combined with increases in housing supply (which are also being supported by policy changes like the KiwiBuild program and Auckland's Unitary Plan), we expect that these measures will result in house price growth remaining muted for some time.

New Zealanders hold a large portion of their wealth in owner-occupied and investor housing, and we've already seen nominal spending growth flattening off through the first half of the year as the housing market has cooled. Looking ahead, we expect that continued softness in the housing market will weigh on household spending for some time yet (though as discussed below, this will be partially offset by increases in family support payments).

The slowdown in the housing market comes atop other signs that growth has cooled. A range of recent surveys

Growth finding a floor... continued

have highlighted falling confidence and softening activity in the business sector. That message was reinforced by the latest surveys of manufacturing and service sector conditions from BusinessNZ, which pointed towards slowing output growth, as well as a cooling in the demand for workers and a moderation in forward orders in recent months.

Fiscal spending to provide a floor for growth going forward

After cooling in recent months, we expect GDP growth will find a floor through the second half of the year. A key reason for this is that significant increases in Government spending are now being rolled out. That includes around $1.5b of spending on the Government's families package and accommodation support payments, which together will provide a significant boost to the disposable incomes of many households. The coming year will also see big spending increases in other areas, including health and education.

Increases in government spending, along with firmness in some export sectors (including tourism) will help to offset the moderation in private sector demand. Putting it all together, we expect to see the economy growing at rates a little below 3% over the next year or two.

The inflation backdrop is also firming

The other area of the economy where things have been changing is inflation. Consumer prices rose by 0.4% in the June quarter to be up 1.5% over the year. That was a little softer than we had expected, weighed down by some one-off factors (like falls in the prices of imported cars and televisions). However, digging into the details, what we are seeing is an ongoing gradual firming in the economy's underlying inflation pulse. That was reflected in the range of core inflation measures StatsNZ and the RBNZ produce, which are now running at levels approaching 2%. Importantly, this lift in core inflation has been underpinned by a rise in the more persistent domestic components of inflation. Combined with a firming in wage growth and rise in petrol prices, this should see inflation finally rising back to 2% by the end of this year.

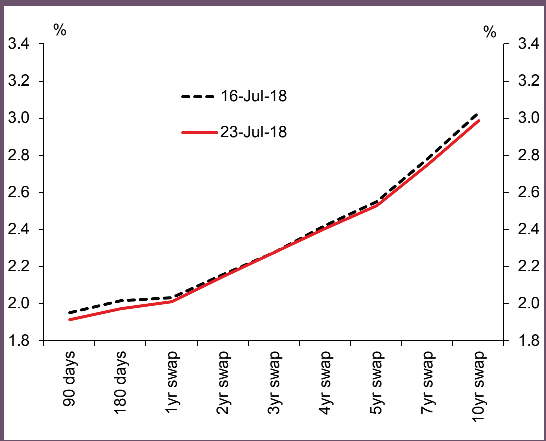
Markets had been flirting with the possibility of a cut from the RBNZ in recent weeks. However, the firming in core inflation has poured cold water on that idea. We continue to expect that the next move in the OCR will be a hike, but don't expect this to occur until the final quarter of 2019. The RBNZ will be mindful that at least some of the current rise in inflation is related to fuel prices, so will likely be temporary. Furthermore, it looks unlikely that inflation will threaten the upper bound of the RBNZ's target band any time soon, particularly given the lingering softness in many retail prices. That means that there's no urgency to adjust rates at this stage.

Fixed vs Floating for mortgages

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.

We expect floating and short-term fixed mortgage rates to rise gradually over the coming few years, meaning that taking a fixed rate may prove worthwhile. 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.

NZ interest rates



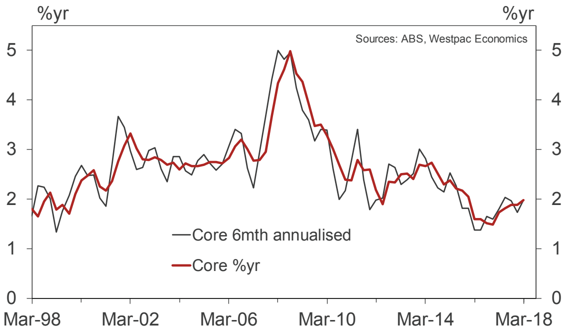
The week ahead

Aus Q2 CPI

Jul 25, Last: 0.4%, 1.9%yr, WBC f/c: 0.4%, 2.1%yr
Mkt f/c: 0.5%, Range: 0.3% to 0.8%

- The Consumer Price index for Q1 was 0.4%qtr, 1.9%yr. For Q2, we anticipate another 0.4% print, lifting the annual figure to 2.1%. The average of the RBA core measures was 0.5%qtr, 2.0%yr in Q1. We anticipate 0.5%qtr, 1.9%yr for Q2.
- In short, inflation is at the bottom of the RBA's target band at a time of weak wages growth, intense competition across retail and supermarkets, as well as a housing slowdown.
- In Q2, petrol prices jumped 6%, adding 0.2ppts to the CPI. Against that, the CPI (which is not seasonally adjusted, unlike the RBA core measures) will be dampened by seasonally soft reads on education and pharmaceuticals.

Core inflation

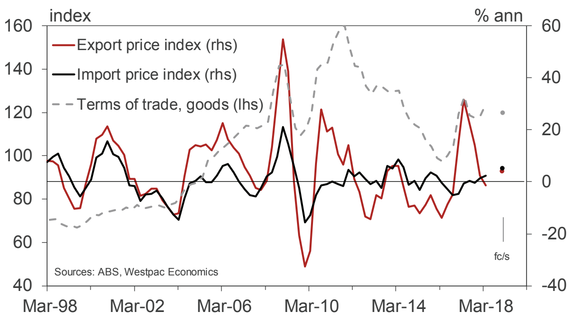


Aus Q2 import price index

Jul 26, Last: 2.1%, WBC f/c: 2.5%
Mkt f/c: 1.9%, Range: 0.5% to 3.5%

- Prices for imported goods increased by 2.1 in the March quarter to be 2.3% above the level a year earlier – moving higher on rising global energy prices and with the Australian dollar pulling back of late.
- For the June quarter, we expect import prices to rise by a further 2.5% to be 5.0% higher than in mid-2017.
- The currency weakened in Q2, making imports more expensive. In the quarter, the dollar fell by 2.6% on a TWI basis to be down by 3.2% over the year.
- The cost of imported fuel increased yet again as oil prices continued their climb.

Import & export goods prices

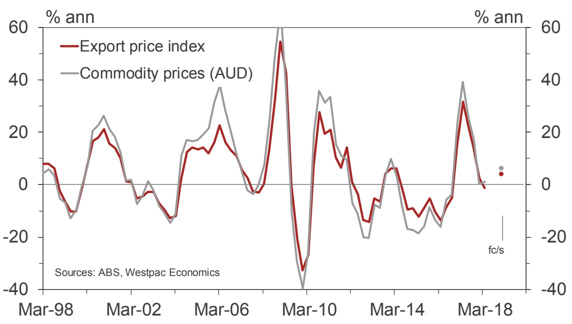


Aus Q1 export price index

Jul 26, Last: 4.9%, WBC f/c: –0.8%
Mkt f/c: –1.3%, Range: –3.0% to 0.0%

- Export prices have been volatile over the past year as global commodity prices fluctuate. The March quarter saw an upward movement in commodity prices, contributing to a near 5% bounce in the export goods price index – but that still left the index 1.4% below the level of a year earlier.
- In the June quarter, commodity prices reversed. We expect the export price index to decline by 0.8% in Q2 despite the lower dollar boosting export earnings.
- The terms of trade for goods, on these estimates, retreated by a little in excess of 3% in the June quarter.
- As to prices for services, an update will be available with the release of the Balance of Payments on September 4.

Commodity prices & export price index

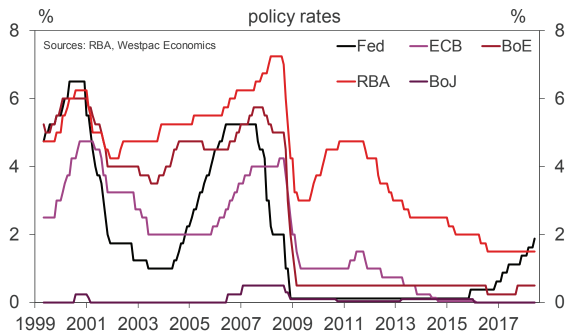


ECB July policy meeting

Jul 26, last –0.40%, WBC –0.40%

- With such clear and purposeful guidance on policy delivered in June, the July ECB meeting feels like a non-event. We know that asset purchases will be tapered again from October before ending completely in December, and that interest rates are on hold until the end of next summer.
- What then is the point of closely scrutinising the July post-meeting communications? In short, the Governing Council's assessment of global risks.
- Of greatest significance will be their view on the effect mounting trade tensions are having on Europe's economy, both businesses and households. Also crucial to the outlook is global financial stability and market liquidity. Finally, we expect another clear warning on the threat that European politics pose to the region's long-term productivity and prosperity.

ECB to hold off on rate hikes till Q3 2019



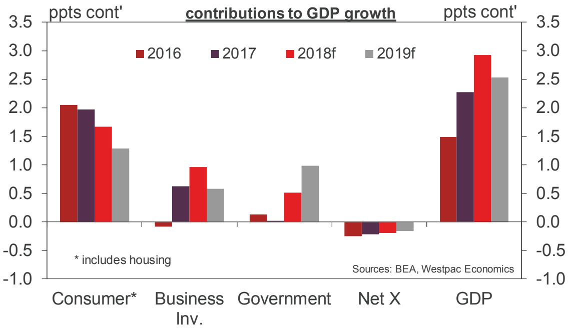
The week ahead

US Q2 GDP, % annualised

Jul 27, last 2.0%, WBC 4.2%

- A very strong Q2 outcome has long been expected by the market. Following a modest gain of 2.0% in Q1, in part because of particularly poor weather, US GDP is set to bounce over 4.0%. There are a number of risks, primarily around deflators for trade and consumption, that could see the final number come out anywhere between 3.5% and 4.5% annualised. But to us the most likely outcome is circa 4.2%. In terms of the components, trade and government spending are expected to be strong positives, with business investment and consumption also set to provide support.
- Following this release, attention will quickly turn to the second half of 2018. Here, expectations are also very high, but to us so are the risks. In recent business investment data, there has been signs of a softening, and anecdotes on the effect from tariffs are rising. Real income growth for the consumer is also a looming constraint.

US growth pulse to narrow



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 23					
Eur	Jul consumer confidence advance	–0.5	–0.7	–	Still robust, but at risk.
US	Jun Chicago Fed activity index	–0.15	–	–	Higher USD and tariffs to weigh in time.
	Jun existing home sales	–0.4%	0.9%	–	Have been soft of late; supply the main cause.
Tue 24					
Eur	Jul Markit manufacturing PMI flash	54.9	54.7	–	Stabilising after early 2018 weakness...
	Jul Markit services PMI flash	55.2	55.0	–	... momentum still robust.
US	May FHFA house prices	0.1%	–	–	Robust.
	Jul Markit manufacturing PMI flash	55.4	55.3	–	Is less positive than ISM's...
	Jul Markit services PMI flash	56.5	–	–	... mix of business surveyed key.
	Jul Richmond Fed index	20	18	–	Highly volatile this year.
Wed 25					
NZ	Jun trade balance, $m	294	25	200	Trade balance entering its seasonal decline.
Aus	Q2 CPI	0.4%	0.5%	0.4%	Annual CPI lifts to 2.1% from 1.9%, core dips to 1.9% from 2.0%.
	Q2 avg RBA core measures	0.5%	0.5%	0.5%	Petrol prices add 0.2ppts in Q2, but o/w lack of price pressure.
Eur	Jun M3 money supply %yr	4.0%	4.0%	–	Credit data also due.
US	Jun new home sales	6.7%	–2.8%	–	Volatile month to month.
Thu 26					
Aus	Q2 import price index	2.1%	1.9%	2.5%	Cost of imports up on lower AUD & higher oil prices.
	Q2 export price index	4.9%	–1.3%	–0.8%	Export prices dip, on commodity price pull-back.
Eur	ECB policy decision	–0.4%	–0.4%	–0.4%	Focus to be on risks, given policy course set.
US	Jun wholesale inventories	0.6%	–	–	Will add materially to growth in Q2.
	Jun durable goods orders prelim.	–0.4%	3.0%	–	Transport creating considerable volatility.
	Initial jobless claims	207k	–	–	Keeps breaking lower.
	Jul Kansas City Fed index	28	–	–	On an uptrend.
Fri 27					
NZ	Jul ANZ consumer confidence	120.0	–	–	Confidence measures have cooled through mid-2018.
Aus	Q2 PPI	0.5%	–	–	Preliminary demand prices tracking ahead of final demand.
UK	Jul Nationwide house prices	0.5%	–	–	Price growth muted, weighed down by weakness in London.
Chn	Jun industrial profits %yr	21.1%	–	–	Elevated thanks to commodities & push for profitability.
US	Q2 GDP 1st estimate % annualised	2.0%	4.0%	4.2%	Unquestionably strong. What will H2 2018 bring?
	Jul Uni. of Michigan sentiment	97.1	97.2	–	Labour market a strong support.

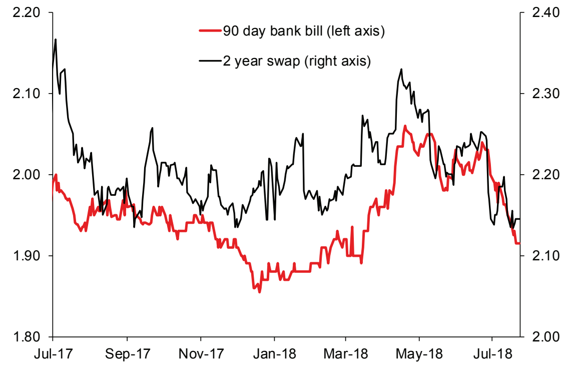
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2018				Calendar years			
% change	Mar (a)	Jun	Sep	Dec	2016	2017	2018f	2019f
GDP (Production)	0.5	0.7	0.8	0.7	4.0	2.8	2.6	3.2
Employment	0.6	0.2	0.3	0.3	5.8	3.7	1.4	1.4
Unemployment Rate % s.a.	4.4	4.4	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	1.4
Current Account Balance % of GDP	-2.8	-3.0	-3.2	-3.2	-2.2	-2.7	-3.2	-3.0

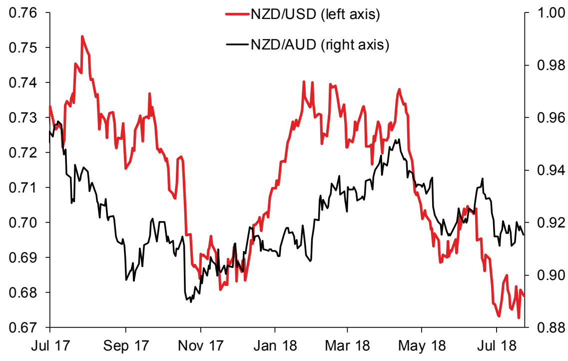
[1] Annual average % change

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	2.70	2.85	3.00	3.15	3.25	3.30
10 Year Bond	2.90	3.15	3.30	3.35	3.40	3.45
NZD/USD	0.68	0.67	0.65	0.65	0.64	0.65
NZD/AUD	0.92	0.91	0.90	0.90	0.91	0.93
NZD/JPY	76.2	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	73.4	72.7	71.2	70.9	70.1	70.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 23 July 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.82%	1.87%	1.90%
60 Days	1.87%	1.93%	1.96%
90 Days	1.92%	1.99%	2.04%
2 Year Swap	2.15%	2.19%	2.25%
5 Year Swap	2.53%	2.57%	2.66%

NZ foreign currency mid-rates as at 23 July 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6791	0.6839	0.6915
NZD/EUR	0.5787	0.5824	0.5929
NZD/GBP	0.5172	0.5133	0.5217
NZD/JPY	75.57	75.51	75.97
NZD/AUD	0.9153	0.9203	0.9294
TWI	73.23	73.16	73.60

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	1.8	1.8
Unemployment %	6.2	5.8	5.7	5.4	5.5	5.6
Current Account % GDP	-3.0	-4.7	-3.1	-2.5	-2.8	-4.0
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	1.2	1.0
Euro zone						
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 6 July 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	1.98	2.04	2.02	1.95	1.95	1.90	1.90	1.85
10 Year Bond	2.62	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	2.84	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	0.7365	0.74	0.74	0.72	0.72	0.70	0.70	0.72
USD/JPY	112.24	111	112	114	113	112	110	109
EUR/USD	1.1661	1.17	1.16	1.15	1.16	1.18	1.20	1.21
AUD/NZD	1.0906	1.09	1.10	1.11	1.11	1.09	1.08	1.09

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