

Weekly Commentary

24 September 2018



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Trundling along

The economy fared better than expected in the June quarter, and more recent data indicate that activity is trundling along. Against this backdrop, we expect the RBNZ will stay pat at this week's OCR review, but the risks for financial markets are still skewed in the direction of lower interest rates. We expect the tone of the September OCR review will be either neutral or dovish, and we still think that any sign of weakness in the data could prompt an OCR cut at some stage – we put the odds of a cut over the coming year at one in three.

The latest GDP figures have helped to allay concerns that the economy is heading into a slump, with economic activity expanding by a solid 1% through the June quarter. We've been highlighting the likelihood of a strong June quarter result for some time and were forecasting a gain of 0.9%. On the day, not only was the result strong like we expected, the details were also encouraging for the economy's prospects. Growth was widespread across industries, with solid gains in areas like agriculture, retail and recreational services. Meanwhile, one-off factors actually played less of a role than we expected.

Importantly, the result was well above the 0.5% increase the RBNZ was factoring in at the time of its last interest rate decision back in August.

As we've moved into the back half of the year, a number of key gauges of economic activity have remained healthy. Notably, there's been continued firmness in retail spending and ongoing strength in dwelling consent numbers. Fixed mortgage rates have also fallen sharply since the RBNZ's August policy statement, which could boost the housing market.

But there are also some clouds on the horizon. One of those is dairy prices, which dropped 1.3% in the latest auction and which have been falling steadily since May. Combined with favourable supply conditions, recent falls in prices have prompted us to lower our forecast for this season's farm

gate milk price to \$6.25 (down from \$6.50). While that's still above the breakeven level for most farmers, it means that returns are set to disappoint relative to Fonterra's more bullish forecast for a \$6.75 milk price.

The other, and perhaps more worrisome, cloud on the horizon is waning economic confidence, which could have important implications for spending and hiring. Nervousness has been evident in the business sector for some time. And it now looks like that nervousness has spread to the household sector, with the Westpac-McDermott Miller Consumer Confidence Index falling to a six year low in September. Households are concerned about the outlook for their own finances and the general economy over the next year, with confidence at particularly low levels in Auckland. That's despite the boost to many households' disposable incomes as a result of the Government's Family's package, and signals some challenge to our forecast for slow but steady growth in household spending over the coming years.

So, what will the Reserve Bank make of all this as they head into their September Official Cash Rate review? With GDP growth surprising to the upside of the RBNZ's forecasts, the chance of an OCR cut in the near future seems distant. Financial markets have reacted accordingly, with the New Zealand dollar rising half a cent and the two-year swap rate rising by five basis points after the GDP release.

Trundling along... continued

However, the strong GDP figures do need a little context. Firstly, the June quarter result is a bit dated from a policy perspective - although the RBNZ is conscious of where the economy has been, they're more focused on where we're heading.

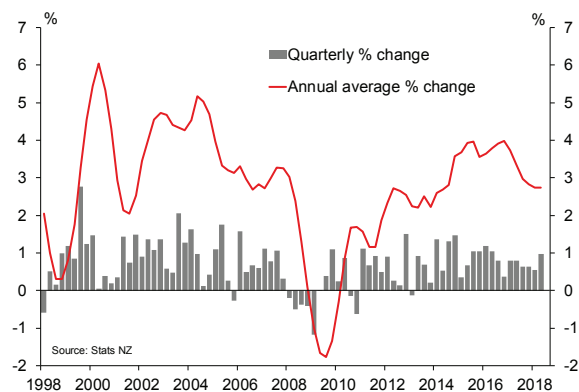
Secondly, the RBNZ actually wants the economy to be growing at a solid pace. With lingering softness in imported inflation, the RBNZ needs the domestic economy to be firing on all cylinders to achieve its 2% target for overall inflation. That came through very clearly at the time of the August *Monetary Policy Statement* when the RBNZ announced that it expected to keep the OCR at its current low level of 1.75% "through 2019 and into 2020" - a longer pause than had previously been forecast. On top of that, subsequent comments from RBNZ Assistant Governor McDermott noted that the RBNZ's OCR forecast was predicated on the economy accelerating, and if that acceleration failed to materialise, the RBNZ would have to consider cutting.

Against this backdrop, we expect an on-hold decision this week, and that the RBNZ will signal the OCR is set to remain at an expansionary level for a considerable time. However, there's a bit more uncertainty regarding the tone of the policy statement. We expect it to be either neutral or dovish from a market point of view - we ascribe equal probabilities to either outcome. A neutral Statement would simply restate that the next move could be "up or down." Alternatively, the RBNZ could plausibly adopt a "soft" easing bias, explicitly warning that if the economy fails to

accelerate as expected, the OCR could fall. That would match RBNZ comments made in the media, and would be in the spirit of open and frank communication that the RBNZ has embraced.

Our central expectation is that the OCR will remain on hold until mid-2020. However, we put the odds of an OCR cut over the coming year at one in three. The RBNZ still has lofty expectations for the economy - they are forecasting 3.5% annual GDP growth for 2019, compared to our forecast of 3.1%. The RBNZ is probably still in wait and see mode, and is wary of the possibility of softness in inflation or the labour market. Any false step from the data could still be met by an RBNZ OCR cut over the coming year.

Annual average GDP growth



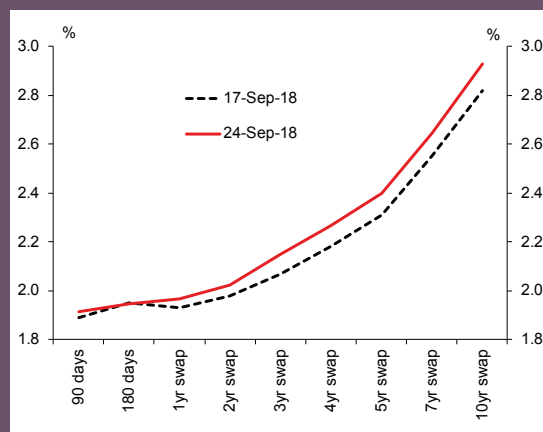
Fixed vs Floating for mortgages

Fixed-term mortgage rates are currently falling, 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 currently 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



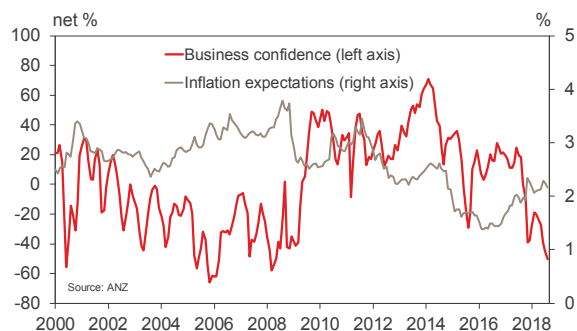
The week ahead

NZ Sep ANZ business confidence

Sept 26, Last: -50.3

- Business confidence fell further in August, reaching its lowest point since 2008. The decline in firms' expectations of their own activity stalled, but remained at a 9 year low.
- Weak confidence has been garnering plenty of attention. Since the last survey, the Prime Minister has responded to weak confidence by announcing a new business advisory council and clarifying some elements of its proposed labour law reforms. However, it remains to be seen whether this reassurance will be sufficient to arrest declining confidence.
- Inflation expectations have generally been rising over the last year, but recorded a surprising fall in August. Further lifts in petrol prices over the last month could see renewed upward pressure on inflation gauges.

NZ business confidence and inflation expectations

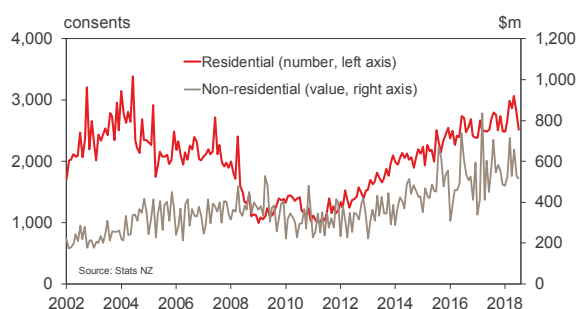


NZ Aug residential building consents

Sept 28, Last: -10.3%, WBC f/c: +3%

- Residential dwelling consent issuance fell by 10.3% in July. The fall was centred on Wellington and was due to a pullback in apartment related consents, following a large increase in June. There was also a modest 5% decline in issuance in Auckland after some strong issuance in recent months.
- Following July's volatility, we expect that dwelling consent numbers will rise by 3% in August. Underlying this gain in overall consent numbers, we expect issuance in Auckland to remain elevated, including ongoing strength in medium-density home numbers. This is being supported by regulatory changes and strong population growth. This strength in Auckland is offsetting the continuing gradual wind back in Canterbury.

NZ building consents

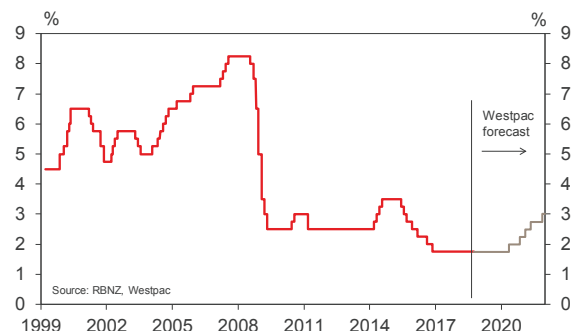


NZ RBNZ OCR Review

Sept 27, Last: 1.75%, Westpac: 1.75%, Market: 1.75%

- We expect the RBNZ will leave the OCR unchanged at next week's review. The tone of the statement is likely to be either neutral or dovish from a market point of view.
- June quarter GDP was much stronger than the RBNZ expected, recent activity data have been reasonably firm, and the exchange rate and mortgage rates have fallen. However, business and consumer confidence have fallen further, and there has been some deterioration in export conditions.
- A neutral statement would simply restate that the next move could be "up or down." The other possibility is that the RBNZ adopts a 'soft' easing bias, explicitly warning that if the economy fails to accelerate as expected, the OCR could be cut further.

RBNZ Official Cash Rate



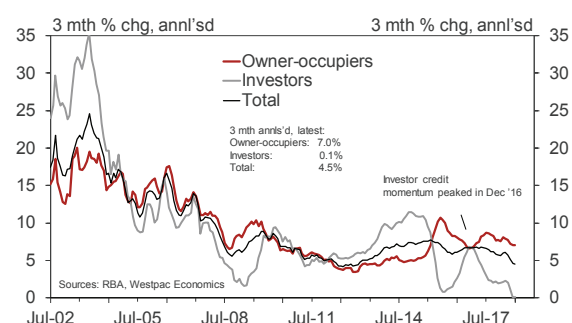
Aus Aug private credit

Sept 28, Last: 0.4%, WBC f/c: 0.3%

Mkt f/c: 0.4%, Range: 0.3% to 0.5%

- Private sector credit growth is modest and slowing as housing cools. Monthly growth averaged 0.3% in Q2, followed by a 0.4% increase in July - an outcome boosted by an above par read for the business segment. Annual growth has eased to 4.4%, down from 5.4% a year ago.
- For August, we anticipate an increase of 0.3%. Housing credit, at this late stage of the cycle, is slowing as tighter lending conditions see new lending decline, particularly for investors. In July, total housing credit growth was 0.37%_{mt}, 5.5%_{yr}, with investors at 0.1%_{mt}, 1.5%_{yr}.
- Business credit, 3.4% above the level of a year ago, is volatile around a modest uptrend as businesses increase investment in the real economy.

Housing: investor credit stalls



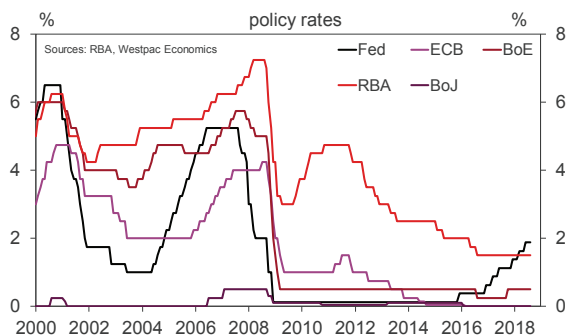
The week ahead

US Sep FOMC policy meeting

Sep 26, Fed funds rate, Last, 1.875%, WBC 2.125%

- The decision of the September FOMC meeting has been known for some time. Despite escalating trade uncertainties, FOMC members have remained resolute in their confidence in the domestic economy and the consequent need to continue with the gradual normalisation of policy.
- Partial data to hand suggests growth will remain above trend (albeit not at the 4% annualised pace of Q2), wages growth will keep trending higher, and inflation will hold at or above target. Dampening this bull case however is recognition that, the closer neutral gets, the more likely an oversized response could be seen. Inflation expectations also remain benign.
- While the forecasts and 'dot plots' will highlight the Committee's growing confidence, we don't expect a sense of urgency. Rate hikes will continue once per quarter to June 2019.

US FOMC to continue gradual normalisation



Data calendar

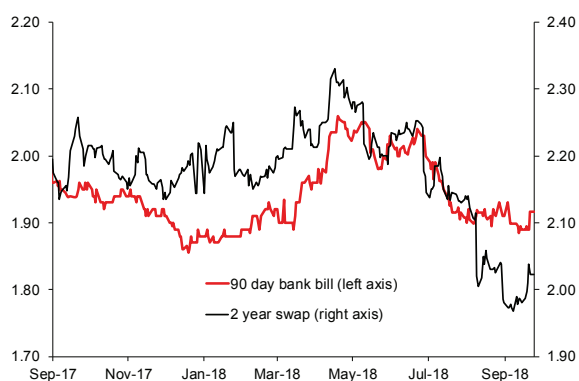
		Last	Market median	Westpac forecast	Risk/Comment
Mon 24					
Eur	ECB President Draghi speaks	-	-	-	At ECON meeting in Brussels.
US	Aug Chicago Fed activity index	0.13	-	-	Remains positive.
	Sep Dallas Fed index	30.9	31.0	-	Conditions very strong in Texas.
Tue 25					
Eur	ECB Praet speaks	-	-	-	In London at various events.
US	Jul FHFA house prices	0.2%	0.2%	-	House price growth remains robust...
	Jul S&P/CS home price index	0.1%	-0.2%	-	... with supply restricted & fundamentals supportive.
	Sep Richmond Fed index	24	21	-	Susceptible to a pull back from elevated levels.
	Sep consumer confidence index	133.4	131.5	-	Labour market providing a strong foundation for sentiment.
Wed 26					
NZ	Aug trade balance, \$m	-143	-925	-1600	Seasonal low for exports, large aircraft import due.
	Sep ANZ business confidence	-50.3	-	-	Very weak confidence garnering plenty of attention.
US	Aug new home sales	-1.7%	0.6%	-	Growth has flattened out.
	FOMC policy decision, midpoint	1.875%	2.125%	-	Sep and Dec hikes looks near certain despite trade tensions.
Thu 27					
NZ	RBNZ policy decision	1.75%	1.75%	1.75%	Tone either neutral or dovish from a market point of view.
Chn	Aug industrial profits %oyr	16.2%	-	-	Buoyed by reform and high steel prices.
Eur	Aug M3 money supply %oyr	4.0%	-	-	Credit data also due.
	Sep economic confidence	111.6	111.5	-	Business sentiment has been gradually cooling off...
	Sep business climate indicator	1.22	-	-	... consistent with growth returning towards trend.
US	Initial jobless claims	201k	-	-	Very low.
	Aug wholesale inventories	0.6%	-	-	Likely to remain volatile.
	Q2 GDP 3rd estimate	4.2%	4.3%	4.2%	Revisions likely to be marginal, if any.
	Aug durable goods orders prelim.	0.1%	0.4%	-	Investment intentions at risk given trade.
	Aug pending home sales	-0.7%	-0.2%	-	Supply the major issue for existing housing.
	Sep Kansas City Fed index	14	-	-	Off highs, but still indicative of robust momentum.
	Fed Chair Powell speaks	-	-	-	Brief remarks on US economy and Q&A.
	Fedspeak	-	-	-	Kaplan at forum for minority banking.
Fri 28					
NZ	Sep ANZ consumer confidence	-0.7%	-	-	Households have become more nervous about the outlook.
	Aug building permits	-10.3%	-	3.0%	Firmness in Auckland, including medium density dwellings.
Aus	Aug private sector credit	0.4%	0.4%	0.3%	Modest and slowing growth, led by cooling housing market.
Chn	Sep Caixin China PMI	50.6	-	-	Out ahead of official measures this month.
	Q2 current account balance \$bn	5.8	-	-	Full detail on trade and financial flows.
Eur	Sep Core CPI %oyr advance	1.0%	1.0%	-	Remains subdued around 1%.
	ECB Praet speaks	-	-	-	At King's college in London.
UK	Sep GfK consumer confidence	-7	-7	-	Brexit continues to raise concerns about the outlook.
	Q2 GDP (final)	0.4%	0.4%	0.4%	Services firm, manufacturing and production softer.
US	Aug personal income	0.3%	0.4%	0.4%	Wages growth is progressively accelerating...
	Aug personal spending	0.4%	0.3%	0.4%	... supporting robust spending growth...
	Aug core PCE deflator	2.0%	2.0%	-	... and inflation around trend.
	Sep Chicago PMI	63.6	62.0	-	Point to growth well above average for region.
	Sep Uni. of Michigan sentiment	100.8	100.4	-	Labour market providing a strong foundation for sentiment.
	Fedspeak	-	-	-	Williams at Conference on reserves and money markets.

New Zealand forecasts

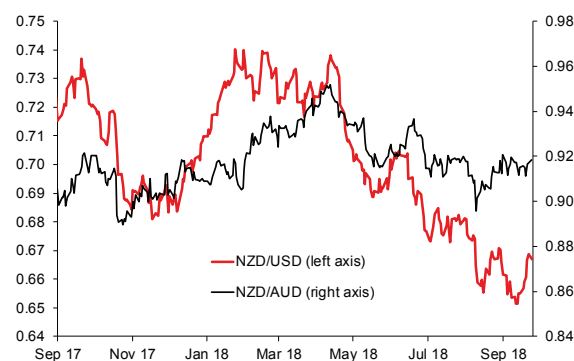
Economic Forecasts	Quarterly				Annual			
	2018				Calendar years			
% change	Mar (a)	Jun	Sep	Dec	2017	2018f	2019f	2020f
GDP (Production)	0.5	1.0	0.7	0.7	2.8	2.8	3.1	2.9
Employment	0.6	0.5	0.4	0.3	3.7	1.8	1.4	1.7
Unemployment Rate % s.a.	4.4	4.5	4.5	4.6	4.5	4.6	4.6	4.4
CPI	0.5	0.4	0.7	0.3	1.6	1.9	1.6	1.8
Current Account Balance % of GDP	-3.0	-3.3	-3.5	-3.5	-2.9	-3.5	-3.4	-2.9

Financial Forecasts	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.95	2.00	2.10
2 Year Swap	2.10	2.20	2.30	2.45	2.60	2.75
5 Year Swap	2.60	2.75	2.90	3.05	3.15	3.25
10 Year Bond	2.80	3.00	3.15	3.25	3.35	3.40
NZD/USD	0.66	0.65	0.64	0.64	0.64	0.65
NZD/AUD	0.92	0.92	0.91	0.91	0.91	0.90
NZD/JPY	73.9	73.5	72.3	71.7	71.7	72.2
NZD/EUR	0.57	0.57	0.57	0.56	0.55	0.55
NZD/GBP	0.52	0.53	0.52	0.52	0.52	0.53
TWI	72.0	71.3	70.3	70.0	69.8	69.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 24 September 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.83%	1.81%
60 Days	1.86%	1.86%	1.86%
90 Days	1.92%	1.90%	1.91%
2 Year Swap	2.02%	1.97%	2.03%
5 Year Swap	2.40%	2.28%	2.36%

NZ foreign currency mid-rates as at 24 September 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6669	0.6534	0.6686
NZD/EUR	0.5676	0.5656	0.5752
NZD/GBP	0.5099	0.5054	0.5208
NZD/JPY	75.07	72.50	74.43
NZD/AUD	0.9184	0.9200	0.9132
TWI	72.44	71.52	72.45

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
Real GDP % yr	2.5	2.6	2.2	3.3	2.7	2.8
CPI inflation % annual	1.7	1.5	1.9	1.7	1.8	1.6
Unemployment %	5.8	5.7	5.4	5.3	5.3	5.2
Current Account % GDP	-4.7	-3.1	-2.6	-2.6	-3.6	-3.7
United States						
Real GDP %yr	2.9	1.5	2.3	2.9	2.5	1.7
Consumer Prices %yr	0.1	1.4	2.1	2.5	2.0	1.9
Unemployment Rate %	5.3	4.9	4.4	3.9	3.6	3.6
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	1.4	0.9	1.7	1.1	0.8	0.7
Euro zone						
Real GDP %yr	2.1	1.8	2.5	2.0	1.5	1.5
United Kingdom						
Real GDP %yr	2.3	1.9	1.8	1.2	1.2	1.4
China						
Real GDP %yr	6.9	6.7	6.9	6.3	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	3.9	4.5	4.4	4.2	4.1
World						
Real GDP %yr	3.5	3.2	3.8	3.8	3.6	3.5

Forecasts finalised 12 September 2018

Interest Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day BBSW	1.92	2.00	1.97	1.97	1.92	1.92	1.83	1.80
10 Year Bond	2.70	2.85	3.00	3.00	3.00	2.80	2.60	2.60
International								
Fed Funds	1.875	2.375	2.625	2.875	2.875	2.875	2.875	2.875
US 10 Year Bond	3.07	3.20	3.40	3.50	3.40	3.20	3.00	2.80
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20	0.00	0.20

Exchange Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
AUD/USD	0.7295	0.72	0.71	0.70	0.70	0.70	0.74	0.75
USD/JPY	112.73	112	113	113	112	112	109	106
EUR/USD	1.1784	1.15	1.14	1.13	1.14	1.16	1.22	1.28
AUD/NZD	1.0901	1.09	1.09	1.09	1.09	1.09	1.12	1.10

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- (ii) physical separation of various Business/Support Units;
- (iii) and well defined wall/cell crossing procedures;
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