Glow Worm (Arachnocampa Luminosa)

Weekly Commentary

26 November 2018

Stranger things

We now expect that the Reserve Bank will keep the Official Cash Rate on hold until November 2020 – a longer pause than we had previously factored in. That's despite stronger outlooks for both GDP growth and inflation. At the same time, we're seeing increased downside risk for dairy prices.

We've just released our latest Economic Overview.[1] In it we highlight what may at first sound like an unusual set of changes in our forecasts. We're now expecting stronger economic growth and a faster pick-up in inflation than we previously forecast. But despite the firming on both of these fronts, we actually expect that the Reserve Bank is going to remain on hold for longer than we previously assumed, and have pushed out our forecast for Official Cash Rate hikes to November 2020 (back from May 2020 as we previously expected). So what's behind this change in the outlook?

Looking first at real economic activity, recent months have seen the New Zealand economy catching a second wind, with GDP growth set to rise to rates a little over 3% through 2019. This pick-up is something we had long been forecasting, despite the pessimistic tone of some business surveys. It was pretty much inevitable, given the large increases in Government spending being rolled out, and it has been reinforced by a lift in construction activity. Demand is also being buoyed by the recent drop in fixed mortgage rates, which has boosted the housing market and household spending.

We still expect that the current firmness in activity will give way to a period of slower growth as we head into the early-2020s. Previous drivers of demand, like population growth and the construction cycle, have now moved into new phases, and going forward they won't provide the same boost they once did. In addition, house price growth is set to slow again over the coming years, with a battery of demand-dampening policy changes already in place or on the horizon.

On the prices front, headline inflation is now set to rise to 2.2% in early-2019. However, much of that rise is due to earlier increases in petrol prices, which are only providing a temporary lift in inflation. In fact, we've already seen some sizeable falls in fuel prices in recent weeks, and that will dampen headline inflation going forward.

Looking through the short-term volatility in fuel prices, we are seeing signs that inflation pressures more generally are building in the economy. Most notably, a growing number of businesses have highlighted increased cost pressures, particularly with regards to wages. Combined with a lower NZ dollar and firmness in demand, we expect that this will push inflation higher over the coming year.

But even accounting for those factors, inflation is only set to rise slowly, with underlying inflation expected to rise from around 1.7% now to a little over 2% in 2020. That's because there are still some big factors limiting the rise in overall inflation. The most important is the continuing strong

[1] Available here: https://www.westpac.co.nz/assets/Business/Economic-Updates/2018/Bulletins-2018/Westpac-QEO-November-2018-EMAIL.pdf

Stranger things continued

competitive pressures in the retail sector. We're also seeing more moderate increases in some Government charges (such as tertiary education) than we did in the previous decade, and that pattern is likely to continue for some time.

The above factors mean that we expect inflation will remain well contained within the RBNZ's 1 to 3% target band over the next few years, albeit at rates that are a little above 2%. We certainly don't think that inflation will rise to levels that would spook the RBNZ into hiking rates any time soon. In fact, the RBNZ's recent communications have highlighted that, since the adoption of its new dual mandate, it is now more willing to tolerate some rise in inflation above the target mid-point in order to shore up growth. That dovish lurch was evident in the RBNZ's recent policy statement which showed higher growth and inflation settling a little above 2%, but assumed absolutely no change in the accompanying interest rate projection. With this in mind, we are now forecasting later and more gradual OCR hikes than we previously assumed.

With inflation currently well contained, this approach will work fine for the RBNZ over the next few years. But over time, we could see inflation expectations creeping higher. That would then mean the Reserve Bank has to maintain higher nominal interest rates to achieve the same real interest rate and keep inflation steady.

The price of milk

The other key development this week was yet another drop in global dairy prices. Prices fell 3.5% in the latest auction and have now fallen 20% since their May peak.

While concerns about the strength of global demand are swirling at the moment, the big factor weighing on prices is the strong growth in domestic milk production. Milk collections were up 6.5% in October compared to last year, and season to date production is up 6%. That's well ahead of what we expected. In addition, pasture conditions are looking good as we head into the summer months.

Increases in production and the related drop in prices have added to the downside risk for this season's farmgate payout. We have been forecasting a \$6.25/kgMS farmgate milk price for the 2018/19 season. However, prices have fallen further than we were anticipating. What's more, our forecast was always contingent on some rise in milk auction prices over the coming months. And with domestic production so strong, there is clearly downside risk to our \$6.25 forecast. Certainly, Fonterra's forecast \$6.25 to \$6.50 is looking increasingly optimistic.

While prices may be softening, we wouldn't describe this as a negative for New Zealand farmers. Despite lower prices, higher volumes will support farmgate returns. And importantly, prices remain well above breakeven levels for most farmers.

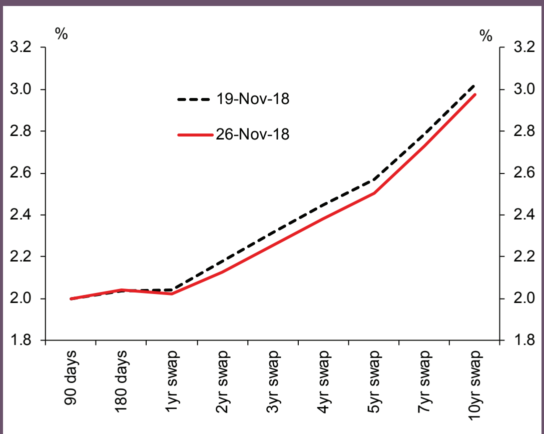
Fixed vs Floating for mortgages

Fixed-term mortgage rates have fallen as the market has adjusted 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



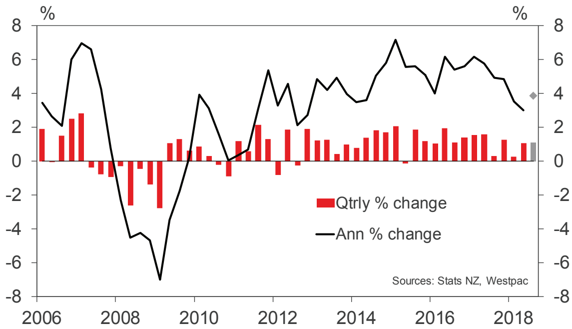
The week ahead

NZ Q3 real retail sales

Nov 26, Last: +1.1%, Westpac f/c: +1.1%, Mkt f/c: +1.0%

- Adjusted for price changes, retail spending rose by 1.1% in the June quarter. Strength was seen in several areas, with spending in core categories (which excludes the volatile vehicle and fuel components) up a strong 1.4%.
- We expect to see another solid increase in retail volumes of 1.1% in the September quarter, including a 2% increase in the core categories.
- Monthly nominal spending figures posted solid gains over the September quarter, buoyed by increases in government transfer payments to households. However, recent months also saw strong increases in fuel prices, which squeezed households' disposable incomes and limited the rise in overall spending.

Real retail sales

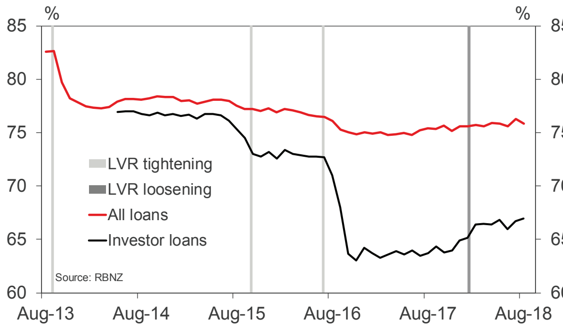


NZ RBNZ Financial Stability Report

Nov 28

- The RBNZ's six-monthly review of the financial system will include a review of the loan-to-value (LVR) restrictions on mortgage lending. Last November the RBNZ eased the restrictions slightly, and indicated that further easing was possible if house prices and credit growth remained in check.
- We have long been of the view that these criteria would be met. Government policies (such as extending the 'bright line' test and restricting foreign buyers) and changes in lending practices are now doing some of the prudential work that the LVR restrictions once did on their own.
- We would expect any changes to be incremental. The RBNZ has said that it will look to reduce the LVR limits to 'neutral' levels, rather than remove them altogether.

Average LVR of new loan commitments

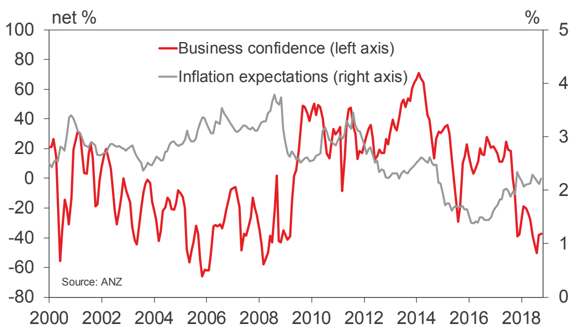


NZ Nov business confidence

Nov 29, Last: -37.1

- Business sentiment has improved marginally in the last two months, but it remains at very low levels.
- Prospects for the November survey look mixed. Fuel prices have fallen sharply in the last month, providing some relief in terms of both business costs and consumers' spending power. However, confidence in the agricultural sector may worsen further, given to the deteriorating outlook for farmgate milk prices.
- While we expect some drag on business investment in the short term, our view remains that overall activity is much more robust than the confidence surveys would imply. The 1% rise in June quarter GDP was boosted by some temporary factors, but we expect solid gains of 0.7-0.8% in the next two quarters.

NZ business confidence and inflation expectations

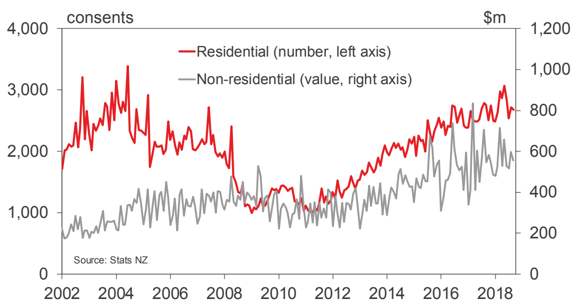


NZ Oct residential building consents

Nov 30, Last: -1.5%, WBC f/c: -5%

- Residential dwelling consent issuance fell by 1.5% in September. However, that only partially offset earlier increases, and still left consent issuance at elevated levels.
- We expect to see a further 5% decline in residential consent numbers in October. That decline is expected to be centred on Canterbury, and follows an unexpected lift in September. Building activity in Canterbury is continuing to gradually ease back following a period of very strong activity in the wake of 2010 and 2011's massive earthquakes.
- Consent numbers in other regions are expected to remain firm. In Auckland, where most of the increase over the past year has been centred, issuance levels are expected to remain very strong (around 13,000 on an annual basis).

NZ building consents



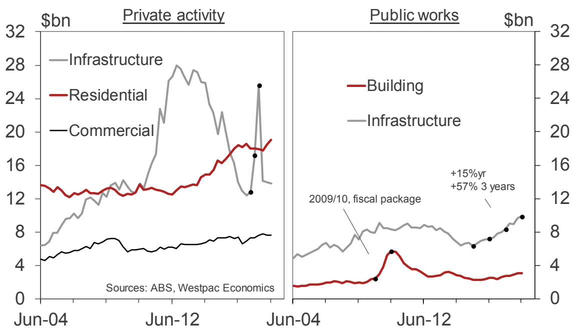
The week ahead

Aus Q3 construction work

Nov 28, Last: 1.6%, WBC f/c: 0.6%
Mkt f/c: 0.9%, Range: -2.5% to 2.0%

- Construction work grew by a robust 1.6% in Q2. Gains were evident across public works, new home building and commercial building. There was a modest decline in private engineering activity, as well as a dip in home renovations.
- For the September quarter, we anticipate a more modest lift in construction work, up a forecast 0.6%. Notably, new home building activity is expected to consolidate after a brisk 4.1% rise in Q2. Approvals have retreated although a sizeable work pipeline remains.
- Public works is a source of growth, +2.5% in Q2 and up a forecast 3% in Q3, with a focus on transport infrastructure.
- Elsewhere conditions are likely to be mixed, with the risk of a small decline in private engineering and a modest gain in commercial building work.

Construction work: by segment

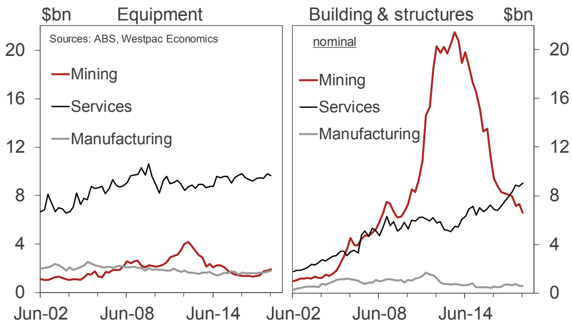


Aus Q3 private business capex

Nov 29, Last: -2.5%, WBC f/c: 0.4%
Mkt f/c: 1.0%, Range: -0.5% to 3.0%

- Private business capex spending was mixed over the first half of 2018, down 2.5% in Q2 after a 1.2% rise in Q1. This followed a 4.2% rise in capex in 2017, after four years of decline, on a diminished drag from the mining investment wind-down and with non-mining investment trending higher.
- For Q3, we expect a soft result, up only 0.4%. Building & structures is expected to be broadly flat. Commercial building up a little, supported by a sizeable work pipeline but with approvals off their highs. Infrastructure down a little with gas projects completed but other projects (roads and iron ore) getting underway.
- Equipment spending is forecast to rise by 0.8%, reversing a 0.9% fall in Q2, to be 5% above the level of a year ago.

CAPEX: by industry by asset

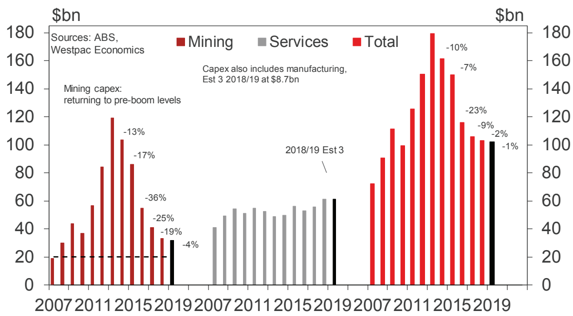


Aus 2018/19 capex plans

Nov 29, Last (Est 3 for 2018/19): $102bn, -1%

- This survey, conducted in October and November, includes the 4th estimate of capex spending plans for 2018/19.
- For Est 4 on Est 4 to be at -1% (matching the Est 3 outcome) would require an upgrade of 6% to $108bn - an upgrade which is in line recent historical experience, including last year. Accordingly, an Est 4 of $108bn is plausible, with risks potentially tilted to the upside.
- Our central case forecast is for business investment to edge higher in 2018/19, up 1%. This is supported by sectors (education and health) and assets (computer software) excluded from the capex survey. That is, the capex survey understates the outlook for business investment.

Capex plans, by industry: Estimate 3

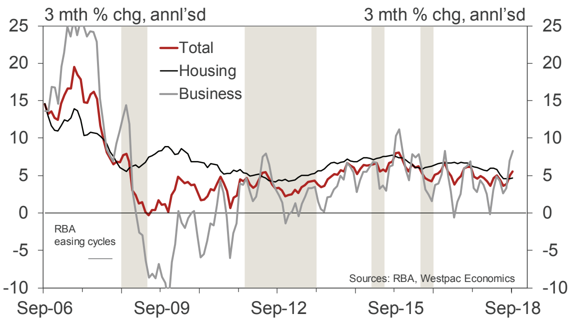


Aus Oct private credit

Nov 30, Last: 0.5%, WBC f/c: 0.4%
Mkt f/c: 0.4%, Range: 0.3% to 0.5%

- Private sector credit growth has been relatively modest over the past year. However, in the September quarter, growth lifted to a 5.5% annualised pace centred on a burst of business lending, running at 8.3% annualised for the period. For October, we expect a 0.4% gain, matching the September outcome.
- Housing credit, at this late stage of the cycle, is slowing as tighter lending conditions see new lending decline, particularly for investors. In September, housing credit grew by 0.4%, 5.2%yr (including investors, at 0.1%mth, 1.4%yr).
- Business credit, 4.4% above the level of a year ago, is volatile around a modest uptrend as businesses increase investment in the real economy. Commercial finance strength of late points to a robust outcome for October.

Credit: momentum



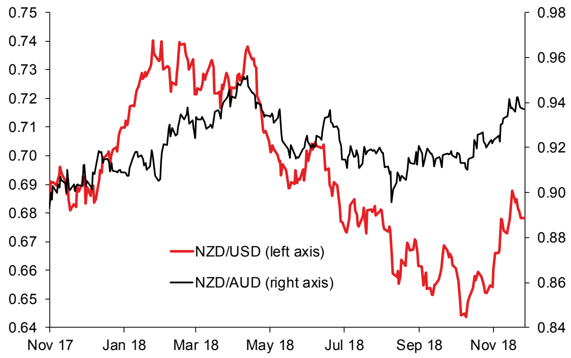
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2018			2019				
% change	Jun (a)	Sep	Dec	Mar	2017	2018f	2019f	2020f
GDP (Production)	1.0	0.7	0.8	0.7	2.8	2.9	3.2	3.1
Employment	0.6	1.1	0.0	0.2	3.7	2.3	1.3	1.6
Unemployment Rate % s.a.	4.4	3.9	4.3	4.4	4.5	4.3	4.2	4.1
CPI	0.4	0.9	0.4	0.4	1.6	2.2	1.9	2.1
Current Account Balance % of GDP	-3.3	-3.4	-3.4	-3.1	-2.9	-3.4	-3.5	-3.0

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	1.90	1.90	1.90
2 Year Swap	2.15	2.10	2.10	2.15	2.20	2.25
5 Year Swap	2.60	2.60	2.60	2.65	2.70	2.75
10 Year Bond	2.80	2.85	2.85	2.95	2.90	2.90
NZD/USD	0.66	0.64	0.63	0.61	0.62	0.63
NZD/AUD	0.92	0.90	0.90	0.90	0.89	0.88
NZD/JPY	75.2	73.0	72.5	69.5	69.4	69.3
NZD/EUR	0.58	0.58	0.57	0.56	0.56	0.56
NZD/GBP	0.52	0.52	0.51	0.49	0.49	0.49
TWI	72.6	70.9	70.2	68.3	68.5	68.5

2 Year Swap and 90 Day Bank Bills

NZD/USD and NZD/AUD



NZ interest rates as at market open on 26 November 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.93%	1.90%	1.83%
60 Days	1.97%	1.95%	1.86%
90 Days	2.00%	1.99%	1.89%
2 Year Swap	2.13%	2.20%	2.01%
5 Year Swap	2.50%	2.65%	2.32%

NZ foreign currency mid-rates as at 26 November 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6781	0.6733	0.6525
NZD/EUR	0.5978	0.5949	0.5723
NZD/GBP	0.5282	0.5212	0.5093
NZD/JPY	76.64	76.63	72.92
NZD/AUD	0.9370	0.9331	0.9184
TWI	74.33	74.00	71.83

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 26					
NZ	Q3 retail sales	1.1%	1.0%	1.1%	Rises in petrol prices constraining spending in other areas.
Aus	RBA Governor Lowe speaks	–	–	–	'A Journey Towards a Near Cashless Payments System'.
	RBA asst. Gov. Kent speaks	–	–	–	'Securitisation and the Housing Market'.
Eur	ECB President Draghi	–	–	–	Addressing the EU Parliament's economic committee.
US	Oct Chicago Fed activity index	0.17	–	–	Suggests aggregate growth is slowing to trend.
	Nov Dallas Fed index	29.4	25.0	–	Has softened of late, but remains above trend.
Tue 27					
NZ	Oct trade balance, $m	–1560	-850	–1000	Underlying balance improving as dairy production picks up.
Chn	Oct industrial profits %yr	–	–	–	Commodities have provided significant support.
US	Sep FHFA house prices	0.3%	0.4%	–	House price growth...
	Sep S&P/CS home price index %yr	5.5%	5.3%	–	... looks to slowly be losing momentum.
	Nov consumer confidence index	137.9	136.0	–	Remains well above average.
	Fedspeak	–	–	–	Vice Chair Clarida in NY. Bostic, Evans and George on panel.
Wed 28					
NZ	RBNZ Financial Stability Report	–	–	–	RBNZ expected to loosen housing lending restrictions.
Aus	Q3 construction work	1.6%	0.9%	0.6%	Construction up but new home building to be less supportive
Eur	Oct M3 money supply %yr	3.5%	–	–	Credit data also due.
UK	Nov Nationwide house prices	0.0%	0.1%	–	Tentative date. Price growth remains muted, esp. in London.
	Oct mortgage approvals	65.3k	64.7k	–	Credit growth subdued ...
	Oct net lending secured on dwellings	3.9b	3.5b	–	...weighed down by uncertainty and increases in rates.
US	Oct wholesale inventories	0.4%	0.5%	–	Volatile, will remain swing factor for growth.
	Q3 GDP 2nd estimate	3.5%	3.6%	3.5%	Revisions possible, but likely insignificant.
	Oct new home sales	–5.5%	5.2%	–	Sector starting to come under pressure from interest rates.
	Nov Richmond Fed index	15	16	–	Oct saw a sharp pullback.
	Fed Chair Powell	–	–	–	Speaking to the Economic Club of New York.
Thu 29					
NZ	Nov ANZ business confidence	–37.1	–	–	Remains at very low levels.
Aus	Q3 private new capital expenditure	–2.5%	1.0%	0.4%	Capex trending higher. Gain likely to be modest, see textbox.
	2018/19 capex plans, AUDbn	102.0	108.5	–	Est 3 –1.1% vs Est 3 a yr ago. Est 4 potentially $108bn. See textbox.
Eur	Nov economic confidence	109.8	109.0	–	Business surveys have eased back...
	Nov business climate indicator	1.01	0.96	–	... but levels still above average...
	Nov consumer confidence final	–3.9	–	–	... uncertain whether downward momentum persists.
	ECB President Draghi	–	–	–	Speaking at joint ECB/Federal Reserve conference.
US	Oct personal income	0.2%	0.4%	0.4%	Incomes slowly gaining greater momentum...
	Oct personal spending	0.4%	0.4%	0.5%	... and, together with sentiment, is supporting spending.
	Oct core PCE deflator	0.2%	0.2%	0.2%	Inflation remains benign at target.
	Initial jobless claims	224k	–	–	Very low.
	Oct pending home sales	0.5%	0.8%	–	Supply and interest rates both acting as headwinds.
	FOMC meeting minutes	–	–	–	May contain guidance ahead of Dec meeting.
	Fedspeak	–	–	–	Evans in panel discussion on economic development.
Fri 30					
NZ	Nov ANZ consumer confidence	115.4	–	–	At moderate levels, has been easing.
	Oct building permits	–1.5%	–	–5%	Earlier strength in Canterbury to reverse, Auckland still firm.
Aus	Oct private sector credit	0.4%	0.4%	0.4%	Housing cooling but business resilient of late.
Chn	Nov non–manufacturing PMI	53.9	–	–	Domestic economy continues to aid resilience...
	Nov manufacturing PMI	50.2	–	–	... as softer global growth impacts momentum.
Eur	Oct unemployment rate	8.1%	8.1%	–	Labour market slack continuing to edge down.
	Nov core CPI %yr advance	1.1%	1.1%	–	Sticky around 1% but wages growth is lifting.
UK	Nov GfK consumer confidence	–10	–11	–	Economic uncertainty continues to dampen sentiment.
US	Nov Chicago PMI	58.4	58.5	–	Robust growth continuing.
	Fedspeak	–	–	–	Williams speaking on the global economy at G30 meeting.

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	2.0	1.7	1.7
Unemployment %	5.8	5.7	5.5	5.1	5.0	4.8
Current Account % GDP	-4.7	-3.1	-2.6	-2.4	-2.5	-3.3
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	2.4	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	0.9	0.8	0.7
Euro zone						
Real GDP %yr	2.1	1.8	2.5	1.9	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	6.4	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	3.9	4.5	4.3	4.1	4.1
World						
Real GDP %yr	3.5	3.2	3.8	3.8	3.6	3.5
Forecasts finalised 9 November 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	1.94	1.98	1.93	1.91	1.90	1.90	1.85	1.83
10 Year Bond	2.66	2.70	2.80	2.80	2.90	2.80	2.70	2.60
International								
Fed Funds	2.125	2.375	2.625	2.875	3.125	3.125	3.125	3.125
US 10 Year Bond	3.06	3.25	3.40	3.50	3.60	3.30	3.10	3.00
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	0.7251	0.72	0.71	0.70	0.68	0.70	0.74	0.74
USD/JPY	112.90	114	114	115	114	112	109	106
EUR/USD	1.1414	1.13	1.11	1.10	1.09	1.10	1.16	1.22
AUD/NZD	1.0646	1.09	1.11	1.11	1.11	1.13	1.16	1.13

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