Weekly Commentary

27 August 2018

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Falling into place

We recently released our latest *Economic Overview*[1]. It highlights that the economic slowdown that we have long warned of is well in train, with earlier drivers of growth having now moved into new phases. The coming year will see a temporary pickup in growth, supported by firmness in export earnings and large increases in fiscal spending. Nevertheless, economic growth over the next few years will be noticeably slower than it was between 2014 and 2016.

After fairly modest increases of 0.5 to 0.6% in recent quarters (rates that were effectively the same as population growth), we expect that GDP growth rebounded to around 1% in June. That's in part due to some temporary factors, particularly in the agricultural sector. Last week's retail sales data also added credence to the idea of a near-term bounce in GDP, with a stronger than expected 1.1% increase in spending in June, underpinned by a lift in core categories.

This rebound in GDP growth is likely to come as a surprise to the Reserve Bank, whose latest policy assessment only factored in an increase of 0.5% in the June quarter. That's particularly important for financial markets. Since the RBNZ's August *Statement*, markets have been pricing in some chance of a near-term rate cut and the NZ dollar has taken a step down. But with it now looking increasingly likely that growth will surprise the RBNZ to the upside, we could see some correction when June quarter GDP is released in late September.

But while GDP growth looks to have rebounded recently, stepping back and looking at the economy more broadly leaves us with a picture of cooling activity. On an annual basis, we estimate that GDP growth has slowed to 2.7% in the year to June. That's a noticeable step down from the rates of 3.5 to 4% annual growth that we saw in earlier years.

This cooling in economic growth has been playing out very much as we have expected. As we've been highlighting for some time, several of the key factors that underpinned demand in recent years have been evolving, and are no longer providing the same boosts to growth that they once did. We've seen this on several key fronts.

First is **reconstruction spending** in Canterbury, which has slowed sharply since it peaked over 2015 and 2016. The continuing winddown in reconstruction work will be a drag on growth for several more years, the impact of which will be felt across the economy.

Construction activity more generally remains elevated, but the sector is unlikely to be the driver of growth and employment that it was in earlier years. That's because factors such as stretched capacity, rising costs, and difficulties accessing finance are providing a brake on how quickly building activity can ramp up.

Tax changes have seen **house price inflation** slowing sharply, with particular softness in Auckland. Restrictions on foreign buyers that are about to come into effect will reinforce this weakness. However, we expect that a drop in mortgage rates and a likely easing in the Reserve Bank's loan-to-value restrictions in January will provide some counterbalance. Nevertheless, we are still looking at a

[1] Available here: https://www.westpac.co.nz/assets/Business/Economic-Updates/2018/Bulletins-2018/Westpac-QEO-August_2018_EMAIL.pdf

Falling into place... continued

subdued outlook for house prices, with modest house price declines over the next few years. And with New Zealand households holding a large proportion of their wealth in owner-occupied and investment housing, this will be a significant drag on spending.

Finally, **net migration** remains elevated, but has been declining. Figures out over the past week showed that the net inflow of people into the country has slowed to just under 64,000 in the year to July - its lowest level since 2015. We expect that net migration will slow substantially further over the coming years. That will see population growth slowing from around 2% currently to around 1% in 2022, signalling a huge reduction in what has been an 'easy' source of demand growth for many businesses.

Against this cooling in GDP growth and changes in the policy backdrop, we have seen a sharp decline in business confidence. However, business surveys appear to be overstating the degree of weakness in activity. In fact, we expect that the next phase of the economic cycle will be a pickup in GDP growth to just over 3% in 2019.

Underpinning the expected lift in near-term growth are large increases in Government spending that are now being rolled out. That includes around $1.5b of spending on the Government's families package and accommodation support payments, as well as increased spending in areas like health and education.

Strength in the export sector will also help to bolster New Zealand's economic performance. While there has been a softening in the prices for some commodities recently (most notably dairy prices, which were down another 3.6% in the latest auction), the terms of trade remain elevated. We're also seeing continued firmness in services exports. Going forward, export returns will be boosted by the depreciation of the New Zealand dollar, which we expect to continue over the coming year.

However, the above factors are only providing a temporary fillip. Beyond 2019, we expect GDP growth to cool once again, as slowing population growth and weakness in the housing market offset increases in fiscal spending. Overall, growth over the next few years will be noticeably slower than it was between 2014 and 2016.

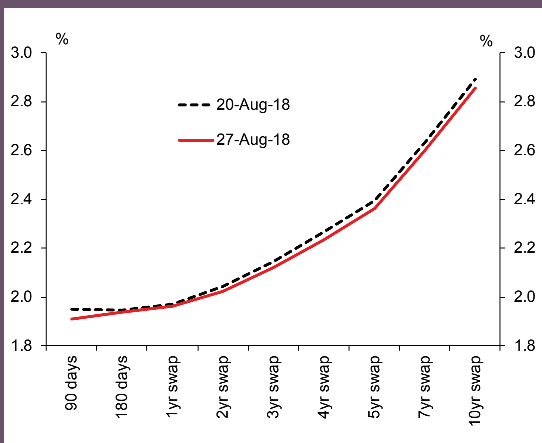
Fixed vs Floating for mortgages

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



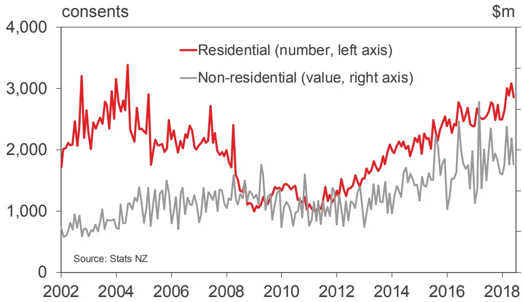
The week ahead

NZ Jul residential building consents

Aug 30, Last: -7.6%, WBC f/c: -5%

- Residential dwelling consent issuance fell by 7.6% in June. However, that followed solid levels of dwelling consent issuance in the preceding months, and still left consent numbers at a high level.
- Recent volatility in consents has been related to apartments and retirement villages, which tend to get issued in lumps. We expect that swings in this group will again contribute to a modest 5% fall in July (that follows a large increase in June centred on Wellington).
- The more interesting story is what's happening to consents for stand-alone and medium density housing in Auckland. Issuance in these groups has taken a large step higher in recent months, supported by regulatory changes and strong population growth. Smoothing through month-to-month swings, we expect issuance in these categories to remain firm.

NZ building consents

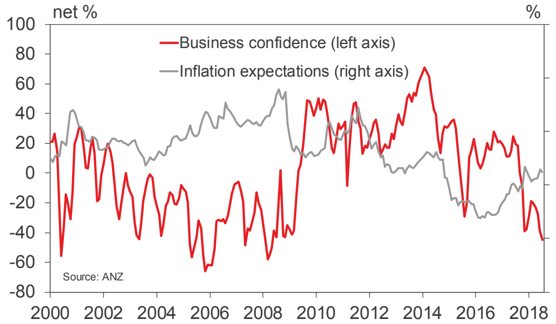


NZ Aug ANZ business confidence

Aug 30, Last: -44.9

- Business confidence has lurched lower again in recent months, with the July survey falling to levels last seen during the Global Financial Crisis.
- There is no doubt a political element to this survey, with firms displeased in particular with the new Government's intended changes to employment law. However, confidence has been falling since well before the election, and there does appear to have been some genuine slowing in growth in the last year.
- Inflation expectations have been higher since the election, with rising fuel prices likely playing a role as well. However, firms still don't seem all that confident about their ability to pass on cost increases; pricing intentions have remained within a range over the last year or so.

NZ business confidence and inflation expectations

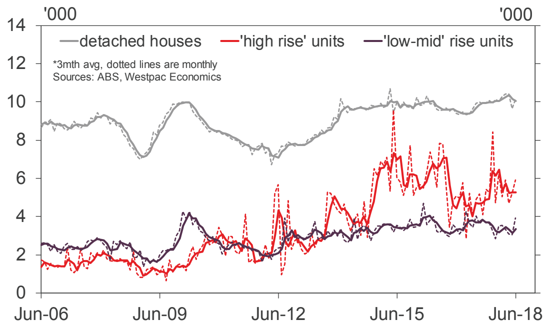


Aus Jul dwelling approvals

Aug 30, Last: 6.4%, WBC f/c: –3.0%
Mkt f/c: -2.0%, Range: -5.0% to 2.0%

- Dwelling approvals bounced 6.4% in June, coming in well above expectations. The detail confirmed May's 2.5% decline was likely a data issue with Qld approvals rebounding from their extreme fall. Outside of this, the picture is more mixed but is clearly not showing the anticipated weakening, particularly across high rise which recorded another relatively strong month.
- Approvals are likely to retrace 3% in July with some risk of a sharper fall. Construction-related finance approvals have been pointing to a pull-back in non high rise approvals for several months now, a shift that has not yet materialised. Similarly, site purchases have been pointing to a further sharp leg lower for high rise approvals for some time now.

Dwelling approvals: houses, low-mid & high rise

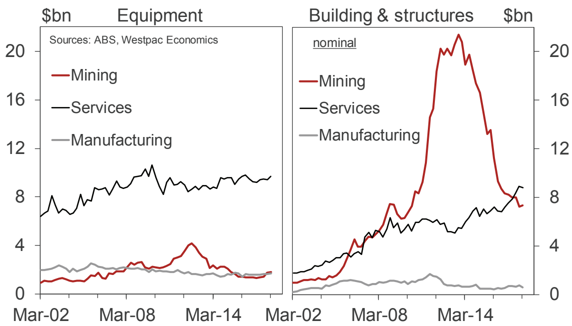


Aus Q2 business capex

Aug 30, Last: 0.4%, WBC f/c: 0.3%
Mkt f/c: 0.6%, Range: -1.0% to 3.0%

- Business capex spending turned the corner in 2017, with the mining investment wind-down almost complete and an emergence upswing in non-mining investment. Capex rose 4% in 2017 after four years of decline.
- In 2018, capex edged 0.4% higher in Q1 and we anticipate a rise of 0.4% in Q2. Building & structures capex is expected to slip, declining by 0.3%. The Construction Work survey reported that infrastructure activity fell (as gas projects are completed), largely offset by a rise in non-residential building work. Equipment spending has trended higher since mid-2017, emerging from a soft spot over the second half of 2016. We anticipate a further gain in Q2, a forecast +1%.

CAPEX: by industry by asset



The week ahead

Aus 2018/19 capex plans

Aug 30, Last (Est 2 for 2018/19): $87.7bn, +1.4%

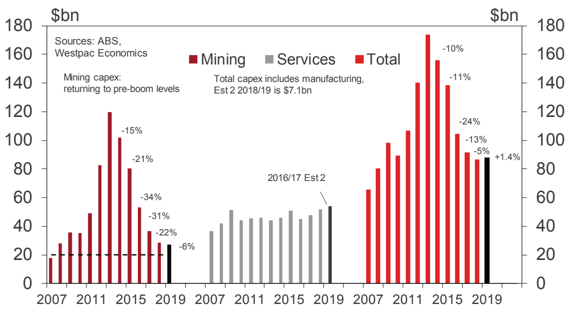
- This survey, conducted during July and August, includes the 3rd estimate of capex spending plans for 2018/19.
- In the previous survey, Est 2 for 2018/19 was $87.7bn, 1% above Est 2 a year ago. This is the first positive 'Est 2 on Est 2' comparison since 2012/13.
- For mining, Est 2 on Est 2 is only a modest negative, at -5.8%. For services, Est 2 vs Est 2 is +4.8%, evidence that the investment upswing is set to continue.
- This update is likely to confirm the broad themes evident in the capex survey 3 months earlier. However, as to the value of Est 3, we see the risk of some apparent slippage.

Aus Jul private credit

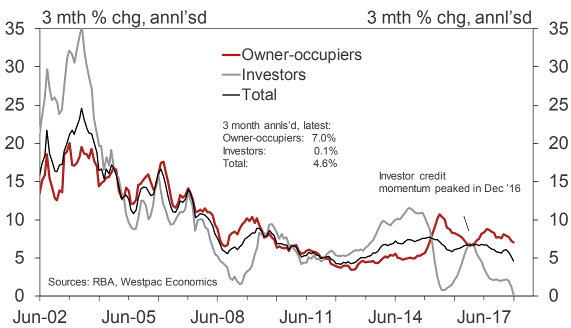
Aug 31, Last: 0.3%, WBC f/c: 0.3%
Mkt f/c: 0.3%, Range: 0.2% to 0.5%

- Private sector credit growth is modest and slowing as housing cools. Monthly growth averaged 0.3% in Q2, and annual growth eased to 4.5%, down from 5.5% a year ago. For July, 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 June, total housing credit growth was 0.34%mth, 5.6%yr, while the figures for investors were -0.1%mth, 1.6%yr.
- Business credit, 3.2% above the level of a year ago, is volatile around a modest uptrend as businesses increase investment in the real economy, spending which is in part funded by retained earnings. The June month was an 'average' one, with a gain of 0.3% - we anticipate a similar result for July.

Capex plans, by industry: Estimate 2



Housing: investor credit stalls



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 27					
Chn	Jul industrial profits %yr	20.0%	–	–	Improving profitability clearly a focus.
US	Jul Chicago Fed activity index	0.43	0.45	–	Pointing to above trend growth.
	Aug Dallas Fed index	32.3	30.0	–	Remains very strong.
Tue 28					
Eur	Jul M3 money supply %yr	4.4%	4.4%	–	Credit data also due.
	ECB Chief Economist Praet speaks	–	–	–	On monetary and macroprudential policy interactions.
UK	Aug Nationwide house prices	0.6%	–	–	Tentative date. House price growth muted, esp. in London.
US	Jul wholesale inventories	0.1%	–	–	To remain a swing variable for growth.
	Jun S&P/CS home price index %yr	6.5%	6.4%	–	Construction activity slowing, but price g'th still robust.
	Aug Richmond Fed index	20	18	–	Remains very strong.
	Aug consumer confidence index	127.4	126.5	–	Lead by labour market.
Wed 29					
US	Q2 GDP 3rd estimate %annualised	4.1%	4.0%	4.0%	Little change expected from prior estimate.
	Jul pending home sales	0.9%	0.5%	–	Softening.
Thu 30					
NZ	Jul building permits	–7.6%	–	–5.0%	Early lift in apartment numbers to reverse, trend in Akd firm.
	Aug ANZBO business confidence	–44.9	–	–	Confidence at low levels, some lift in inflation pressures.
Aus	Jul dwelling approvals	6.4%	-2.0%	–3.0%	Surprise bounce in June but should retrace in July.
	Q2 private capital expenditure	0.4%	0.6%	0.3%	Equipment spending uptrend, but infrastructure work down.
	2018/19 capex plans, AUDbn	78	100.1	–	Est 2 on Est 2, +1%, reduced mining drag & non-mining up.
Eur	Aug economic confidence	112.1	111.9	–	Growth remains above trend...
	Aug business climate indicator	1.29	1.26	–	... giving cause for optimism...
	Aug consumer confidence	-1.9	–	–	... for households as well.
UK	Jul net lending on dwellings, £bn	3.9	3.8	–	Softness in the housing market ...
	Jul mortgage approvals	65.6k	65.0	–	...continuing to dampen credit growth.
US	Jul personal income	0.4%	0.4%	0.4%	Income gains robust and are accelerating slowly.
	Jul personal spending	0.4%	0.4%	0.3%	But personal spending g'th likely to slow....
	Jul core PCE deflator	0.1%	0.2%	0.2%	.... limiting upside risks for inflation.
	Initial jobless claims	210k	–	–	Very low.
Fri 31					
Aus	Jul private sector credit	0.3%	0.3%	0.3%	Growth modest and slowing, housing cooling.
Chn	Aug non-manufacturing PMI	54.0	–	–	Have held up well...
	Aug manufacturing PMI	51.2	51.2	–	... employment outcomes have been pleasing of late.
Eur	Jul unemployment rate	8.3%	8.2%	–	Continues to drift lower.
	Aug core CPI %yr flash	1.1%	1.1%	–	Set to struggle to move towards target.
UK	Aug GfK consumer confidence	–10	–10	–	Brexit uncertainty continues to weigh on consumer sentiment.
	Aug Nationwide house prices	0.6%	–	–	House price growth remains muted, esp. in London.
US	Aug Chicago PMI	65.5	63.0	–	Remains very strong.
	Aug Uni. of Michigan sentiment	95.3	95.7	–	Lead by labour market.

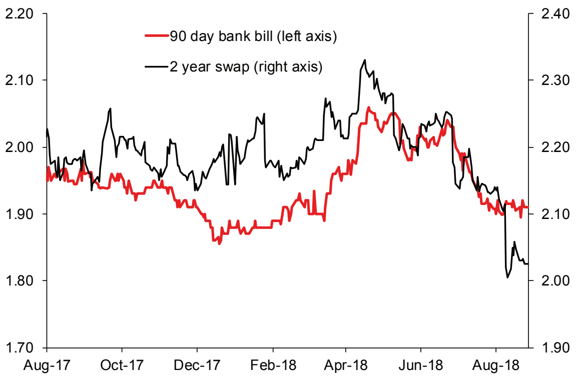
New Zealand forecasts

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

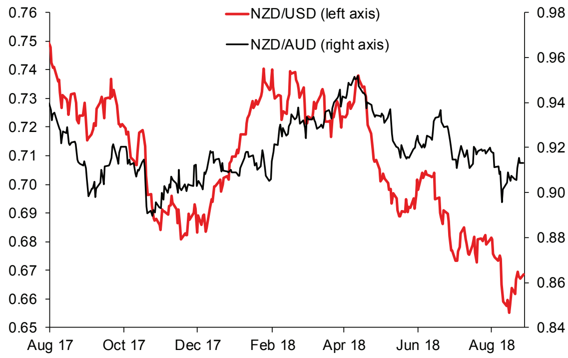
[1] Annual average % change

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	0.64	0.64	0.64
NZD/AUD	0.91	0.90	0.90	0.91	0.91	0.91
NZD/JPY	74.37	73.9	73.5	72.3	71.7	71.7
NZD/EUR	0.58	0.57	0.57	0.57	0.56	0.55
NZD/GBP	0.52	0.52	0.53	0.52	0.52	0.52
TWI	72.57	71.8	71.1	70.3	70.0	69.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 27 August 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.81%	1.80%	1.81%
60 Days	1.86%	1.85%	1.86%
90 Days	1.91%	1.92%	1.92%
2 Year Swap	2.03%	2.01%	2.13%
5 Year Swap	2.36%	2.35%	2.54%

NZ foreign currency mid-rates as at 27 August 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6686	0.6576	0.6794
NZD/EUR	0.5752	0.5778	0.5829
NZD/GBP	0.5208	0.5152	0.5188
NZD/JPY	74.43	72.71	75.38
NZD/AUD	0.9132	0.9034	0.9184
TWI	72.45	71.69	73.34

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	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	1.95	2.00	1.97	1.97	1.92	1.92	1.83	1.80
10 Year Bond	2.54	3.00	3.10	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	2.83	3.35	3.50	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	0.7279	0.73	0.72	0.70	0.70	0.70	0.74	0.75
USD/JPY	111.46	112	113	113	112	112	109	106
EUR/USD	1.1555	1.15	1.14	1.13	1.14	1.16	1.22	1.28
AUD/NZD	1.0959	1.11	1.11	1.09	1.09	1.09	1.12	1.10

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