Weekly Commentary

3 December 2018

New Zealand Bush Giant Dragonfly (Kapokapowai)

Easy does it

The Reserve Bank has announced a further easing of its mortgage lending restrictions, as we expected. These changes, along with the recent falls in mortgage rates, are likely to see the housing market liven up over the coming months, adding to the flow of positive signals for the local economy. However, we still think that markets are misreading how the Reserve Bank will respond to the economic data, and that official interest rate hikes are some time away.

In its latest six-monthly *Financial Stability Report* the RBNZ announced a further easing of its restrictions on high loan-to-value ratio (LVR) mortgage lending, following the modest easing that was announced a year ago. The 'speed limit' for owner-occupier loans – the share of lending that can be above an 80% LVR – will be raised from 15% to 20%. For investor loans, the effective cap on LVRs will be raised from 65% to 70%. Both changes will take effect from the start of next year.

While household debt levels remain high, the growth in house prices and credit has moderated in recent years, and is now more broadly in line with household income growth. The LVR restrictions have no doubt played a part in this moderation. But since they were first introduced in 2013, they have been joined by a range of other forces that have dampened housing demand. Policies such as the 'bright-line test' for taxing capital gains have targeted investor demand, while the banking sector has moved to tighten lending standards in recent years.

We'd expect the housing market to respond to these LVR changes in a similar way to what we saw last year. Banks increased their high-LVR lending, but maintained a sizeable buffer below the maximum levels. Much of the additional leeway on owner-occupier lending appears to have gone towards first-home buyers. House price growth did pick up a little in early 2018, but it's hard to distinguish between the impact of the LVR changes and the drop in mortgage rates around the same time.

Similar conditions prevail this time – in fact there has been quite a sharp fall in mortgage rates in recent months. Consequently, we're expecting the housing market to be a bit livelier in the next few months. However, we still expect government policies and an eventual rise in interest rates to keep house prices subdued over the next few years as a whole.

A livelier housing market would add to the signals of a stronger economy that we expect to see over 2019. Rising house prices tend to support consumer spending growth, Government spending is accelerating from its previous pace, and a large pipeline of approved work will support construction activity. We're forecasting GDP growth to pick up to 3.2% next year, after slowing to 2.9% growth over 2018.

Financial markets will need to carefully consider what a stronger economy holds in store for monetary policy. We've seen some quite strong reactions to recent RBNZ policy reviews. In August the RBNZ said that it was nearing the threshold for cutting the OCR; market interest rates fell sharply, with some fixed-term mortgage rates falling to new record lows. But in November, when the RBNZ acknowledged that the economy had outperformed its forecasts, interest rates and the New Zealand dollar moved sharply higher again. Interest rate markets are now pricing some chance of an OCR hike by the end of 2019.

Easy does it continued

We're still of the view that the recent market reaction has been overcooked. The RBNZ sent a clear signal about its intentions in its November *Monetary Policy Statement*: when faced with a stronger outlook for the economy, it chose to take this as higher inflation (and higher employment) rather than higher interest rates. Its projected path for the OCR was identical to August, with no hikes until well into 2020.

We'd also point out that, unlike in the previous quarter, the economy is not currently outperforming the RBNZ's forecasts. Last week's retail trade report showed that sales volumes were flat in the September quarter. The result was surprising given the strength in electronic card spending over the quarter, but nevertheless this is what will go into the official GDP figures. Soft retail spending supports our view that September quarter GDP will see a more modest gain of 0.7% after the whopping 1% rise in the June quarter.

As for inflation pressures, recent developments have actually been to the downside. World oil prices have fallen sharply, from a peak of around US$85 a barrel for Brent crude in early October to below $60 a barrel today. Accordingly, petrol prices have fallen to their lowest levels since May (despite increases in fuel taxes since then).

Meanwhile, the New Zealand dollar has strengthened to its highest against the US dollar since June. Some of that is due to market perceptions that the RBNZ will hike rates sooner. But more recently we've also seen a weaker US dollar, as softer economic data in the US has led to speculation that the Federal Reserve could slow the pace of its rate hikes.

We should point out that the RBNZ's forecasts of near-term inflation are still on the low side (with a pickup in later years). But it's looking less likely that they will be grappling with upside surprises at their next review in February. And a softer US economy, lower fuel prices and a high New Zealand dollar would all make the RBNZ even less inclined to signal OCR hikes any time soon.

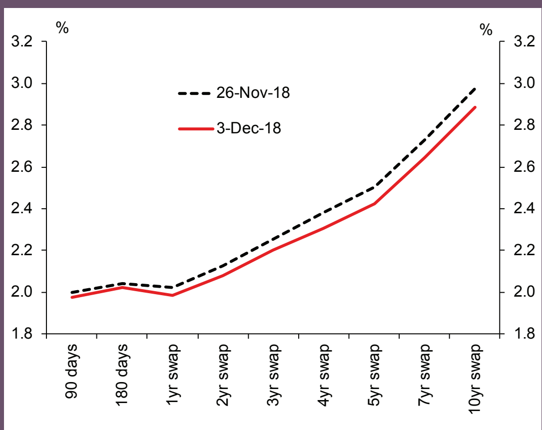
Fixed vs Floating for mortgages

Fixed-term mortgage rates fell sharply during spring, but have now settled down. From here, we expect wholesale fixed interest rates to remain stable or rise slowly. This means that retail fixed mortgage rates are more likely to rise than fall, although there are uncertainties around any forecast.

One-year fixed rates are currently the lowest on offer, and appear to offer good value to borrowers. 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 terms of trade

Dec 3, Last: +0.6%, WBC f/c: -0.7%, Mkt f/c: 0.2%

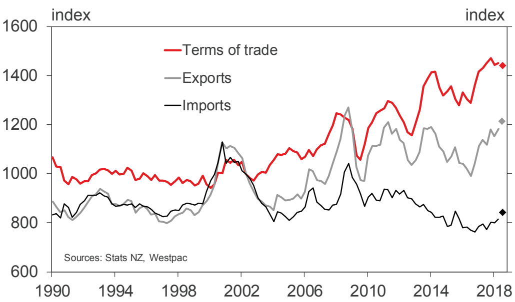
- New Zealand's terms of trade have edged back slightly after reaching an all-time high in 2017. We expect a 0.7% drop for the September quarter, unwinding the 0.6% rise in the June quarter.
- We expect a 2.7% rise in export prices overall, led by a 7% rise in dairy prices. Other commodity exports saw modest price gains, largely as a result of the lower New Zealand dollar over the quarter.
- The rise in dairy export prices is likely to be outweighed by a 14% surge in oil import prices. We also expect small price gains for other imports (mostly manufactured goods), again due to the lower exchange rate.

NZ Q3 building work put in place

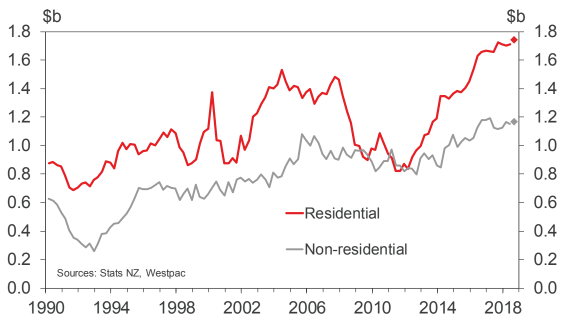
Dec 5, Last 0.8%, Westpac f/c: +2.3%, Mkt f/c: 2.3%

- Building activity rose by 0.8% in the June quarter, reversing the small drop in the previous quarter. Underlying this rise was a 1.2% increase in non- residential activity, as well as a 0.5% increase in residential construction.
- We're expecting a 2.3% increase in overall building activity in the September quarter, supported by gains in both residential and non-residential building. On the residential front, we expect building levels to increase by 1.8% in September with gains centred on Auckland. We also expect a 3% increase in non- residential construction, with increases spread across the retail, industrial and accommodation sectors. Public sector building work is also increasing slowly.

NZ terms of trade



NZ real building work put in place



Aus Nov CoreLogic home value index

Dec 3, Last: –0.5%, WBC f/c: –1.0%

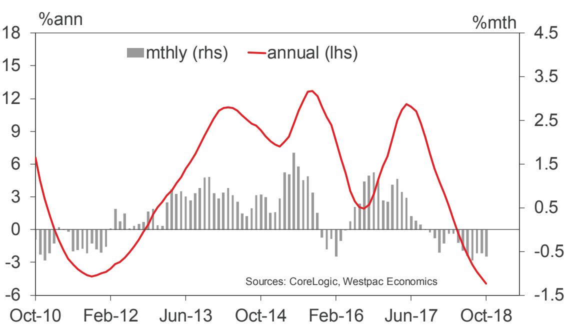
- Australia's housing market continues to correct. The CoreLogic home value index fell 0.6% in October to be down 4.6%yr, revisions accentuating the annual decline. The correction continues to be more pronounced for the previously strong Sydney and Melbourne markets, with Perth's longer running adjustment continuing but prices stable across the other major capital cities.
- November looks to have been an even weaker month, auction clearance rates dropping to previous cycle lows in Sydney and Melbourne. The daily index points to a 1.0% drop in prices nationally with the cumulative price adjustment across the five major capital cities now close to 6% since last September's peak.

Aus Oct dwelling approvals

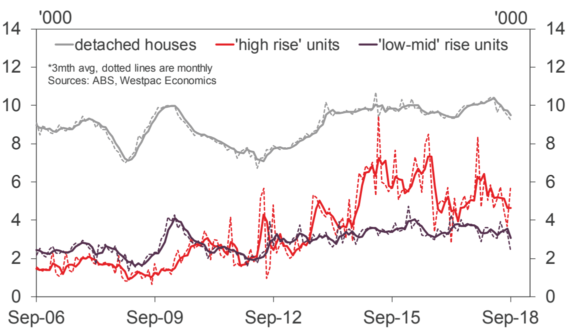
Dec 3, Last: 3.3%, WBC f/c: –3.0%
Mkt f/c: -1.5%, Range: -4.0% to 3.0%

- Dwelling approvals rose 3.3% in September, reversing part of the 13% slide over the previous two months. However, the detail was weak with the monthly gain centred on Victoria high rise units and approvals outside of this narrow state segment significantly weaker (our estimates suggest total dwelling approvals ex Victoria high rise were down about 7.5%mth).
- The October update looks likely to show a fall with some risk that this may be sharp. Housing markets have weakened significantly since mid year. Site purchases continue to point to lower high rise activity while construction-related finance approvals suggest non-high activity will remain weak, stabilising at best. On balance, we expect a 3% decline in total approvals with risks skewed to the downside.

Australian dwelling prices



Australian residential dwelling approvals



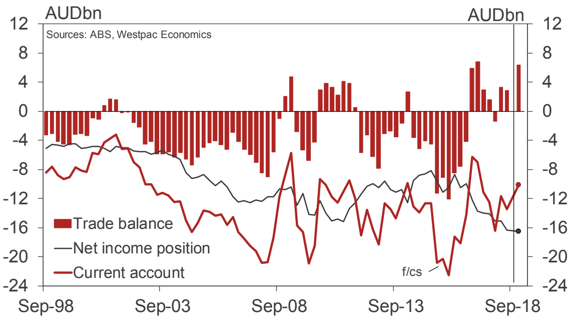
The week ahead

Aus Q3 current account, AUDbn

Dec 4, Last: -13.5, WBC f/c: -10.1
Mkt f/c: -10.2, Range: -12.2 to -9.9

- Australia's current account deficit is relatively well contained currently, at 2.9% of GDP in the June quarter.
- In the June quarter, the deficit was $13.5bn, with a trade surplus of $2.8bn (since upgraded to $4.2bn) and an income deficit of $16.3bn.
- For the September quarter, the current account is set to narrow, improving to a deficit of $10.1bn. Key to the improvement is a larger trade surplus, increasing to $6.4bn on higher export earnings. The terms of trade rose by 1.2%, we estimate, driven by commodity prices.
- The net income deficit is expected to increase to $16.5bn, up sharply over the past two years from $10bn. Over this period, the deficit increased largely due to rising returns to foreign investors in the mining sector.

Current account: f/c –$10.1bn in Q3

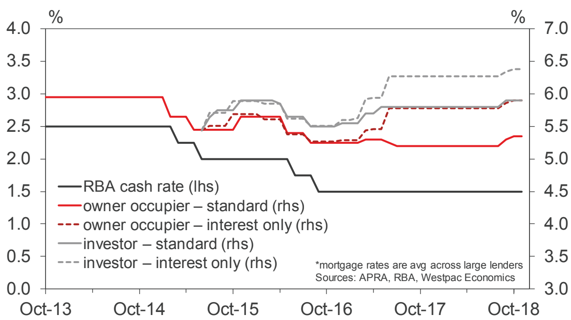


Aus RBA policy announcement

Dec 4, Last: 1.50%, WBC f/c: 1.50%
Mkt f/c: 1.50%, Range: 1.50% to 1.50%

- The Reserve Bank will leave interest rates unchanged at 1.50% at the December meeting. We continue to expect rates to be on hold throughout 2019 and 2020.
- Macro-prudential measures have seen a tightening of lending conditions for housing, triggering a cooling of the sector following a strong upswing. Notably, the correction in the housing market is occurring against the backdrop of a robust economy. Growth has been above trend and unemployment has fallen to a six year low.
- The RBA expects further, but only gradual, progress in reducing unemployment and returning inflation towards the middle of the target band. A lift in wages growth, from the current sluggish pace, will be key to achieving a sustained lift in inflation.

RBA cash rate and mortgage interest rates

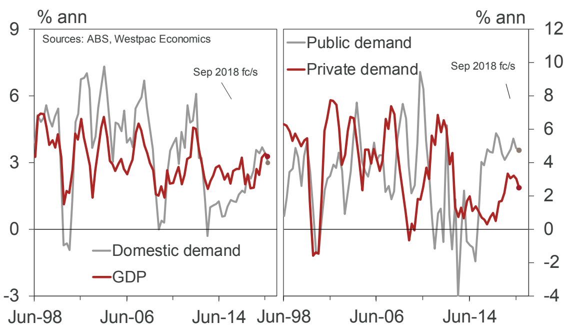


Aus Q3 GDP

Dec 5, Last: 0.9%qtr, 3.4%yr, WBC f/c: 0.7%qtr, 3.4%yr
Mkt f/c: 0.6%, Range: 0.4% to 0.9%

- Australia's output performance surprised to the high side over the past year, at a well above trend 3.4%, including a 4.1% annualised pace over the first half of 2018.
- For Q3, momentum eased back to around a trend pace, at a forecast 0.7%qtr - albeit with risks tilted to the downside. That leaves annual growth at 3.4% (subject to revisions). Key to some slowing between Q2 and Q3 is the cooling of the housing sector, both prices and activity, as well as an ongoing choppy profile for consumer spending.
- The arithmetic of our GDP forecast is: domestic demand 0.5%; net exports, +0.2ppts and inventories a very small negative, rounding up to -0.1ppts. Labour conditions were robust in Q3, employment +0.7%, evidence that the economy still had solid momentum.

Australian economic conditions

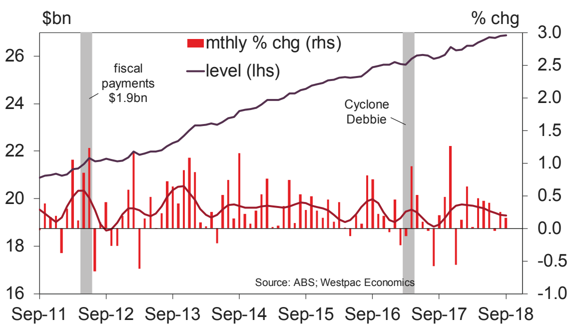


Aus Oct retail trade

Dec 6, Last: 0.2%, WBC f/c: 0.1%
Mkt f/c: 0.3%, Range: 0.0% to 0.5%

- September retail sales were on the soft side, rising 0.2% in the month, holding annual growth at 3.7%yr. Sales have been tracking closer to a 3.3% annual pace over the last six months. The detail showed gains in the month concentrated in food categories (up 0.5% on a combined basis) with non food retail declining 0.2%mth.
- Indicators have been mixed in October. Consumer sentiment lifted a little to be slightly above average. Private business surveys showed soft readings amongst retail responses to the NAB survey but a lift in the AiG PSI. Anecdotal reports have tended to be on the soft side. Weakening housing markets may also be starting to affect demand. On balance, we expect October to show a subdued 0.1% gain taking annual growth to 3.3%yr.

Australian monthly retail sales



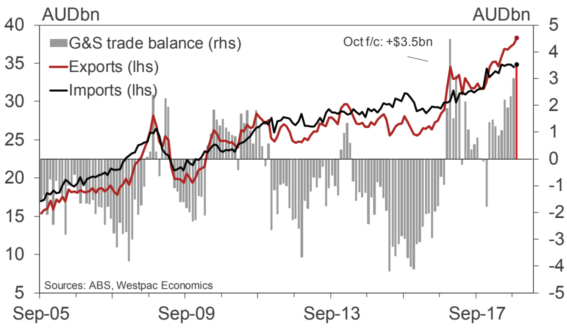
The week ahead

Aus Oct trade balance, AUDbn

Dec 6, Last: 3.0, WBC f/c: 3.5
Mkt f/c: 3.0, Range: 2.0 to 3.7

- Australia's trade account has been in surplus every month so far in 2018.
- For October, we expect the surplus to rise higher, to $3.5bn, the largest surplus since the end of 2016.
- Export earnings are up a forecast 2.2%, +$0.8bn. Key is a rebound in coal volumes from the supply disruptions of the past couple of months. Commodity prices were also higher in the month.
- The import bill is forecast to rise by around 1.0%, +$0.3bn. Volumes are expected to resume their uptrend, emerging from the softness of Q3, while prices are higher associated with rising global energy prices and a lower dollar (down 1.4% against the US dollar to 71¢ in October).

Australia's trade balance

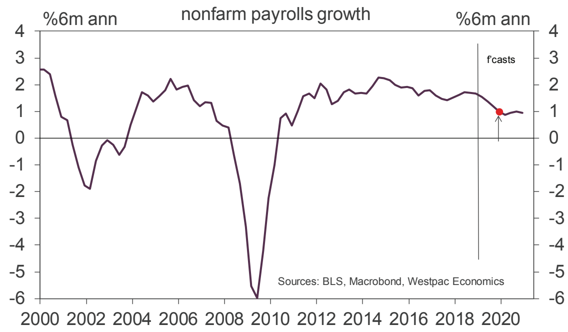


US Nov employment report

Dec 7, nonfarm payrolls, last 250k, WBC 200k
Dec 7, unemployment rate, last 3.7%, WBC 3.7%
Dec 7, hourly earnings %yr, last 3.1%, WBC 3.2%

- The average monthly gain for nonfarm payrolls has been very steady this year, at around 215k. This has been well above the pace necessary to keep the unemployment rate unchanged, indicating demand for labour remains strong.
- This strength in employment will see downward pressure remain on the unemployment rate, though the next step lower is more likely in a few months time than November.
- Hourly earnings have been picking up momentum over the past year and, given full employment, this is expected to continue. An annual rate a little above 3.0%yr is expected near term, before a further firming to circa 3.5% mid-2019.

US non-farm payrolls

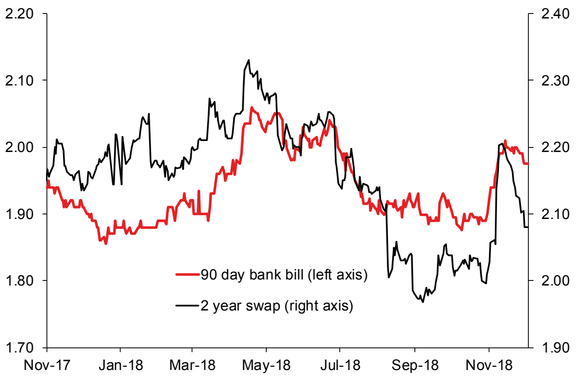


New Zealand forecasts

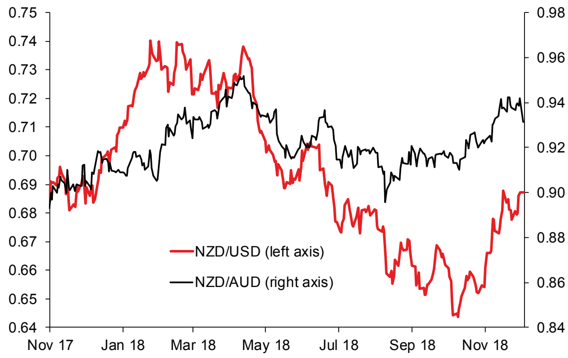
Economic Forecasts	Quarterly				Annual			
	2018			2019				
% change	Jun (a)	Sep	Dec	Mar	2017	2018f	2019f	2020f
GDP (Production)	1.0	0.7	0.8	0.7	2.8	2.9	3.2	3.1
Employment	0.6	1.1	0.0	0.2	3.7	2.3	1.3	1.6
Unemployment Rate % s.a.	4.4	3.9	4.3	4.4	4.5	4.3	4.2	4.1
CPI	0.4	0.9	0.4	0.4	1.6	2.2	1.9	2.1
Current 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 3 December 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.91%	1.90%	1.85%
60 Days	1.95%	1.95%	1.90%
90 Days	1.98%	2.00%	1.94%
2 Year Swap	2.08%	2.18%	2.06%
5 Year Swap	2.43%	2.57%	2.39%

NZ foreign currency mid-rates as at 3 December 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6872	0.6862	0.6645
NZD/EUR	0.6066	0.6015	0.5827
NZD/GBP	0.5395	0.5349	0.5094
NZD/JPY	78.47	77.45	75.19
NZD/AUD	0.9314	0.9382	0.9238
TWI	75.33	75.04	72.71

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 03					
NZ	Q3 terms of trade	0.6%	–	–0.7%	Surge in imported oil prices outweighed gains in dairy.
Aus	Oct dwelling approvals	3.3%	-1.5%	–3.0%	Sep detail was weak. Risk of a sharper pull back.
	Nov CoreLogic home value index	–0.6%	–	–1.0%	Housing market posting a very weak finish to 2018.
	Q3 company profits	2.0%	2.8%	1.3%	Up on higher commodity prices, while non-mining mixed.
	Q3 inventories	0.6%	0.4%	0.5%	A slightly more modest gain in Q3, on softer consumer.
	Nov AiG PMI	58.3	–	–	Manf'g robust expansion on construction & lower AUD.
	Nov ANZ job ads	0.2%	–	–	Job ads levelled in the last 6 months as employment slowed
Chn	Nov Caixin manufacturing PMI	50.1	50.1	–	NBS measure edged down again in Nov.
Eur	Nov Markit manufacturing PMI final	51.5	–	–	Flash estimate continued to edge lower.
UK	Nov Markit manufacturing PMI	51.1	52.0	–	Headwinds from softening domestic demand, exports firmer.
US	Nov Markit manufacturing PMI final	55.4	–	–	Regional surveys have been losing momentum.
	Oct construction spending	0.0%	0.4%	–	Energy-related spending positive – for now.
	Nov ISM manufacturing	57.7	58.0	–	Remains at an elevated level despite softening in regions.
	Fedspeak	–	–	–	Kaplan at community forum.
Tue 04					
Aus	Q3 net exports, ppts cont'n	0.1	0.3	0.2	Exports advance while imports slip.
	Q3 current account, AUDbn	-13.5	-10.2	-10.1	Improved trade position outweighs widening income deficit.
	Q3 public demand	0.6	–	1.4%	Public investment strong upswing to resume after Q2 dip.
	RBA policy decision	1.50%	1.50%	1.50%	On hold, conditions solid, consumer a source of uncertainty.
UK	BOE Governor Carney	–	–	–	Speaking to Parliament on Brexit withdrawal agreement.
Wed 05					
NZ	GlobalDairyTrade auction	–3.5%	–	–	Likely to remain under pressure from strong NZ milk prod'n.
	Q3 vol of building work put in place	0.8%	–	2.3%	Gains in residential and non–residential, centred on Auckland.
	Nov ANZ commodity prices	–2.4%	–	–	Falling dairy prices to weigh on index.
Aus	Q3 GDP	0.9%	0.6%	0.7%	Strength in public spending & net exports a positive.
	Nov AiG PSI	51.1	–	–	Pace of expansion slowed over recent months.
Chn	Nov Caixin China PMI services	50.8	50.9	–	NBS measure edged down again in Nov.
UK	Nov Markit services PMI	52.2	52.7	–	After firming through mid–2018, demand has cooled again.
US	Nov ADP employment change	227k	200k	195k	An unreliable indicator of payrolls.
	Q3 productivity	2.2%	2.3%	–	Has improved in 2018, aiding capacity.
	Nov ISM non–manufacturing	60.3	59.5	–	Holding near historic highs.
	Fed Chair Powell	–	–	–	Testimony before Joint Economic Committee of Congress.
	Federal Reserve's Beige book	–	–	–	Conditions across the 12 districts.
Thu 06					
Aus	Oct retail sales	0.2%	0.3%	0.1%	Indicators mixed for the month.
	Oct trade balance, AUDbn	3.0	3.3	3.5	Surplus up on higher exports as coal vol's rebound.
	RBA Dep Governor Debelle speaks	–	–	–	'Lessons and Questions from the GFC', ABE dinner, Syd 8 pm.
US	Oct trade balance US$bn	–54.0	-54.9	–	Strength of consumer and pull forward of trade boosting.
	Initial jobless claims	234k	–	–	At historically low levels.
	Oct factory orders	0.7%	-2.0%	–	Durables surprised to the downside; and trend soft.
	Fedspeak	–	–	–	Bostic on the US economic outlook
Fri 07					
Chn	Nov foreign reserves $bn	3053.1	–	–	Authorities have been a little more active recently.
Eur	Q3 GDP 3rd estimate	0.2%	–	–	Update will provide expenditure detail.
UK	Nov Halifax house prices	0.7%	–	–	Economic uncertainty continues to dampen price gains.
US	Nov non-farm payrolls	250k	205k	200k	Strong 2018 trend to continue.
	Nov unemployment rate	3.7%	3.7%	3.7%	Unchanged in Nov, but slow trend decline intact.
	Nov avg hourly earnings %yr	3.1%	3.2%	3.2%	Increasingly the focal point of this release.
	Oct wholesale inventories	0.7%	–	–	Remains volatile.
	Dec Uni. of Michigan sentiment	97.5	97.0	–	Strong.
	Fedspeak	–	–	–	Brainard on financial stability.
Sat 08					
Chn	Nov trade balance USDbn	34.0	–		Benefitting from pull forward ahead of tariffs.

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	1.95	1.98	1.93	1.91	1.90	1.90	1.85	1.83
10 Year Bond	2.59	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	3.03	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	0.7317	0.72	0.71	0.70	0.68	0.70	0.74	0.74
USD/JPY	113.43	114	114	115	114	112	109	106
EUR/USD	1.1395	1.13	1.11	1.10	1.09	1.10	1.16	1.22
AUD/NZD	1.0658	1.09	1.11	1.11	1.11	1.13	1.16	1.13

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