Weekly Commentary

30 July 2018

Crossroads

Over the past week we've seen more evidence that the economy slowed in the first half of the year. Notably, net migration has continued to slow and there are signs that firms are aren't importing capital equipment at the same pace they were earlier in the year. Soft growth in recent months is also likely to mean that after a string of stronger reports, the labour market took a breather in the June quarter.

Last week we had further confirmation that the economy shifted down a gear in the first half of the year. One thing we have been expecting was a lull in business investment on the back of policy uncertainty and weak business confidence over recent months. This view was supported by recent surveys where businesses reported that they intended to invest less over the coming months. However, until last week, we had little hard evidence of an actual decline in investment. June merchandise trade data may be one of the first signs. The pace of capital equipment imports slowed in June, consistent with our forecasts of a temporary lull in business investment in the second half of the year. We expect to capital equipment imports slide further in the coming months.

Another key element of the slowdown is lower net migration. June net migration data was again consistent with this view. Monthly net migration slowed further, taking annual net migration to its lowest point since November 2015. While this is still a historically high level, annual net migration has fallen from a peak of 72,500 to just below 65,000 now.

Much of the recent easing in net migration has been driven by changing trans-Tasman flows. The relative attractiveness of the Australian labour market has improved on the back of strong employment growth and a falling unemployment rate. We expect the relative attractiveness of labour market conditions to continue to move in Australia's favour over the coming years. This is likely to lead to a growing number of New Zealanders once again heading to Australia to seek their fortunes across the ditch.

That said, local labour market conditions are currently uncertain. Presently, labour market conditions are very firm with the unemployment rate at a 9 year low and widespread angst amongst firms about the difficulty of finding workers. However, we expect the slowdown in broader economic conditions to ultimately impact on demand for labour – albeit with a lag. These competing tensions are likely to be evident in the suite of labour market data for the June quarter released this week.

On balance we expect the unemployment rate to hold steady at 4.4%. While labour market data can be notoriously choppy from quarter to quarter, the unemployment rate tends to be the most reliable measure of what's truly going on. What's more, some of the detail in in next week's release could be a little surprising for financial markets. Most notably we're forecasting negative employment growth for the quarter. Much of this reflects our allowance for a distorted seasonal pattern in the survey rather than a genuine difference of opinion with other forecasters expecting positive employment growth. Nevertheless, such a seemingly weak result would likely generate some commentary and a reaction in financial markets. We emphasise focusing on the unemployment rate as the most reliable measure.

Crossroads... continued

With inflation firmly back on the radar for both markets and the Reserve Bank in recent weeks, there will also be interest in how the various wage measures are evolving. To date there has been little evidence that the tightening labour market has led to a pickup in wage pressures. And our forecasts assume that this remains the case in the June quarter. Although we expect a 0.5% quarterly lift in the Labour Cost Index (LCI) (an step up from the string of 0.4% increases) the lift is mostly due to this year's larger than usual minimum wage hike and last year's aged care workers' pay equity settlement. The LCI tends to evolve very slowly, so any deviation from our forecast – in either direction – would be noteworthy. Importantly, we don't expect wage pressure will be contained indefinitely. Rising inflation expectations combined with a low unemployment rate and policy changes that have swung the dial in favour of employees in wage negotiations should see wage inflation eventually start to drift higher next year.

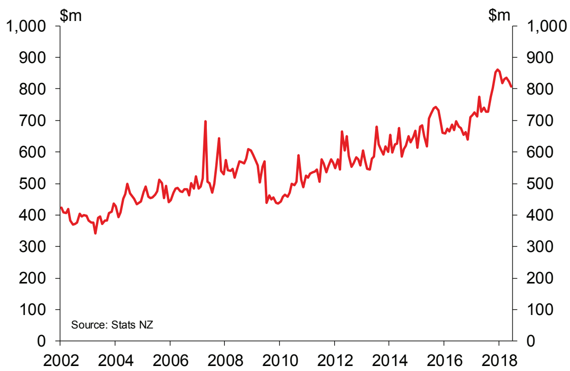
With the Reserve Bank's dual employment and inflation mandate now firmly in place, next week's labour market data will also form an important part of the deliberations ahead of the Monetary Policy Statement released on the 9th of August.

For the record, we think it's extremely unlikely that any surprises in the labour market data will be enough to shift the Bank from its on hold "for some time to come" stance.

While inflation pressures are rising, most notably with non-tradable inflation printing above the RBNZ's forecasts in Q2, and measures of core inflation edging higher, rising inflation pressures are being largely offset by slower growth. GDP grew 0.4% in the March quarter, well short of the RBNZ's 0.7% forecast while their 0.8% forecast for Q2 also looks too optimistic to us.

Given these broadly offsetting developments, the RBNZ is unlikely to be hurried into action any time soon. We maintain our view that it will be the final quarter of 2019 before the RBNZ raises the OCR.

Monthly imports of capital equipment

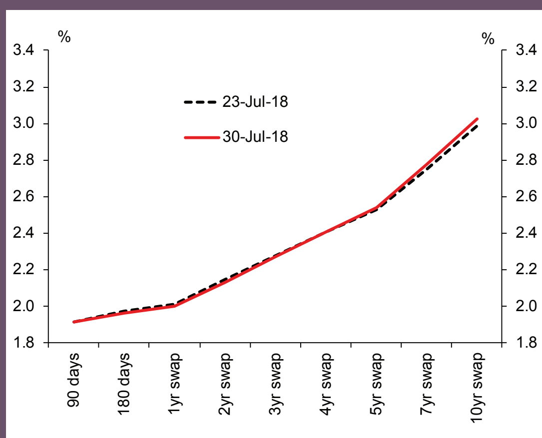


Fixed vs Floating for mortgages

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



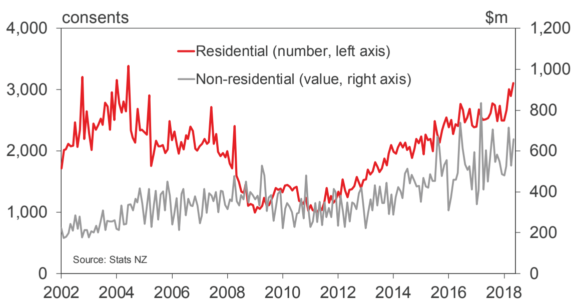
The week ahead

NZ Jun residential building consents

Jul 31, Last: +7.1%, WBC f/c: -12%

- Residential consent issuance surged higher in May, rising by 7.1%. That took consent numbers to their highest level since 2004. In part, this pickup was due to some 'lumpy' changes, including a roughly 25% increase in the usually stable standalone homes category in Auckland last month. More importantly, there has been a sizeable trend increase in medium density consents in Auckland, supported by regulatory changes.
- Consent numbers in most other regions remain firm, though issuance in Canterbury is gradually easing back.
- With some 'lumpy' issuance in recent months, we expect to see a sizeable pullback in overall consent numbers in June. However, the level of issuance is still expected to remain elevated, supported by continued high numbers of consents for medium density homes in Auckland.

NZ building consents

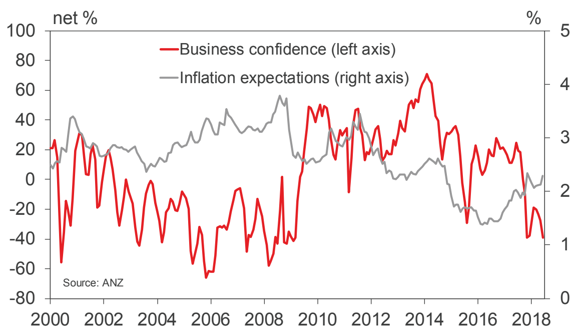


NZ Jun ANZ business confidence

Jul 31, Last: -39

- Business confidence weakened further in June and firms' expectations of their own activity fell to its lowest level since November 2017.
- The fall in business confidence was relatively widespread. However, there was some improvement in confidence in the agricultural sector in June following the Government's announcement of its intention to attempt eradication of Mycoplasma bovis and a strong opening payout forecast from Fonterra. Since then dairy prices have fallen sharply which may dent confidence.
- Inflation expectations edged higher in June and could go further in the coming months on the back of rising petrol prices and higher headline inflation.

NZ business confidence and inflation expectations

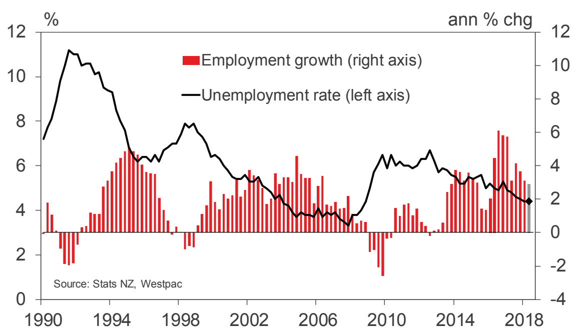


NZ Q2 Household Labour Force Survey

Aug 1 Employment, Last: +0.6%, WBC f/c: -0.3%, Mkt f/c: +0.4%
Aug 1 Unemployment Last: 4.5%, WBC f/c: 4.4%, Mkt f/c: 4.4%

- New Zealand's labour market has tightened over recent years. But slowing economic growth is likely to put a dampener on the pace of improvement.
- We expect the unemployment rate to hold steady at 4.4% in the June quarter, ending a five-quarter run of declines. This is in line with the Reserve Bank's forecast and other market forecasts.
- Where we differ is in our forecast of a drop in employment for the quarter. That largely reflects our allowance for a distorted seasonal pattern in the survey. Nevertheless, such a seemingly weak result would likely generate some reaction in the market. We recommend focusing on the unemployment rate as the most reliable measure of labour market trends.

Household Labour Force Survey

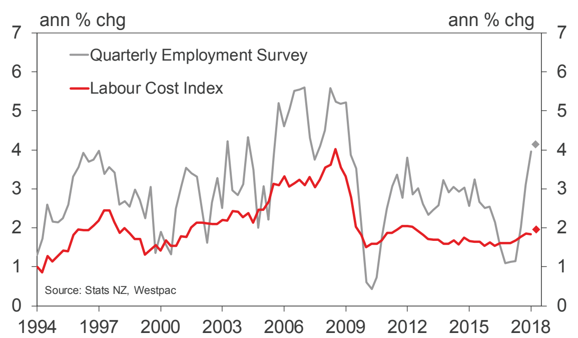


NZ Q2 Labour Cost Index

Aug 1, Private sector Last: 0.4%, WBC f/c: 0.5%, Mkt f/c: 0.6%

- The Labour Cost Index is a very slow-moving measure of wage growth. Recent years have seen a string of 0.4% quarterly gains, aside from the aged-care workers' pay equity settlement in Q3 last year.
- We expect a slightly larger 0.5% increase for the June quarter. The main factor is the 4.8% minimum wage hike this year, compared to average increases of 3.4% in the last few years. That aside, we don't expect to see widespread evidence of a pickup in wage growth yet.
- In contrast, the Quarterly Employment Survey (QES) measure of average hourly earnings has accelerated in the last year, and we expect a further pickup this time. But this measure slowed sharply a year ago, and it's not clear whether this rebound will be sustained.

LCI and QES wages



The week ahead

Aus Jun dwelling approvals

Jul 31, Last: –3.2%, WBC f/c: flat, Mkt f/c: 1.0%

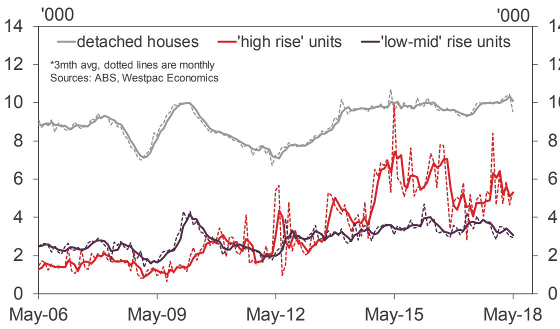
- Dwelling approvals fell 3.2% in May with a surprisingly sharp 8.6% fall in private detached houses partially offset by a 4.3% rise in units. With some wild swings in some of the state detail, we advise caution in interpreting the latest figures. In particular, a sharp fall in Qld may prove to be noise or a temporary pull-back. More generally, key parts of Westpac's forecast for a further weakening in high rise construction have yet to come through.
- The June update should resolve some of these questions. While the May drop looks overdone, construction-related housing finance approvals continue to point to a clear downtrend in non-high rise approvals. Meanwhile site purchases have for some time been pointing to a further sharp leg lower for high rise approvals. On balance we expect total approvals to hold flat in June even with some give back on the May weakness in houses.

Aus Jul CoreLogic home value index

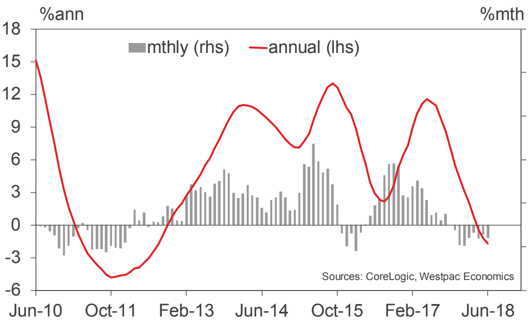
Aug 1, Last: –0.3%, WBC f/c: –0.5%

- Australia's housing market continues to correct. Prices dipped 0.3% in June marking the ninth successive monthly decline. Prices nationally are down 2.2% from their Sep peak.
- The correction remains both relatively shallow and narrowly-based, concentrated in the previously strong Sydney and Melbourne markets. These two markets have now seen no net gain in prices since late 2016 and mid-2017 respectively. The Perth market remains stuck in its long running correction as well.
- The daily index suggests price slippage quickened again in July with a 0.5% decline that will mean prices are down –2.5%yr nationally. Auction clearance rates weakened notably through May-June-July, pointing to an additional drag from tightening loan criteria and longer approval processing times.

Dwelling approvals: houses, low-mid & high rise



Australian dwelling prices



Aus Jun trade balance, AUDbn

Aug 2, Last: 0.8, WBC f/c: 1.1, Mkt f/c: 0.9

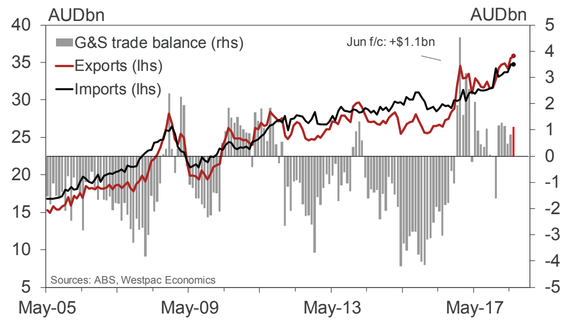
- Australia's monthly trade account has been in surplus so far in 2018. For June, we anticipate another trade surplus, widening a little to $1.1bn, up from $0.8bn in May.
- The import bill is expected to be broadly unchanged, with a lift in volumes potentially offset by a modest pull-back in fuel prices (following sharp rises of late).
- Export earnings are expected to expand by 0.8%, $0.3bn, boosted by a lift in coal volumes and higher coal prices. Fuels (including LNG) and metal ores (including iron ore) are expected to be little changed with modest gains in volumes offset by lower prices.

Aus Jun retail trade

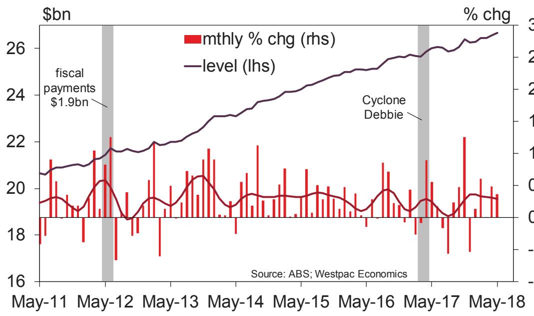
Aug 3, Last: 0.4%, WBC f/c: 0.3%, Mkt f/c: 0.3%

- Retailers reported a slightly better than expected, though still modest, 0.4% lift in sales in May. A rebound in clothing and department stores drove the gain with weak conditions across other categories. Some of the rebound is likely weather-related after abnormally warm conditions weighed on clothing sales in the early part of winter.
- Indicators suggest retailers continued to see mixed conditions in June. Consumer sentiment lifted following the tax cuts announced in the May Budget but key spending-related components remained soft. Private business surveys were mixed, retail responses to the NAB survey softening but the AiG survey showing an improvement. On balance, we expect May to show a 0.3% gain.

Australia's trade balance



Monthly retail sales



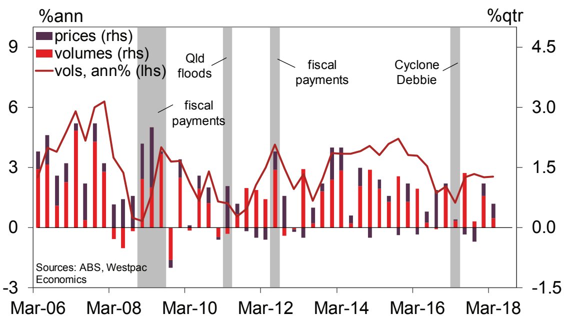
The week ahead

Aus Q2 real retail sales

Aug 3, Last: 0.2%, WBC f/c: 0.8%, Mkt f/c: 0.8%

- Q1 was a weak quarter for consumers with real retail sales rising just 0.2%. The main surprise was around retail prices which rose 0.4%, accounting for most of the nominal gain in sales over the quarter. The price lift was mainly driven by food with price deflation continuing across non food categories.
- The disappointing Q1 result follows a choppy run, the previous four quarters showing gains of 0.2%, 1.4%, 0.2% and 0.8%. Some of this may be due to shifts in the timing of sales, particularly around the Christmas-New Year period.
- The Q2 update is likely to show a rebound. Nominal sales are on track to be up 1.0% vs 0.6% in Q1. The Q2 CPI detail suggests retail prices rose about 0.2% in the quarter – this time with weakness in food offsetting firmer non-food prices. While uncertain, the mix points to a 0.8% rise in real sales.

Quarterly retail volumes and prices

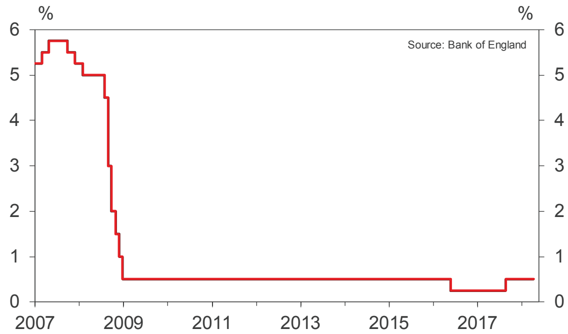


UK Bank of England Bank Rate

Aug 2, Last: 0.5%, WBC f/c: 0.5%, Mkt f/c: 0.75%

- The Bank of England's August decision is looking finely balanced. The BOE has previously signalled a gradual modest tightening will be required over the next few years. And since their previous decision, we've seen the unemployment rate remain low and a number of indicators have pointed to a firming in growth through the middle part of the year.
- However, the pace of growth remains muted. In addition, inflation has been easing back, with the core rate now down to 1.9%. On top of those factors, the political backdrop remains rocky, with Brexit casting a long shadow over the economy's longer-term outlook.
- Given the lingering downside risks, we expect that the Bank of England will keep the Bank Rate on hold at its August meeting, and that they will maintain a gradual tightening bias.

Bank of England Bank Rate

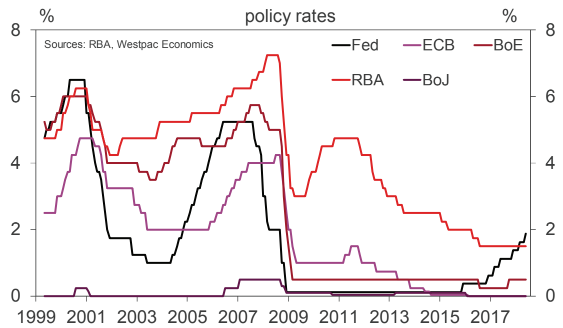


US FOMC Aug policy meeting

Aug 1, Last: 1.875%, WBC f/c: 1.875%

- The recent run of data has been with confidence and the FOMC. While they are very unlikely to upset the apple cart by accelerating the pace of fed fund rate hikes, the view put forward for the economy after the Aug 1 meeting will be very constructive.
- Evident in recent communications has been strong confidence in the labour market and hence household consumption. Meanwhile in the business sector, though recent trade tensions have fostered risks, broadly the Committee continues to believe that investment will add to growth through this year and next.
- Also apparent is that Chair Powell and the rest of the FOMC are not (yet) concerned about what the yield curve may be signalling, or financial conditions more broadly. The latter will bite, but not until mid-2019 after four more hikes.

FOMC to continue going it alone

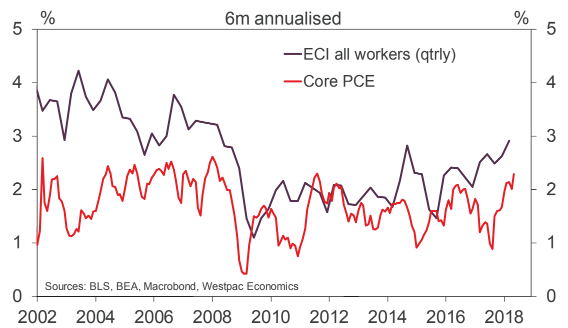


US Jul employment report

Aug 3 Employment change, Last: 213k, WBC f/c: 180k
Aug 3 Unemployment rate, Last: 4.0%, WBC f/c: 3.9%

- The US labour market has continued to exceed expectations in 2018. Employment growth continues to run well ahead of the pace needed to hold the unemployment rate constant. And, as a result, all measures of labour market slack have continued to move lower, past historically low levels.
- Come July, we look for another strong result, albeit a little more modest than those seen of late. A 180k gain would still see the average pace of 2018-to-date remain above that of 2017, and would further build the case for stronger wage gains.
- On that point, it is worth noting that the June data for personal income and the employment cost index on 31 July will precede the July employment report. Both are worthy of close attention.

US jobs growth to support wages and inflation



Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 30					
Eur	Jul economic confidence	112.3	112.1	–	Held up by strength in domestic demand.
	Jul business climate indicator	1.39	–	–	External sector to remain a risk.
UK	Jul Nationwide house prices	0.5%	–	–	Due this week. Weakness in London weighing on price growth.
	Jun net mortgage lending, £b	3.9	–	–	Credit growth remains muted.
US	Jun pending home sales	–0.5%	0.4%	–	Softer of late, primarily on lack of supply.
	Jul Dallas Fed index	36.5	31.0	–	Very strong.
Tue 31					
NZ	Jun building consents	7.1%	–	–12.0%	Reversal of lumpiness. Trend firm, esp. in Auckland.
	Jul ANZ business confidence	–39	–	–	Confidence has been weak & inflation pressures emerging.
Aus	Jun dwelling approvals	–3.2%	1.0%	flat	Data quirks exacerbated May fall but trends still weak.
	Jun private sector credit	0.2%	0.3%	0.3%	A trend slowdown as housing sector cools.
Chn	Jul non–manufacturing PMI	55.0	55.0	–	Has improved in recent months...
	Jul manufacturing PMI	51.5	51.3	–	... despite softening of external demand.
Eur	Jun unemployment rate	8.4%	8.3%	–	Continues to edge lower.
	Jul CPI core %yr	0.9%	1.0%	–	A long way from target.
	Q2 GDP advance	0.4%	0.5%	0.5%	First release, no detail.
UK	Jul GfK consumer confidence	–9	–	–	Political uncertainty, World Cup loss weighing on sentiment.
US	Q2 employment cost index	0.8%	–	0.7%	Will be closely watched for evidence of acceleration.
	Jun personal income	0.4%	0.4%	0.4%	Real income growth has remained soft...
	Jun personal spending	0.2%	0.4%	0.5%	... acting as a headwind for spending...
	Jun core PCE deflator	2.0%	2.0%	2.0%	... and limiting demand–driven inflation pressures.
	Jul Chicago PMI	64.1	61.8	–	Very positive.
	Jul consumer confidence index	126.4	126.0	–	The labour market remains a key support.
Wed 01					
NZ	Q2 unemployment rate	4.5%	4.4%	4.4%	Slowing economic growth to halt decline in unemployment.
	Q2 employment change	0.6%	0.4%	–0.3%	Seasonal pattern distorted; focus on unemployment rate.
	Q2 Labour Cost Index (private sector)	0.4%	0.6%	0.5%	Uptick in wage growth due to larger minimum wage hike.
Aus	Jul CoreLogic home value index	–0.3%	–	–0.5%	Price correction looks to have quickened in June.
	Jul AiG PMI	57.4	–	–	Manufacturing sector expanding, construction upswing & lower AUD.
US	Jul ADP employment change	177k	180k	170k	Due a softer month, though ADP underperforming payrolls.
	Jun construction spending	0.4%	0.3%	–	Higher rates to weigh?
	Jul ISM manufacturing	60.2	59.2	–	Remains well ahead of Markit measure.
	FOMC policy decision, midpoint	1.875%	1.875%	1.875%	No change for policy. Focus is September.
Thu 02					
Aus	Jun trade balance $bn	0.8	0.9	1.1	Another surplus, exports +0.8% on higher coal vols & prices.
UK	BoE policy decision	0.50%	0.75%	0.50%	Mkt prices 70% hike chance but inflation easing, risks linger.
US	Initial jobless claims	217k	–	–	Very low.
	Jun factory orders	0.4%	1.7%	–	Transport creating volatility.
Fri 03					
Aus	Jun retail sales	0.4%	0.3%	0.3%	Indicators point to mixed conditions in June month but ...
	Q2 real retail sales	0.2%	0.8%	0.8%	... Q2 wash–up likely to show clear improvement on weak Q1.
	Jul AiG PSI	63.0	–	–	Sharp rise in services index may be overdone – risk of pull–back.
US	Jul non–farm payrolls	213k	190k	180k	Due a softer month, but risks to upside.
	Jul unemployment rate	4.0%	3.9%	3.9%	Likely to reverse Jun rise in Jul.
	Jun trade balance US$bn	–43.1	–44.6	–	Partial reversal of recent improvement.
	Jul Markit services PMI	54.4	54.4	–	Both services PMIs point...
	Jul ISM non–manufacturing	59.1	58.6	–	... to continued robust momentum.

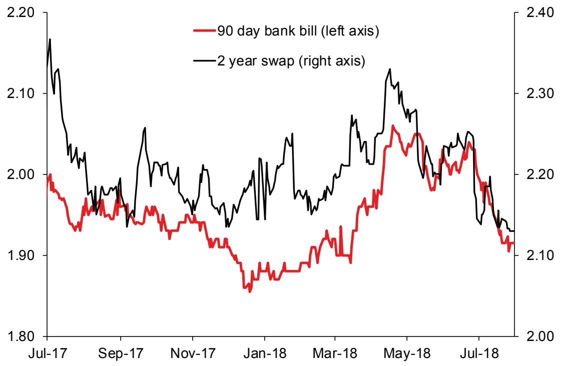
New Zealand forecasts

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	-0.3	0.9	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

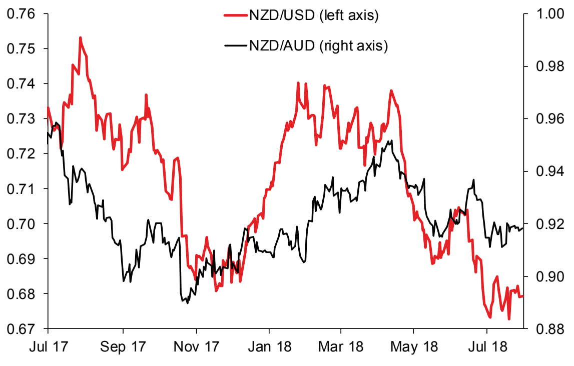
[1] Annual average % change

Financial Forecasts	Sep-18	Dec-18	Mar-19	Jun-19	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 30 July 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.81%	1.86%	1.90%
60 Days	1.86%	1.90%	1.94%
90 Days	1.92%	1.95%	1.99%
2 Year Swap	2.13%	2.16%	2.15%
5 Year Swap	2.54%	2.55%	2.54%

NZ foreign currency mid-rates as at 30 July 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6794	0.6763	0.6782
NZD/EUR	0.5829	0.5785	0.5813
NZD/GBP	0.5188	0.5114	0.5139
NZD/JPY	75.38	75.88	75.08
NZD/AUD	0.9184	0.9113	0.9166
TWI	73.34	72.76	72.68

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	1.96	2.04	2.02	1.95	1.95	1.90	1.90	1.85
10 Year Bond	2.66	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	2.98	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	0.7391	0.74	0.74	0.72	0.72	0.70	0.70	0.72
USD/JPY	110.94	111	112	114	113	112	110	109
EUR/USD	1.1654	1.17	1.16	1.15	1.16	1.18	1.20	1.21
AUD/NZD	1.0894	1.09	1.10	1.11	1.11	1.09	1.08	1.09

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