

Weekly Commentary

8 October 2018



Glow Worm (*Arachnocampa Luminosa*)

A winter of discontent?

Business confidence has fallen significantly over the past year. There's no doubt that at least some of this comes from firms registering their discontent with the new Government's policies. But there are also some genuine reasons for concern, as firms find their margins squeezed between rising costs and slowing consumer demand.

Last week saw the release of the Quarterly Survey of Business Opinion (QSBO) for the September quarter. General sentiment fell to -28, its lowest level since 2009, matching the fall that we've seen in the monthly ANZ survey. The more informative own-activity measure fell by a smaller degree, but was still at its lowest level since 2012. On its own, the survey suggests some downside risk to our forecast of a 0.7% rise in September quarter GDP.

Readers may be feeling some fatigue at the debate around whether business confidence surveys tell us anything useful. However, the QSBO warrants some attention for a number of reasons.

The first is that over time the QSBO has proven to be the more reliable early indicator of economic activity, compared to the monthly survey. Indeed, the message from the latest QSBO was a little more nuanced than what we've seen elsewhere: firms reported that the last three months were tougher, but the outlook for the next three months was little changed from the previous survey.

The QSBO's better track record as an indicator of GDP largely stems from the fact that, unlike the monthly survey, it hasn't shown a persistent downward bias under centre-left governments. However, that's not to say that it is entirely free from political influences.

The latest QSBO explored this aspect by asking businesses why they responded the way that they did. For those who

see the economic outlook getting worse, government policy was by far the most common reason given. (For firms who are more optimistic, finding workers is their biggest concern.) Unfortunately, the survey didn't uncover which particular policies are worrying businesses, but the planned changes to employment law are likely to be high on the list.

There are some obvious parallels between today and the year 2000, during what was dubbed the 'winter of discontent'. Then, a recently elected Labour-led Government was working to pass legislation (the Employment Relations Act) that would strengthen workers' rights to collective bargaining with employers. Business organisations lobbied vigorously against these changes, and surveys of business confidence (including the QSBO) fell suddenly and sharply in mid-2000. Notably, within a few months after the legislation was passed, business confidence had risen back to its previous levels.

So is the recent plunge in business confidence just another message of protest? No, or at least not entirely. There is plenty of corroborating evidence that the economy's pace of growth has slowed since its peak in 2016, though it's nowhere near the recessionary levels that the headline measures of business confidence would imply. Moreover, the details of the QSBO suggest that businesses are not merely unhappy with who's in power, but are genuinely feeling the pinch in some areas.

A winter of discontent? continued

The first detail is that over recent quarters a growing number of firms have said that demand is the biggest constraint on their growth (as opposed to supply-side factors such as the availability of workers). Concerns about demand haven't risen dramatically, but this marks a break in the downward trend going back to 2010 as the economy recovered from the Global Financial Crisis.

There is certainly evidence that growth in consumer spending has slowed in the last year or so, in line with the slowdown in house price growth. We expect that the Government's Families Package, which came into effect from July, will help to lift spending growth in the near term. But since the package is largely aimed at low-income households, the effects won't be felt evenly – for instance, sales of big-ticket items such as cars are unlikely to benefit.

The second detail is that a growing number of firms are reporting an increase in their costs. Some of the likely factors behind this are the increase in the minimum wage earlier this year, rising oil prices, and the fall in the exchange rate which has made imported goods and equipment more expensive.

There has also been a rise in the number of firms reporting that they have raised their own prices, but not to the same extent as for costs. In some ways this relates to the previous issue – demand isn't strong enough for firms to feel confident about passing on cost increases. As a result, more firms are seeing a squeeze on their profit margins, and they expect this squeeze to continue.

Unfortunately, those cost pressures have further to run. The New Zealand dollar has fallen to its lowest level since early 2016, with the US dollar in ascendancy as its economy gathers speed and US interest rates rise. At the same time, world oil prices have surged above \$80 a barrel, due to strong world demand and restricted supply from the OPEC countries. Together, these forces have pushed petrol pump prices up to record highs, and the latest increase in fuel taxes (up 4c a litre including GST) will add to the pain.

One of the effects of higher petrol prices is that they eat into household budgets, leaving less room for spending in other areas. This week's electronic card spending figures will shed some light on how consumers fared over September. Data from Paymark (the largest cards processor) showed a solid rise in total spending for the month, but it remains to be seen how much of this was absorbed by the rise in fuel prices.

Another implication is that it's increasingly likely that inflation will push above the 2% midpoint of the Reserve Bank's target range, for at least a short period. A jump in inflation caused by fuel prices is the kind of thing that the Reserve Bank can look through, if there's reason to believe that it won't continue to rise at the same pace. Nevertheless, what we're seeing now is markedly different from the central case that the RBNZ laid out in its August *Monetary Policy Statement*, where inflation was expected to remain below 2% until early 2021. If the RBNZ were contemplating OCR cuts in the near future, above-target inflation could make it a harder sell.

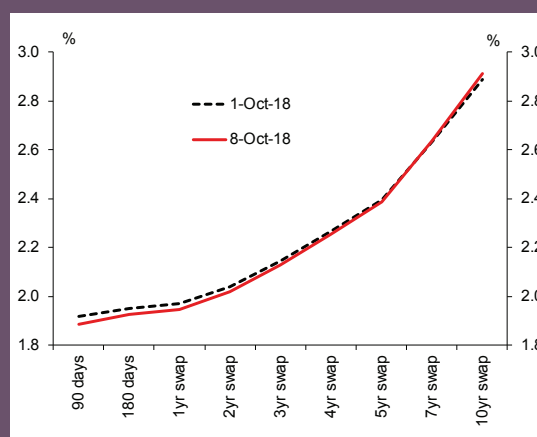
Fixed vs Floating for mortgages

Fixed-term mortgage rates are currently falling, as the market adjusts to the Reserve Bank's softer stance. Looking further ahead, we expect floating and short-term fixed rates to rise gradually over the next few years, so taking a fixed rate may prove worthwhile once they have settled down.

One-year fixed rates are currently the lowest on offer, and appear to offer good value for borrowers. Longer-term fixed rates are high relative to where we think one-year fixed rates are going to go. However, longer-term rates offer security against the possibility of mortgage rates rising more rapidly than expected in the future.

Floating mortgage rates usually work out to be more expensive for borrowers than fixed rates. However, floating may still be the preferred option for those who require flexibility in their repayments.

NZ interest rates



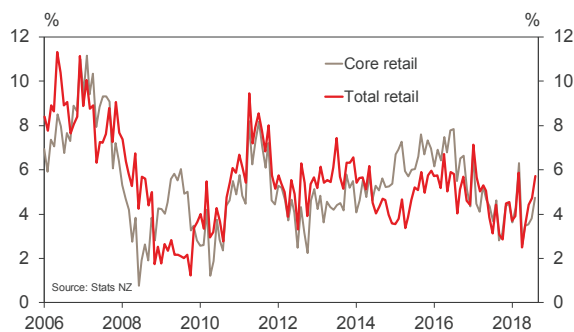
The week ahead

NZ Sep retail card spending

Oct 10, Last: +1.0%, Westpac f/c: +0.7%

- Retail spending rose by 1% in August. While spending levels were boosted by an increase in fuel prices, there was growth across all major categories. Spending has been supported by the Government's Families Package, which came into effect on 1 July and has boosted the incomes of many households.
- We expect a 0.7% increase in retail spending in September. However, with fuel prices pushing upwards, core spending growth is expected to be more modest at around 0.5%. Increases in disposable incomes are adding to spending in some areas like consumables. But at the same time, the continuing slowdown in the housing market is dampening spending on items like household furnishings.

Card transactions, annual % change

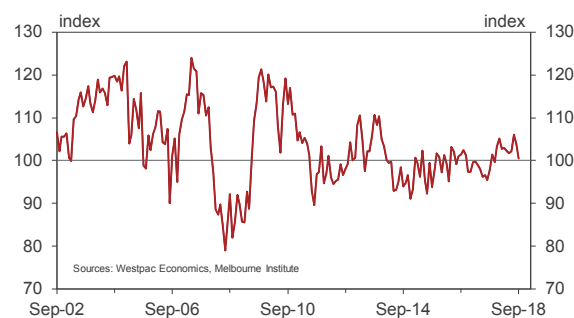


Aus Oct Westpac-MI Consumer Sentiment

Oct 10, Last: 100.5

- The Westpac Melbourne Institute Index of Consumer Sentiment declined 3% to 100.5 in September, marking the weakest read since November last year. Confidence was clearly knocked by increases in mortgage interest rates; political instability and ongoing household budget pressures. That said, there appeared to be some support from the strong June quarter growth figures and an encouraging lift in consumers' labour market expectations. Sentiment overall is still in positive territory, albeit only just above the 100 level. A notable feature of the firmer sentiment reads in 2018 is the more even spread across states with a clear improvement in the previously weak mining states.
- The October survey was in the field from October 1-6. The backdrop looks a little more settled this month, suggesting some of the impact from September's negatives may dissipate.

Consumer Sentiment Index



NZ Sep house sales and prices

Oct 10 (tbc), Sales last: +0.7%, Prices last: +4.1%/yr

- The housing market has cooled over the past year. Nationwide house sales have slowed, prices in Auckland have drifted lower, and there has been continued softness in Canterbury. However, price growth remains firm in most regions outside of Auckland and Canterbury.
- We expect nationwide average house prices to remain fairly subdued over the remainder of the year, with Auckland and Canterbury underperforming the rest of the country. Fixed mortgage rates have fallen recently following a dovish tilt from the RBNZ, and this is likely to provide some boost to house prices. However, there is still a sense of nervousness related to changes in Government policy. Such concerns are particularly acute in Auckland, where there is a greater prevalence of investors and affordability remains highly stretched.

REINZ house prices and sales



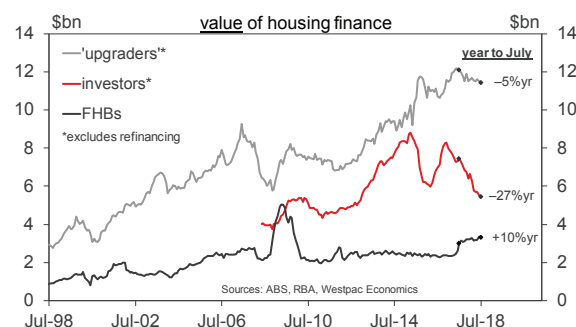
Aus Aug housing finance (no.)

Oct 12, Last: 0.4%, WBC f/c: -1.5%

Mkt f/c: -1.0%, Range: -3.0% to 0.5%

- While the headline number of owner occupier loans edged up 0.4% in July, this was entirely due to a 3% surge in refi activity with the number of 'new' loans down 0.8% mth to be 9.6% lower over the last year. The value of investor loans also declined 1.3% to be 15.7% lower over the year (an estimated -27% yr ex refi). The soft tone in the detail is consistent with the continued slowing in market conditions evident in auction markets and prices.
- The August update is likely to be a weak one. Housing markets continued to correct in the month, albeit with auction clearance rates showing some signs of finding a base. Overall we expect owner occupier finance approvals to be down 1.5%. The value of investor loans will again be of interest, as will the average value of owner occupier loans given the tightening in lending standards.

Value of finance approvals by segment



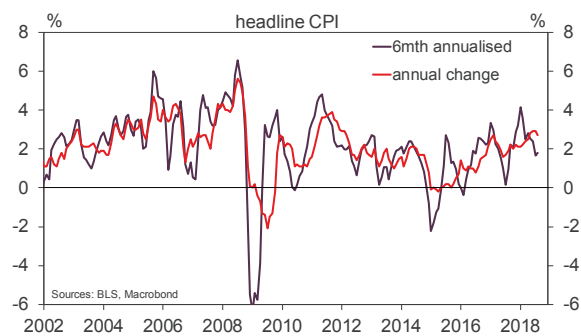
The week ahead

US Sep CPI

Oct 11, last 0.2%, WBC 0.2%

- The US headline CPI rose 0.2% in August. The core measure was softer at just 0.1%. Both outcomes were below expectations, as declines in health care and clothing dampened inflation pressures from gasoline and rents.
- While the annual headline rate is materially above the FOMC's 2.0%yr inflation target (2.7%yr), on a six and three month basis, the pulse is broadly in line – respectively 1.8% and 2.1% annualised. Core inflation is also consistent with target, at 1.9% on a six-month annualised basis and 2.2%yr for the year.
- As per their recent communications, the FOMC see little risk of an acceleration in underlying inflation away from target. Energy prices will however continue to create sporadic volatility, given recent movements in the price of oil.

For inflation, a sustained breakout unlikely



Data calendar

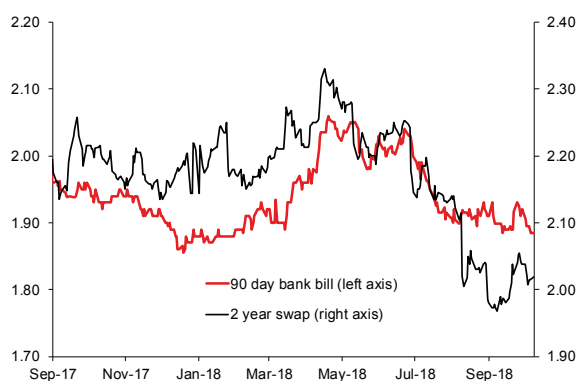
| | | Last | Market median | Westpac forecast | Risk/Comment |
|---------------|-------------------------------------|-------|---------------|------------------|--|
| Mon 08 | | | | | |
| Aus | Daylight saving time begins | - | - | - | Clocks forward 1 hr (except in the north west, WA, NT & Qld). |
| | Sep ANZ job ads | -0.6% | - | - | Has eased lower recently. |
| Chn | Sep Caixin China PMI services | 51.5 | 51.4 | - | NBS variant pointed to robust strength in services sector. |
| | Sep foreign direct investment %yr | 1.9% | - | - | Tariff tensions cloud outlook for investment. |
| Eur | Oct Sentix investor confidence | 12.0 | 11.8 | - | Stabilised after falling back though H1 2018. |
| US | Columbus Day | - | - | - | Public holiday. |
| | Fedspeak | - | - | - | Bullard speaking in Singapore, incl. media Q+A. |
| Tue 09 | | | | | |
| Aus | Sep NAB business survey | 15 | - | - | Conditions elevated, off highs. Confidence slipped further in Aug. |
| US | Sep NFIB small business optimism | 108.8 | 109.0 | - | Clearly very happy with current circumstances. |
| | Fedspeak | - | - | - | Williams speaking at NY Fed/Indonesia central banking forum. |
| | Fedspeak | - | - | - | Harker speaking on higher education. |
| Wed 10 | | | | | |
| NZ | Sep retail card spending | 1.0% | 0.6% | 0.7% | Increases in fuel prices, core spending firm. |
| | Sep REINZ house prices, %yr | 4.1% | - | - | Due this week. Recent softness to persist... |
| | Sep REINZ house sales | 0.7% | - | - | ...though falls in borrowing rates boosting areas outside of Akd. |
| Aus | Oct WBC-MI Consumer Sentiment | 100.5 | - | - | Knocked by leadership and mortgage rate changes last month. |
| Chn | Sep M2 money supply %yr | 8.2% | 8.5% | - | Tentative date. |
| | Sep new loans, CNYbn | 1280 | 1340 | - | Bank loans & market sourced funding to show improvement. |
| UK | Aug GDP (monthly) | 0.3% | 0.2% | - | Growth remains lacklustre, with a cooling in services sectors... |
| | Aug construction activity | 0.5% | 0.0 | - | ...sluggish growth construction activity... |
| | Aug industrial production | 0.1% | 0.1% | - | ...and slowdown in the manufacturing sector... |
| | Aug trade balance, £bn | -111 | -100 | - | ...with Brexit uncertainty one factor dampening activity. |
| US | Sep PPI | -0.1% | 0.2% | - | Stronger dollar restricting upstream price inflation. |
| | Aug wholesale inventories | 0.8% | - | - | Inventories supporting growth in Q3. |
| | Fedspeak | - | - | - | Williams on recent monetary policy developments. |
| | Fedspeak | - | - | - | Evans on policy and the economy. |
| Thu 11 | | | | | |
| NZ | Sep food prices | -0.5% | - | -0.4% | Food prices broadly flat year-on-year. |
| Aus | Oct MI inflation expectations | 4.0% | - | - | Watch for any boost from petrol prices. |
| | RBA Asst. Governor Ellis speaks | - | - | - | At Economic and Social Outlook Conference, Melb 9:30 am. |
| UK | Sep RICS house price balance | 2% | - | - | Brexit concerns weighing on prices, esp. in London. |
| US | Sep CPI | 0.2% | 0.2% | 0.2% | Another near target outcome. |
| | Initial jobless claims | 207k | - | - | At historic lows. |
| | Sep m'thly budget statement \$bn | 214.1 | - | - | Deficit to continue to rise. |
| | Fedspeak | - | - | - | Bostic speaks on the economy and monetary policy. |
| Fri 12 | | | | | |
| NZ | Sep BusinessNZ manufacturing PMI | 52.0 | - | - | Business surveys point to softer activity in H2 2018. |
| Aus | RBA Financial Stability Review | - | - | - | Condition of the financial system and risks to stability. |
| | Aug housing finance | 0.4% | -1.0% | -1.5% | Detail was soft in July. August likely to be weak. |
| Chn | Sep trade balance USDbn | - | - | - | Bring-forward of trade flows to create volatility. |
| Eur | Aug industrial production | -0.8% | 0.5% | - | Manufacturing PMI has continued to drift back to trend. |
| US | Sep import price index | -0.6% | 0.3% | - | Stronger dollar restricting import price inflation. |
| | Oct Uni. of Mich' sentiment prelim. | 100.1 | 100.8 | - | Well above average. |
| | Fedspeak | - | - | - | Evans in panel on the economy at investment conference. |
| | Fedspeak | - | - | - | Bostic discussing recruitment, economics and public policy. |
| | Fedspeak | - | - | - | Quarles at IIF event in Bali. |

New Zealand forecasts

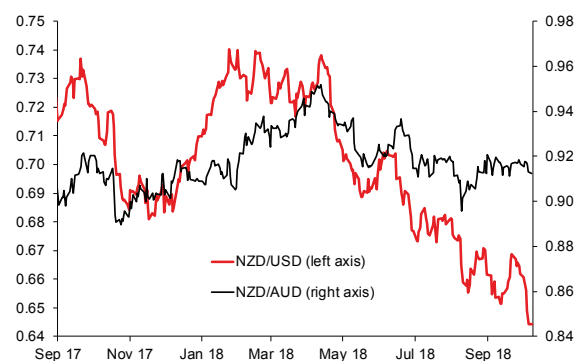
| Economic Forecasts | Quarterly | | | | Annual | | | |
|----------------------------------|-----------|------|------|------|--------|-------|-------|-------|
| | 2018 | | | 2019 | 2019 | | | |
| % change | Jun (a) | Sep | Dec | Mar | 2017 | 2018f | 2019f | 2020f |
| GDP (Production) | 1.0 | 0.7 | 0.7 | 0.7 | 2.8 | 2.8 | 3.1 | 2.9 |
| Employment | 0.5 | 0.4 | 0.3 | 0.3 | 3.7 | 1.8 | 1.4 | 1.7 |
| Unemployment Rate % s.a. | 4.5 | 4.5 | 4.6 | 4.7 | 4.5 | 4.6 | 4.6 | 4.4 |
| CPI | 0.4 | 0.7 | 0.5 | 0.4 | 1.6 | 2.1 | 1.6 | 1.8 |
| Current Account Balance % of GDP | -3.3 | -3.5 | -3.5 | -3.2 | -2.9 | -3.5 | -3.4 | -2.9 |

| Financial Forecasts | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Mar-20 |
|---------------------|--------|--------|--------|--------|--------|--------|
| Cash | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 | 1.75 |
| 90 Day bill | 1.90 | 1.90 | 1.90 | 1.95 | 2.00 | 2.10 |
| 2 Year Swap | 2.10 | 2.20 | 2.30 | 2.45 | 2.60 | 2.75 |
| 5 Year Swap | 2.60 | 2.75 | 2.90 | 3.05 | 3.15 | 3.25 |
| 10 Year Bond | 2.80 | 3.00 | 3.15 | 3.25 | 3.35 | 3.40 |
| NZD/USD | 0.66 | 0.65 | 0.64 | 0.64 | 0.65 | 0.65 |
| NZD/AUD | 0.92 | 0.92 | 0.91 | 0.91 | 0.90 | 0.90 |
| NZD/JPY | 75.2 | 74.1 | 72.3 | 71.7 | 72.8 | 72.2 |
| NZD/EUR | 0.57 | 0.57 | 0.57 | 0.56 | 0.56 | 0.55 |
| NZD/GBP | 0.52 | 0.53 | 0.52 | 0.52 | 0.53 | 0.53 |
| TWI | 72.4 | 71.6 | 70.6 | 70.4 | 70.8 | 70.8 |

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 8 October 2018

| Interest Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| Cash | 1.75% | 1.75% | 1.75% |
| 30 Days | 1.83% | 1.83% | 1.83% |
| 60 Days | 1.86% | 1.86% | 1.86% |
| 90 Days | 1.89% | 1.92% | 1.90% |
| 2 Year Swap | 2.02% | 2.02% | 1.97% |
| 5 Year Swap | 2.39% | 2.40% | 2.28% |

NZ foreign currency mid-rates as at 8 October 2018

| Exchange Rates | Current | Two weeks ago | One month ago |
|----------------|---------|---------------|---------------|
| NZD/USD | 0.6444 | 0.6669 | 0.6534 |
| NZD/EUR | 0.5592 | 0.5676 | 0.5656 |
| NZD/GBP | 0.4908 | 0.5099 | 0.5054 |
| NZD/JPY | 73.33 | 75.07 | 72.50 |
| NZD/AUD | 0.9125 | 0.9184 | 0.9200 |
| TWI | 70.77 | 72.44 | 71.52 |

International forecasts

| Economic Forecasts (Calendar Years) | 2015 | 2016 | 2017 | 2018f | 2019f | 2020f |
|-------------------------------------|------|------|------|-------|-------|-------|
| Australia | | | | | | |
| Real GDP % yr | 2.5 | 2.6 | 2.2 | 3.3 | 2.7 | 2.8 |
| CPI inflation % annual | 1.7 | 1.5 | 1.9 | 1.7 | 1.8 | 1.6 |
| Unemployment % | 5.8 | 5.7 | 5.5 | 5.3 | 5.5 | 5.5 |
| Current Account % GDP | -4.7 | -3.1 | -2.6 | -2.5 | -2.9 | -3.8 |
| United States | | | | | | |
| Real GDP %yr | 2.9 | 1.5 | 2.3 | 2.9 | 2.5 | 1.7 |
| Consumer Prices %yr | 0.1 | 1.4 | 2.1 | 2.5 | 2.0 | 1.9 |
| Unemployment Rate % | 5.3 | 4.9 | 4.4 | 3.9 | 3.6 | 3.6 |
| Current Account %GDP | -2.3 | -2.3 | -2.3 | -2.6 | -2.5 | -2.4 |
| Japan | | | | | | |
| Real GDP %yr | 1.4 | 0.9 | 1.7 | 1.1 | 0.8 | 0.7 |
| Euro zone | | | | | | |
| Real GDP %yr | 2.1 | 1.8 | 2.5 | 2.0 | 1.5 | 1.5 |
| United Kingdom | | | | | | |
| Real GDP %yr | 2.3 | 1.9 | 1.8 | 1.2 | 1.2 | 1.4 |
| China | | | | | | |
| Real GDP %yr | 6.9 | 6.7 | 6.9 | 6.3 | 6.1 | 6.0 |
| East Asia ex China | | | | | | |
| Real GDP %yr | 3.8 | 3.9 | 4.5 | 4.4 | 4.2 | 4.1 |
| World | | | | | | |
| Real GDP %yr | 3.5 | 3.2 | 3.8 | 3.8 | 3.6 | 3.5 |

Forecasts finalised 5 October 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 | 1.93 | 1.98 | 1.93 | 1.91 | 1.90 | 1.90 | 1.85 | 1.83 |
| 10 Year Bond | 2.72 | 2.80 | 3.00 | 3.00 | 2.90 | 2.80 | 2.60 | 2.60 |
| International | | | | | | | | |
| Fed Funds | 2.125 | 2.375 | 2.625 | 2.875 | 2.875 | 2.875 | 2.875 | 2.875 |
| US 10 Year Bond | 3.20 | 3.20 | 3.40 | 3.50 | 3.40 | 3.20 | 3.00 | 2.80 |
| ECB Deposit Rate | -0.40 | -0.40 | -0.40 | -0.40 | -0.30 | -0.20 | 0.00 | 0.20 |

| Exchange Rate Forecasts | Latest | Dec-18 | Mar-19 | Jun-19 | Sep-19 | Dec-19 | Jun-20 | Dec-20 |
|-------------------------|--------|--------|--------|--------|--------|--------|--------|--------|
| AUD/USD | 0.7068 | 0.72 | 0.71 | 0.70 | 0.70 | 0.72 | 0.74 | 0.75 |
| USD/JPY | 113.95 | 114 | 114 | 113 | 112 | 110 | 109 | 106 |
| EUR/USD | 1.1509 | 1.15 | 1.14 | 1.13 | 1.15 | 1.18 | 1.22 | 1.28 |
| AUD/NZD | 1.0930 | 1.09 | 1.09 | 1.09 | 1.09 | 1.11 | 1.12 | 1.10 |

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