Weekly Commentary

11 February 2019

Larnach Castle, Dunedin

Flatlining

We expect the RBNZ will leave the OCR unchanged in this week's Monetary Policy Statement, but shift to a strictly neutral monetary policy outlook. What's more we've also changed our OCR call. We are now forecasting no change in the OCR for 2019, 2020 and 2021. Last week's suite of labour market indicators were a little weaker than anticipated with the softness in hours worked pointing to a weak Q4 GDP outturn.

At Wednesday's *Monetary Policy Statement*, we expect the RBNZ will leave the OCR firmly on hold, and shift to a more neutral policy outlook with language such as "the next move could be up or down". We expect the RBNZ's OCR forecast will be flat until mid-2021 (previously mid-2020).

Three key developments will be dominating the RBNZ's deliberations. Firstly, the loss in momentum in the second half of 2018 has been greater than the RBNZ had been expecting. Secondly, the NZ dollar has been higher than they were projecting back in November as the Federal Reserve has cooled on the idea of lifting official interest rates. This stronger-than-expected NZ dollar dampens the outlook for tradables inflation. And finally, new net migration estimates from Stats NZ means the population is smaller and growing more slowly than previously thought. This may see the RBNZ lower its construction forecasts which in turn would dampen the outlook for GDP growth and inflation.

So if that RBNZ is not intending to raise the OCR anytime soon, what about the risk of a cut in the OCR? Financial markets are pricing an 80% chance that the RBNZ will cut the OCR by the end of 2019. We think that overstates the risk.

While the New Zealand economy has lost momentum, this is likely to be temporary and has not created conditions requiring an OCR cut. The New Zealand economy is currently in an extraordinarily ordinary position – pretty much anything that matters for monetary policy is neutral at present including a zero output gap, and near target inflation.

While it is now abundantly clear that the economy lost momentum in late 2018, we don't expect this slower momentum to continue into the New Year. Fiscal policy is still set to provide a key support for growth in 2019 as the Government directly boosts incomes of households via its Families Package. The broader government spend-up on infrastructure and hiring is also set to continue, and petrol prices are predicted to be less of a drain on household budgets in 2019 than they were in 2018.

In addition, firm commodity prices and excellent growing conditions for some of New Zealand's key commodity producers should support rural incomes this year. Dairy prices jumped almost 7% in last week's GlobalDairyTrade auction. And while firm demand from China appeared to support the run-up in prices over January, hot and dry weather in New Zealand in recent weeks were the catalyst for the most recent price gains. If they're sustained our freshly minted $6.30 milk price forecast for the current season may yet prove too conservative.

Looking beyond this week's *Statement*, we have changed our OCR call. Previously we were forecasting gradual OCR hikes from November 2020. We are now forecasting no change in the OCR over 2019, 2020, and 2021. That is

Flatlining continued

as far as the proverbial eye can see – what we are really saying is that the OCR outlook is evenly balanced over the foreseeable future, with risks on both sides. The key catalyst for our change of call is the new migration estimates from Stats NZ, which imply lower construction in the early 2020s.

Turning to recent data developments and last week's highlight was labour market data. The sharp drop in the unemployment rate in the September quarter from 4.5% to 3.9% always looked ripe for a reversal. And indeed this is what we saw. Most of the surprise fall in September reversed out in the December quarter as the unemployment rate rose to 4.3% (from an upwardly revised 4%). While this doesn't change the "big picture" view that the labour market gradually tightened over the last year, at the margin most recent developments have been weaker than we were anticipating as the pace of improvement in the labour market has slowed.

There was a pickup in wage inflation, but it was only gradual. The Labour Cost Index (LCI) rose by 0.5% in the March quarter for the quarter, with annual growth up slightly to 1.9%. That's an improvement from the 1.6% pace that prevailed a few years ago, though some of that is due to government-directed pay increases such as the nurses' pay settlement and the bigger minimum wage hike this year. The more volatile QES measure of average hourly earnings saw a more robust 1% rise, with annual growth ticking up slightly to 3.7%.

We expect wage inflation to feature more strongly over the coming years. Higher actual inflation, further hikes in the minimum wage and a more supportive political backdrop which shifts the dial a little further in the favour of employees rather than employers, should all help support a pickup in wage growth from here. However, this last week's data only took a small step in that direction.

Notably, employment growth across the suite of labour market measures was soft in the quarter. In the Household Labour Force Survey employment grew 0.1% in the quarter, and 2.3% in the year. That's only slightly ahead of the 2.0% growth in the working age population. Cross checking with the QES, which surveys employers rather than households, confirms the softness. Filled jobs were up 0.3% in the December quarter and hours worked up just 0.1%.

Importantly, the weakness in hours worked measure increases the risk of a soft December quarter GDP result. The survey is a direct measure of activity in key service sectors. Our preliminary forecast for Q4 GDP growth was 0.8% but the QES outturn, combined with other recent activity indicators for Q4, implies this was too optimistic. The indictors we have on board to date suggest Q4 GDP growth was just 0.3%, in line with the rise in the previous quarter.

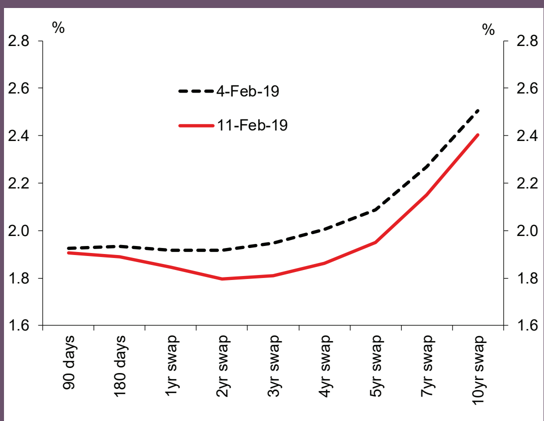
Fixed vs Floating for mortgages

Wholesale fixed interest rates have dropped lately in response to weaker NZ data and a dovish shift from key central banks offshore. This could see fixed mortgage rates drop in the coming weeks, providing an opportunity to fix at lower rates than those currently on offer.

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



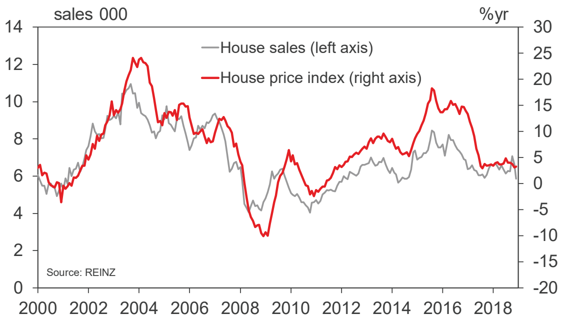
The week ahead

NZ Jan REINZ house sales and prices

Feb 11 to 15 (tbc), sales last: -11.8%, prices last: 3.3%yr

- The impact of the foreign buyer ban was evident in December's housing market update. Sales fell sharply, with the drop concentrated in Auckland. There was also softness in Wellington and Christchurch. That pattern matches where foreign buyers have been most active.
- Heading into 2019, we've seen signs that the housing market has caught a second wind. Sales for Auckland have picked up again. There's also been an easing in lending restrictions, while mortgage rates have been pushing down from their already low levels.
- Regional differences in price growth are likely to persist, with many areas outside of Auckland and Canterbury likely to see continued strong house price growth. Foreign buyers play almost no role in many regional centres, and the combination of lower mortgage rates and lending restrictions will give demand a further shot in the arm.

REINZ house prices and sales

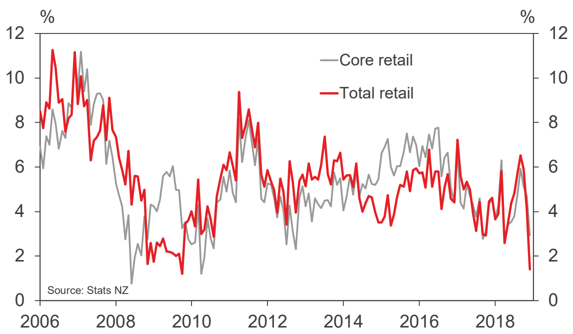


NZ Jan retail card spending

Feb 12, Last: -2.3%, WBC : +1.4%

- Retail spending fell by 2.3% in December – a much weaker result than had been expected. In part, that drop was due to falls in fuel prices. However, spending in core (ex-fuel) categories was also soft. That included a very sharp drop in spending on durable items, which posted their largest monthly decline since the financial crisis.
- While there are questions about the strength of spending appetites, some of the recent weakness in durables could be related to measurement issues.
- The recent volatility in durables means that there is greater-than-usual uncertainty around this month's outturn. We're forecasting a 1.4% increase in retail spending in January. Underlying that is an assumed bounce in durables spending and moderate increases in other areas.

NZ card transactions, annual % change

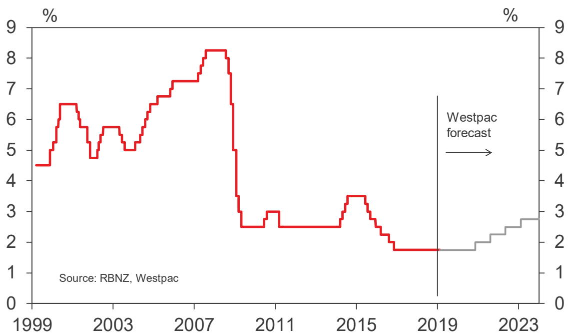


RBNZ policy decision

Feb 13, Last: 1.75%, Mkt: 1.75%, WBC: 1.75%

- The RBNZ's last statement was that the OCR would remain on hold through 2019 and into 2020, with gradual hikes forecast beyond that.
- Recent data shows the New Zealand economy lost momentum in late-2018, and the exchange rate is higher than the RBNZ expected.
- We expect the RBNZ will leave the OCR on hold but to shift to a strictly neutral monetary policy outlook.
- We expect the RBNZ will say something similar to "the next move could be up or down". The RBNZ's OCR forecast will be flat until at least 2021.

RBNZ Official Cash Rate

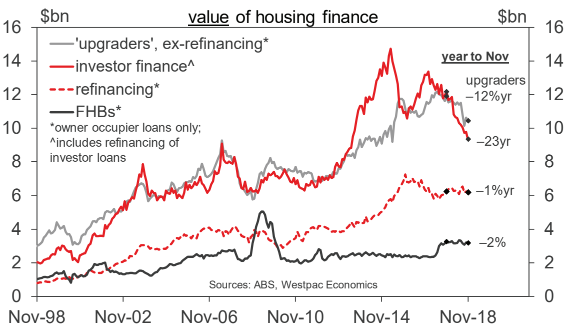


Aus Dec housing finance (no.)

Feb 12, Last: –0.9%, WBC f/c: –3.0%
Mkt f/c: -2.0%, Range: -7.0% to -0.3%

- Housing finance approvals softened in November with weakness concentrated in investor loans and the value, as opposed to the number of owner occupier loans. The headline number of owner occupier loans held up a little better than expected, recording a 0.9% decline. However, the total value of housing finance approvals including investors but excluding owner occupier refi, was down –2.9%mth and –16%yr.
- The December update is expected to show a further weakening with industry data covering the major banks pointing to a sharp decline in the final month of the year. Owner occupier approvals are expected to show a 3% drop, adding to the bleak picture around housing in late 2018.

Aus value of finance approvals by segment



The week ahead

Aus Feb Westpac-MI Consumer Sentiment

Feb 13 Last: 99.6

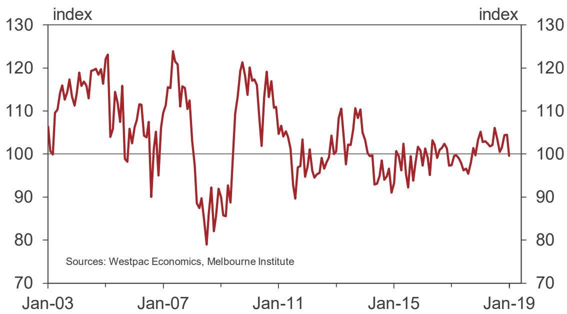
- The Westpac Melbourne Institute Index fell 4.7% to 99.6 in Jan, dipping into pessimistic territory for the first time since late 2017. Confidence is coming under pressure from a continued slide in house prices; disappointing updates on Australia's economic growth; ongoing concerns around global trade wars; and political uncertainty.
- The Feb survey is in the field from Feb 4-9 and will be an important update given the Jan reading is clouded somewhat by holiday-related effects, and that the consumer remains the key focus of uncertainty and downside risks to the domestic outlook. The survey will capture reactions to the RBA's shift to a less optimistic view on growth and 'more balanced' position on rates.

US Jan CPI

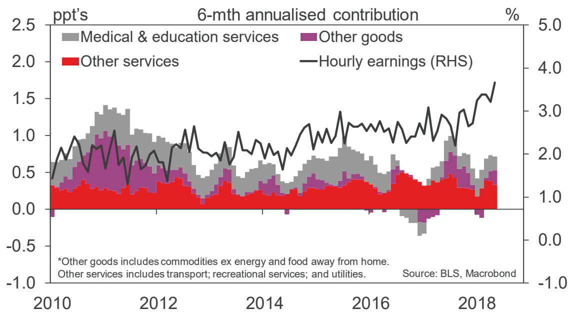
Feb 13, last –0.1%, WBC 0.1%

- Through late-2018, annual growth in the US CPI slowed abruptly, from 2.9%yr in July to 1.9%yr come December. This was the result of the sharp decline in energy prices, with core inflation (ex food and energy) instead unchanged over the period at 2.2%yr. Being above the 2.0%yr medium-term target of the FOMC, and with the labour market unquestionably tight, inflation pressures could be seen as a clear and present risk.
- To our mind however, this would be a mistake. In six-month annualised terms, core inflation has already decelerated to a 2.0% pace over the December quarter. And, looking ahead, the trends in its key components point to inflation remaining around the current level. Most interesting in this detail is the absence of a link between wages and inflation for cyclical goods.

Aus Consumer Sentiment Index



US CPI components and wage growth

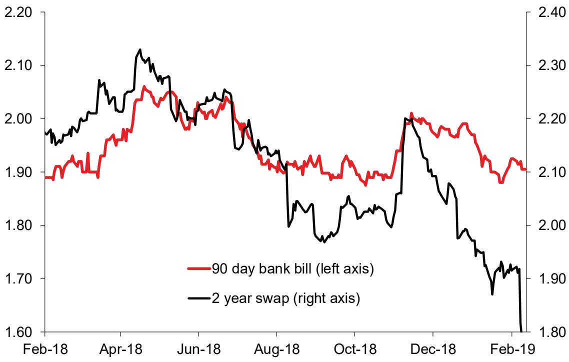


New Zealand forecasts

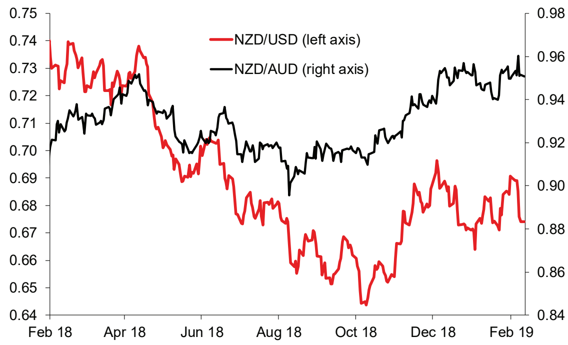
Economic Forecasts	Quarterly				Annual			
	2018		2019					
% change	Sep (a)	Dec	Mar	Jun	2017	2018f	2019f	2020f
GDP (Production)	0.3	0.3	0.7	0.9	3.1	2.7	2.6	3.1
Employment	1.0	0.1	0.2	0.3	3.7	2.3	1.1	1.7
Unemployment Rate % s.a.	4.0	4.3	4.4	4.3	4.5	4.3	4.2	4.0
CPI	0.9	0.1	0.3	0.5	1.6	1.9	2.0	2.1
Current Account Balance % of GDP	-3.6	-3.9	-3.6	-3.7	-2.9	-3.9	-3.6	-3.1

Financial Forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-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	1.90	2.00	2.00	2.00	2.00	2.05
5 Year Swap	2.10	2.20	2.25	2.30	2.35	2.40
10 Year Bond	2.20	2.25	2.35	2.35	2.35	2.45
NZD/USD	0.67	0.66	0.64	0.64	0.65	0.66
NZD/AUD	0.94	0.94	0.94	0.93	0.93	0.93
NZD/JPY	73.7	73.3	72.3	71.7	72.2	72.6
NZD/EUR	0.59	0.59	0.58	0.58	0.59	0.58
NZD/GBP	0.53	0.52	0.49	0.48	0.49	0.49
TWI	73.4	73.0	71.3	70.7	71.0	71.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 11 February 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.83%	1.83%
60 Days	1.88%	1.87%	1.88%
90 Days	1.91%	1.91%	1.93%
2 Year Swap	1.80%	1.92%	1.93%
5 Year Swap	1.95%	2.13%	2.18%

NZ foreign currency mid-rates as at 11 February 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6741	0.6835	0.6832
NZD/EUR	0.5952	0.5976	0.5954
NZD/GBP	0.5208	0.5192	0.5316
NZD/JPY	74.03	74.67	74.03
NZD/AUD	0.9508	0.9536	0.9473
TWI	73.41	74.03	73.97

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 11					
NZ	Jan REINZ house prices %yr	3.3%	–	–	Due this week. Lower mortgage rates providing some support.
	Jan REINZ house sales	–11.8%	–	–	Signs that weak December turnover was temporary.
Chn	Jan foreign direct investment %yr	24.9%	–	–	Authorities seeking to attract a greater flow of investment.
	Jan M2 money supply %yr	8.1%	8.2%		Tentative date.
	Jan new loans, CNYbn	1080.0	2970.5		Tentative date.
Eur	ECB Vice President speaks	–	–	–	de Guindos in Madrid.
UK	Q4 GDP	0.6%	0.3%	0.3%	Ongoing uncertainty a drag on investment and GDP growth.
	Dec trade balance £bn	–2904	–3000	–	External headwinds mounting…
	Dec industrial production	–0.4%	0.3%	–	..while domestic uncertainty…
	Dec construction	0.6	–	–	…continues to weigh on investment spending.
	Fedspeak	–	–	–	Bowman on community banking.
Tue 12					
NZ	Jan card spending	–1.9%	–	1.4%	A bounce following last month's unexpected drop in durables.
Aus	Dec housing finance	–0.9%	–	–	Number of owner occupier approvals edging lower…
	Dec investor finance (value)	–4.5%	–	–	… while downtrend in investor finance continues.
	Jan NAB business survey	2	–	–	Conditions have collapsed, false read or 'watershed' moment.
US	Jan NFIB small business optimism	104.4	103.0	–	Small businesses positive, aided by domestic demand.
	Dec JOLTS job openings	6888	–	–	Hiring; firing; quits and job openings.
	Jan budget statement $bn	–204.9	–10.5	–	Deficit to continue trending up in 2019.
	Fed Chair Powell speaks	–	–	–	In Mississippi on rural poverty.
Wed 13					
NZ	RBNZ policy decision	1.75%	1.75%	1.75%	RBNZ to shift back to strictly neutral "up or down" language.
	Q1 RBNZ inflation expectations	2.0%	–	–	Reports of rising costs, but core inflation stable.
Aus	Feb WBC–MI Consumer Sentiment	99.6	–	–	High uncertainty. Weakening or clouded by holiday effects?
	RBA Head of Economics speaks	–	–	–	Alexandra Heath, ABE conference, Sydney 7.50am.
Eur	Dec industrial production	–1.7%	–0.2%	–	External demand has continued to weaken.
UK	Jan CPI	0.2%	–0.6%	–	Seasonal drop. Annual inflation well contained.
US	Jan CPI	–0.1%	0.1%	0.1%	Another benign print expected.
Thu 14					
NZ	RBNZ Governor Orr testimony to FEC	–	–	–	Testimony to Finance and Expenditure Committee.
	Jan food price index	–0.2%	–	1.4%	Seasonal bounce in prices; up slightly on an annual basis.
Aus	Feb MI inflation expectations	3.5%	–	–	Has eased back of late.
Chn	Jan trade balance USDbn	57.1	32.0	–	Being affected by pull forward ahead of tariffs.
Eur	Q4 GDP 2nd estimate	0.2%	0.2%	–	Flash was 0.2% but considerable national dispersion.
UK	Jan RICS house price balance	–19%	–20%	–	Brexit nervousness a drag, especially in London.
US	Jan PPI	–0.2%	0.1%	–	Upstream price pressures modest.
	Initial jobless claims	234k	–	–	Very low.
	Fedspeak	–	–	–	Mester, George and Bostic.
Fri 15					
NZ	Jan manufacturing PMI	55.1	–	–	Off its lows, signs growth has firmed after last year's moderation.
	Dec net migration	2480	–	2850	Annual downtrend continues.
Aus	RBA Ast' Gov' Fin. Markets speaks	–	–	–	Chris Kent, FX event, Melbourne, 7:45am.
Chn	Jan CPI %yr	1.9%	–	–	Price pressures up and downstream are modest…
	Jan PPI %yr	0.9%	–	–	… consistent with the slowdown in aggregate growth.
	Q4 current account balance	23.3	–	–	Full detail on trade and financial position.
Eur	Dec trade balance €bn	15.1	–	–	Surplus is now back to 2014 levels.
UK	Jan retail sales	–0.9%	0.0%	–	Spending growth soft despite the tight labour market.
US	Feb Fed Empire state index	3.9	7.5	–	Regional surveys have been volatile of late.
	Jan import price index	–1.0%	–0.2%	–	Strength of US dollar offsetting import inflation.
	Dec retail sales	0.2%	0.1%	0.2%	Oil price a clear negative; core sales likely solid.
	Jan industrial production	0.3%	0.1%	–	Very modest growth.
	Feb Uni. of Michigan sentiment	91.2	94.0	–	A post-shutdown bounce likely.
	Dec total net TIC flows $bn	31.0	–	–	Demand for treasuries remains robust.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	2.9	2.2	2.6
CPI inflation % annual	1.7	1.5	1.9	1.8	1.8	1.9
Unemployment %	5.8	5.7	5.5	5.0	5.2	5.1
Current Account % GDP	-4.7	-3.1	-2.6	-2.4	-2.0	-2.8
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.5	2.1
Consumer Prices %yr	0.1	1.4	2.1	2.3	1.8	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	1.0	1.7	1.1	0.8	0.7
Euro zone						
Real GDP %yr	2.1	1.9	2.4	1.8	1.4	1.5
United Kingdom						
Real GDP %yr	2.3	1.8	1.7	1.3	1.4	1.4
China						
Real GDP %yr	6.9	6.7	6.9	6.6	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	4.0	4.5	4.4	4.2	4.3
World						
Real GDP %yr	3.5	3.3	3.7	3.7	3.5	3.5
Forecasts finalised 8 February 2019						

Interest Rate Forecasts	Latest	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	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	2.01	2.05	2.05	2.00	2.00	1.95	1.95	1.90
10 Year Bond	2.09	2.30	2.40	2.60	2.60	2.50	2.50	2.50
International								
Fed Funds	2.375	2.375	2.625	2.875	2.875	2.875	2.875	2.875
US 10 Year Bond	2.64	2.85	3.00	3.10	3.00	2.90	2.80	2.75
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.40	−0.30	−0.20	−0.10	0.00

Exchange Rate Forecasts	Latest	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Dec-20
AUD/USD	0.7077	0.71	0.70	0.68	0.69	0.70	0.71	0.72
USD/JPY	109.78	110	111	113	112	111	110	106
EUR/USD	1.1341	1.13	1.11	1.10	1.10	1.11	1.14	1.20
AUD/NZD	1.0478	1.06	1.06	1.06	1.08	1.08	1.08	1.08

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