Weekly Commentary

14 January 2019

New Zealand Bush Giant Dragonfly (Kapokapowai)

Here we go again

The New Zealand economy is into its eighth year of expansion, and another year of firm activity is on the cards over 2019. However, beneath the surface, conditions in the economy are changing and there are several key areas to watch over the coming year.

With the new year upon us, it's a good time to take a look at how the economy has been tracking and where we're heading over the next few years. On this front, the latest update on GDP from Stats NZ revealed that the economy has lost a bit of steam, with annual GDP growth slowing to 3% in the year to September (down from 3.1% in June and a peak of 3.9% in late-2016). But while the economy has lost some momentum, this slowdown hasn't been as stark as initially estimated. In fact, with more detailed information on economic activity now available, Stats NZ's updated estimates of GDP growth over past years have actually painted a more upbeat picture. And in particular, estimates of growth over 2017 have been revised up quite a bit. Overall, we're left with a picture of an economy that has slowed, but as we enter 2019 is continuing to trundle along at a reasonable pace.

Looking to the year ahead, we expect to see firm economic activity on the back of increases in government spending, a lift in construction, and low interest rates which are boosting both the housing market and household spending. Combined, those conditions should see the economy growing by a little over 3% over 2019. However, those factors are only providing a temporary boost to growth, and as we head into 2020, GDP growth is set to cool again as the current drivers of demand move into new phases.

There are a number of key areas that we'll be keeping a close eye on over 2019. The first is the **housing market**. Policy changes saw a marked slowdown in house price growth over the past couple of years. However, the next phase of the housing market cycle is actually likely to be an upturn. We've already seen early signs that low mortgage rates are supporting some firming in housing market activity (particularly in Auckland). And that's likely to continue through the early part of this year.

But the current firming in the housing market is likely to be temporary, with further big changes in housing market policy on the cards over the next few years. That includes the ring-fencing of financing costs for investment properties (aka. negative gearing) and the potential introduction of a capital gains tax ahead of the 2020 election. As we've highlighted before, those sorts of policies could sap a lot of strength from the housing market, particularly in terms of investor demand. It's also important to remember that housing market trends have been varied across the country: while there's been softness in Auckland and Canterbury, many other parts of the country are still seeing strong gains. There's a good chance we'll see these sorts of divergences continuing, at least for a time.

We also expect to see some important changes in terms of **construction** activity. This sector has been a key driver of growth and employment in recent years, and some further lift in activity is on the cards over 2019. However, a note of caution is needed. Post-earthquake construction in the South Island is continuing to wind down. And in Auckland,

Here we go again continued

home building is now close to levels that are commensurate with population growth. These conditions mean that even though the level of construction activity is likely to remain strong for some time, the sector isn't likely to be the driver of growth or employment gains that it was in previous years.

Next is **migration**. The combination of strong inflows from other countries and low departures of New Zealand citizens saw population growth soaring to rates of over 2% per annum in recent years. That provided a powerful boost to spending levels. It also played an important role in helping businesses source skilled labour. However, while net migration is still elevated, new arrivals into the country have levelled off and many of those who arrived in recent years are now returning home. Those developments are likely to see population growth slowing to around 1.6% by the end of 2019, and it's set to slow even further over the coming years. That implies a substantial reduction in the economy's rate of potential growth, and will moderate an 'easy' source of demand growth that many businesses have been enjoying.

The **inflation** environment is also looking different from recent years. While still below 2%, consumer price inflation has been rising over the past year. And with firm activity and rising wages, we're likely to see it continuing to climb over 2019. The question is: how far will it rise? Although we do expect to see some increase inflation over the coming year, we don't think that it will rise to levels that will spook the RBNZ. Several factors are continuing to limit the rise in prices. The most important of these are the ongoing strong competitive pressures in the retail sector and more moderate increases in government charges than in previous years. Combined, these conditions should see overall inflation remaining close to 2%.

With inflation well contained and several key drivers of growth now moving into different phases, we expect that the RBNZ will keep the **Official Cash Rate** on hold for some time yet. We continue to expect that the next move in the OCR will be a hike, but that is still a way off. There also are questions around how the stance of monetary policy and interest rates could be affected by the RBNZ's recent proposal to require banks to hold more capital. We'll be looking at this in more detail in an upcoming Bulletin.

Finally, **Government policy** will continue to play a big role in shaping economic conditions over the coming year. In addition to changes affecting the housing and labour markets, big increases in spending are on the cards. And it's likely that the Government will aim to get its major spending initiatives rolling well ahead of the 2020 election. That will naturally have spillover impacts on the economy more generally.

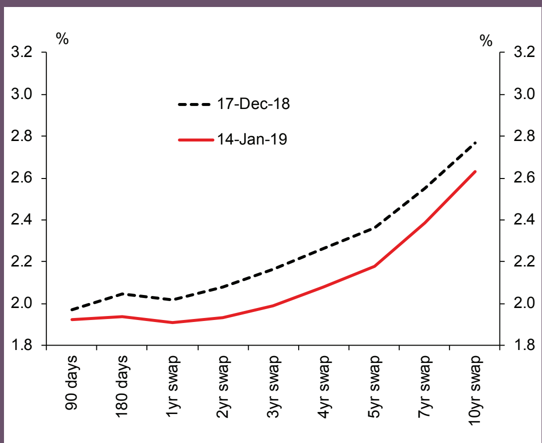
Fixed vs Floating for mortgages

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 Q4 Survey of Business Opinion

Jan 15, Domestic trading activity, Last: 10
Business confidence, Last: -28

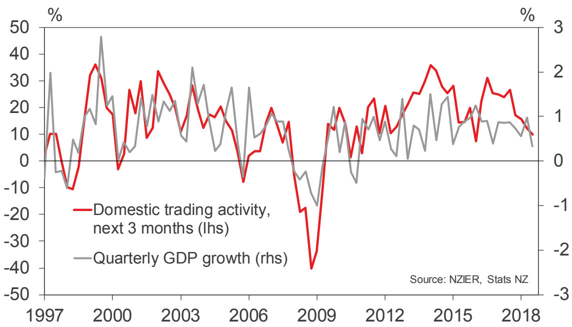
- Business confidence fell sharply in the September quarter, to its lowest level since 2009. Domestic trading activity, also softened a little further in the quarter.
- However, since then monthly measures of business confidence have shown some signs of improvement. While confidence remains weak, it has lifted off its recent lows.
- Firms are increasingly noting growing cost pressures. And although oil prices have fallen sharply since the September survey, the tight labour market is likely putting further upward pressure on wage costs.

NZ Dec retail card spending

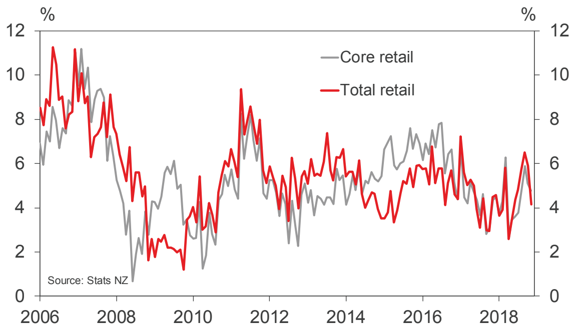
Jan 16, Last: -0.4%, WBC f/c: flat

- Retail spending fell by 0.4% in November. However, that fall was mainly due to sharp declines in petrol prices over the month, which actually put money back into households' wallets and supported spending in other areas. This saw core spending (which excludes fuel purchases) rise by 0.5% over the month.
- With continued falls in petrol prices and reports of wide-spread price discounting, we're expecting to see overall nominal spending remaining flat in December. But as in November, reduced spending on fuel should allow for another solid gain in core (ex-fuel) categories.

QSBO domestic trading activity and GDP



Card transactions, annual % change



Aus Jan Westpac-MI Consumer Sentiment

Jan 16 Last: 104.4

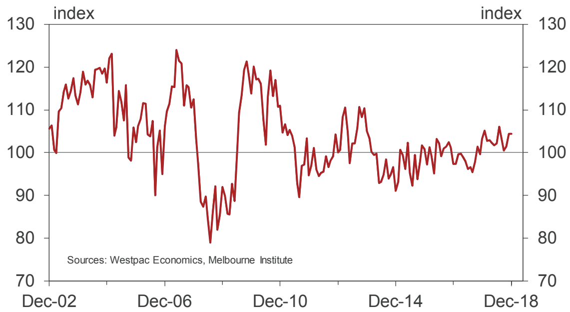
- The Westpac Melbourne Institute Index essentially held steady at 104.4 in December. The 'cautiously optimistic' consumer mood is despite the negative atmospherics around falling house prices; a falling sharemarket; ongoing concerns around global trade wars; and political uncertainty.
- Continued low interest rates, diminished fears about rising rates, firm labour market conditions and a sharp drop in petrol prices look to have been key supports.
- The January survey is in the field from January 7-12. Note that the headline is adjusted to remove a regular 'holiday' sentiment bump worth about 4pts.
- The survey is being conducted as a gloom descends over Australian mens cricket - with the national team losing to India in a domestic test series - for the first time ever.

Aus Nov housing finance (no.)

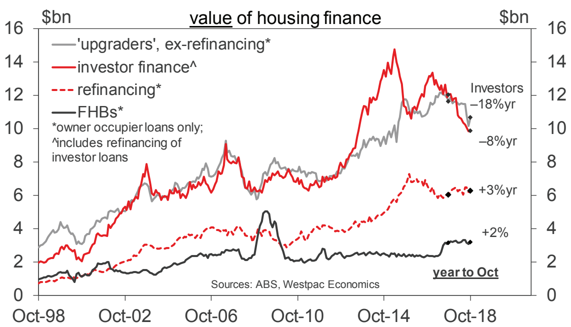
Jan 17, Last: 2.2%, WBC f/c: –1.5%
Mkt f/c: -1.5%, Range: -2.0% to flat

- Housing finance trended lower in 2018, particularly for investors, as demand softened and lending conditions tightened.
- October bucked this trend, with housing finance approvals up, reversing some of the sharp weakening over the previous two months - a drop which in part was related to processing delays as lenders applied more rigorous assessments. The headline number of owner occupier loans rose 2.2%. The value of owner occupier loans increased by 3.5% after an 8.4% decline over the previous two months. The value of investor loans rose 0.6% but is still down 18%yr.
- The November update is expected to show a resumption of the downtrend.

Consumer Sentiment Index



Value of finance approvals by segment



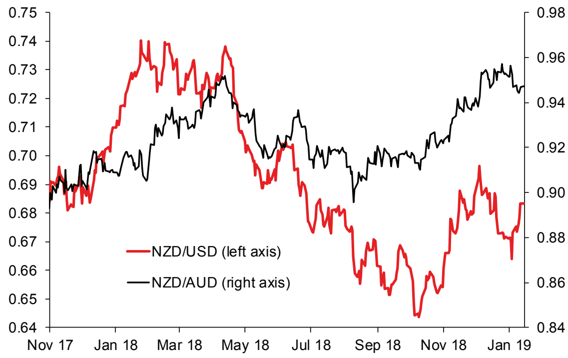
New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2018		2019					
% change	Sep (a)	Dec	Mar	Jun	2017	2018f	2019f	2020f
GDP (Production)	0.3	0.8	0.7	0.9	3.1	2.9	3.0	3.1
Employment	1.1	0.0	0.2	0.4	3.7	2.3	1.3	1.7
Unemployment Rate % s.a.	3.9	4.3	4.4	4.3	4.5	4.3	4.2	4.0
CPI	0.9	0.3	0.3	0.5	1.6	2.1	1.9	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	1.95
2 Year Swap	2.10	2.10	2.15	2.20	2.25	2.30
5 Year Swap	2.45	2.50	2.55	2.60	2.65	2.70
10 Year Bond	2.60	2.70	2.80	2.85	2.85	2.90
NZD/USD	0.66	0.64	0.62	0.62	0.64	0.65
NZD/AUD	0.93	0.91	0.91	0.90	0.90	0.89
NZD/JPY	75.2	73.0	71.3	70.7	71.7	71.5
NZD/EUR	0.59	0.58	0.57	0.56	0.58	0.57
NZD/GBP	0.53	0.52	0.50	0.49	0.50	0.50
TWI	73.0	71.2	69.5	68.9	70.2	70.3

2 Year Swap and 90 Day Bank Bills

NZD/USD and NZD/AUD



NZ interest rates as at market open on 14 January 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.86%	1.90%
60 Days	1.88%	1.92%	1.94%
90 Days	1.93%	1.97%	1.99%
2 Year Swap	1.93%	1.97%	2.06%
5 Year Swap	2.18%	2.21%	2.36%

NZ foreign currency mid-rates as at 14 January 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6832	0.6713	0.6860
NZD/EUR	0.5954	0.5865	0.6015
NZD/GBP	0.5316	0.5290	0.5383
NZD/JPY	74.03	74.09	77.37
NZD/AUD	0.9473	0.9520	0.9553
TWI	73.97	73.48	75.01

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 14					
Aus	Dec MI inflation gauge	1.6%	–	–	A general absence of consumer inflationary pressures.
Eur	Nov industrial production	0.2%	–1.1%	–	German IP has been very weak of late.
Tue 15					
NZ	Q4 QSBO general business survey	–28	–	–	Monthly surveys show confidence improving, after Q3 slump.
	Dec food prices	–0.6%	–	–0.4%	Christmas period discounting; annual inflation remains modest.
Eur	Nov trade balance €bn	12.5	–	–	External demand has softened along with global growth.
UK	UK Parliament Brexit vote	–	–	–	Vote on agreement reached with Europe last November.
US	Jan Fed Empire state index	10.9	11.5	–	Jolted lower in Dec, but still points to growth.
	Dec PPI	0.1%	–0.1%	–	Energy price declines to weigh.
	Fedspeak	–	–	–	Kashkari, George and Kaplan speak.
Wed 16					
NZ	GlobalDairyTrade auction	–	–	–	Offer volumes starting to taper off.
	Dec retail card spending	–0.4%	–0.4%	flat	Falls in petrol prices masking continued gains in core categories.
Aus	Jan WBC–MI Consumer Sentiment	104.4	–	–	Will the housing downturn sour the mood.
UK	Dec CPI	–	–	–	Sluggish domestic demand to keep inflation well contained.
	Nov house price index	–	–	–	Economic uncertainty continuing to dampen prices.
	BOE Governor Carney	–	–	–	Testifies on Financial Stability Report.
US	Dec retail sales	0.2%	0.3%	0.2%	Census Bureau closed due to shutdown. Delay likely.
	Dec import price index	–1.6%	–1.3%	–	US dollar strength and energy price declines weighing.
	Nov business inventories	0.6%	–		Census Bureau closed due to shutdown. Delay likely.
	Jan NAHB housing market index	56	–		Has lagged other housing data as builders remain positive.
	Jan Beige Book	–	–	–	Conditions across the 12 Federal Reserve districts.
	Nov total net TIC flows	42.0	–		Foreign demand for US Treasuries.
Thu 17					
Aus	Nov housing finance	2.2%	–1.5%	–1.5%	Downtrend in 2018: softer demand, tighter lending conditions.
Eur	Dec CPI %yr	1.9%	1.6%	1.6%	Flash points to 1.6%yr pace in Dec; core stuck around 1.0%yr.
US	Dec housing starts	3.2%	–0.2%	–	Census Bureau closed due to shutdown. Delay likely.
	Dec building permits	5.0%	–3.6%	–	Census Bureau closed due to shutdown. Delay likely.
	Initial jobless claims	216k	–		Remain near historic lows.
	Jan Phily Fed index	9.1	10.0		Pointing to slowing momentum for manufacturers.
	Fedspeak	–	–	–	Kashkari speaks in Asia trade; Quarles overnight.
Fri 18					
NZ	Dec BusinessNZ manufacturing PMI	53.5	–	–	Pointing towards modest growth in economic activity.
UK	Dec retail sales	1.4%	–1.0%	–	Anecdotes point to poor Christmas spending.
US	Dec industrial production	0.6%	0.3%	–	Industrial production continues to underperform ISMs.
	Jan Uni. of Michigan sentiment	98.3	96.4	–	Confidence remains above average.
	Fedspeak	–	–	–	Williams on economic outlook. Harker also.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	3.0	2.4	2.8
CPI inflation % annual	1.7	1.5	1.9	1.7	1.8	1.7
Unemployment %	5.8	5.7	5.5	5.0	5.0	4.8
Current Account % GDP	-4.7	-3.1	-2.6	-2.4	-2.4	-3.0
United States						
Real GDP %yr	2.9	1.5	2.3	2.9	2.5	2.1
Consumer Prices %yr	0.1	1.4	2.1	2.4	1.9	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	1.8	1.7	1.3	1.4	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	3.5	3.5
Forecasts finalised 12 December 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	2.06	1.93	1.91	1.90	1.90	1.87	1.85	1.83
10 Year Bond	2.33	2.50	2.60	2.80	2.70	2.60	2.60	2.50
International								
Fed Funds	2.375	2.625	2.875	3.125	3.125	3.125	3.125	3.125
US 10 Year Bond	2.73	3.00	3.20	3.40	3.10	3.00	2.90	2.80
ECB Deposit Rate	−0.40	−0.40	−0.40	−0.30	−0.20	−0.10	0.00	0.20

Exchange Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
AUD/USD	0.7197	0.71	0.70	0.68	0.69	0.71	0.73	0.74
USD/JPY	108.33	114	114	115	114	112	110	106
EUR/USD	1.1521	1.11	1.10	1.09	1.10	1.11	1.14	1.20
AUD/NZD	1.0591	1.08	1.09	1.10	1.11	1.11	1.12	1.11

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