Weekly Commentary

2 September 2019

Cardboard Cathedral, Christchurch

It's gonna get worse before it gets better

It’s been a tumultuous time in the global economy with ongoing trade tensions between the US and China, as well as a deepening political crisis in the UK. For New Zealand businesses, these developments have reinforced concerns that conditions in the global economy will remain soft for some time yet. They’ve also added to the downside risks for domestic economic growth.

The deterioration in the global backdrop has already been felt in some of our major export sectors. In recent months, prices for some of our key commodity exports like dairy and logs have fallen (both down around 10% from their recent highs). There’s also been a 3% decline in international visitor numbers since the start of the year. We expect that there will be further softness on these fronts through the final part of the year.

These increasingly rocky external conditions have reinforced our expectations that economic conditions in New Zealand are going to get worse before they get better. GDP growth has already taken a step down in the early part of the year, with particular softness in the household sector (retail spending rose by just 0.2% in the June quarter - slower than the rate of population growth). We’re now seeing increasing signs that conditions in the business sector are also cooling. Over the past few months the manufacturing PMI has dropped to contractionary territory. There’s also been a softening in gauges of service sector activity.

Against this backdrop, it’s no surprise that business confidence has been falling. In fact, August saw confidence dropping to its lowest level since 2008, during the depths of the Global Financial Crisis. Importantly, businesses expect that this general weakening in the economic environment will affect their own activity, and they’ve scaled back plans for investment and hiring accordingly. We were already expecting sluggish growth in domestic activity over the remainder of 2019, and on its own this survey suggests downside risk to that forecast.

The survey period for the latest confidence report straddled the Reserve Bank’s August rate decision, and we were interested in how the surprise 50 bp cut in the Official Cash Rate would affect business sentiment: would this powerful shot in the arm for the economy boost confidence, or would the unexpectedly large rate cut reinforce the nervousness in the business sector? As it turned out there was no significant difference in responses before and after the cut, with businesses remaining down in the mouth.

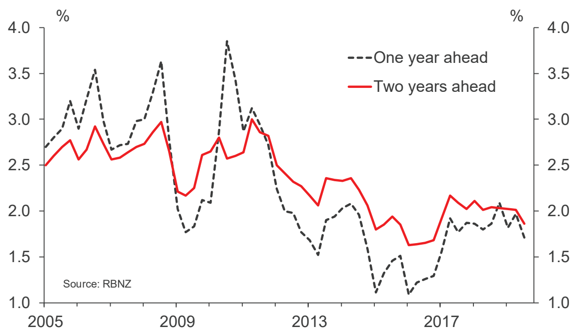
A related concern for the RBNZ, which has also reinforced our expectation for another cut in the cash rate, is the persistent softness in inflation. Core (ex-fuel) inflation has lingered below the 2% mid-point of the RBNZ’s target band for eight years now. But what’s even more worrying for the RBNZ is that businesses have become increasingly sceptical that inflation will return to target any time soon. That’s been reflected in recent surveys, most notably the RBNZ’s own survey of two-year ahead inflation expectations which unexpectedly dropped from 2% in June to 1.86% in the September quarter. That’s despite the historically low level of interest rates and increases in operating costs such as the rise in the minimum wage.

It's gonna get worse before it gets better

This fall in inflation expectations is very important in terms of the outlook for monetary policy, and was referenced by RBNZ Governor Orr as well as other Bank officials as a key factor underpinning August's rate cut. Inflation expectations are a significant influence on how businesses adjust wages and prices, and as a result play a key role in determining actual inflation. The recent downshift in expectations means that the uphill battle the RBNZ has been fighting to generate a sustained lift in inflation has now gotten that much harder.

The next update on the RBNZ's Survey of Expectations is due on 12 November. Although that's just one day before the November policy decision, it's important to remember that the RBNZ gets the results of this survey about a week before it's released publicly. As a result, this survey could again have a big impact on the Monetary Policy Committees thinking, just as it did in August. This will certainly be a key event for markets to watch ahead of the November policy statement and could impact market pricing. We expect the RBNZ will cut the cash rate by 25bps in November, taking it to a fresh record low of 0.75%.

RBNZ survey of inflation expectations



Fixed vs Floating for mortgages

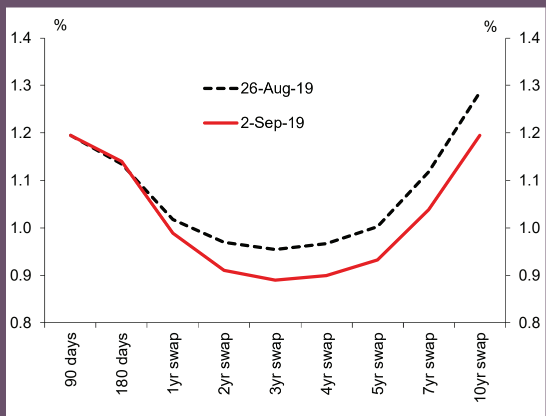
Mortgage rates are falling, and with the Reserve Bank expected to cut the OCR once more, we think they will keep falling. This means there is no hurry to fix.

Among the fixed rates on offer, we think the best value at present is the one-year rate. It is lower than the floating or six-month rates, yet it may still allow borrowers to roll onto lower rates at the end of the fixed term. Fixing for a longer term may mean that borrowers miss out on re-fixing at the lowest rates, at least according to our forecasts.

That said, fixing for longer terms does offer security against future interest rate increases, and therefore may be preferred by those with low risk tolerance.

Floating mortgage rates are normally expensive for borrowers, but they may be the preferred option for those who require flexibility in their repayments.

NZ interest rates



The week ahead

NZ Q2 terms of trade

Sep 2, Last: +1.0%, WBC f/c: +1.0%

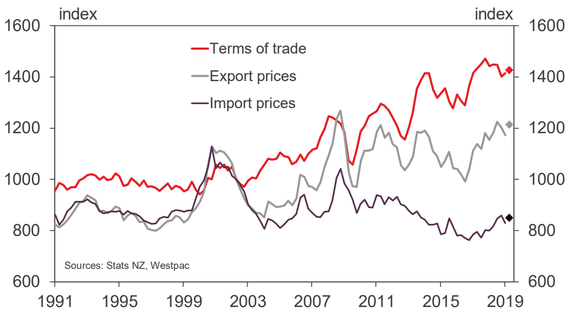
- New Zealand's terms of trade is down modestly from the all-time high that was reached in 2017. We expect a 1% rise for the June quarter, though this gain is likely to be short-lived as the slowing global economy and the US-China trade war threaten to weigh on commodity prices.
- We estimate that export prices rose by 3.5% for the quarter, led by a 10% rise in dairy prices. Other products were mixed, with gains for meat, fish and oil, but lower prices for wool and wood products.
- We expect a 2.5% rise in import prices, dominated by a 13% rise in oil products. We also expect higher prices for manufactured goods, largely due to the lower New Zealand dollar over the quarter.

NZ Q2 building work put in place

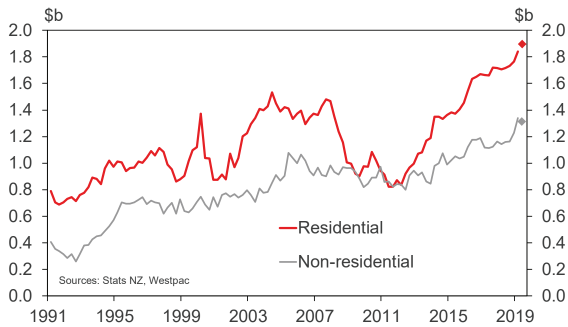
Sep 5, Last +6.2%, WBC f/c: +0.9%

- Total construction activity rose by 6.2% in the March quarter. That was underpinned by a 9% rise in non-residential construction. We also saw a solid 4.3% increase in residential building. Gains were centred on Auckland but were widespread.
- We're forecasting a 0.9% increase in total building activity in the June quarter. Underlying that, we expect residential construction to be up 3% over the quarter, with gains continuing to be centred on Auckland. Those increases are balanced against an expected 2% fall in the lumpy non-residential components after solid gains in the past two quarters.
- The underlying trend in construction is expected to remain firm through the remainder of 2019.

NZ terms of trade



NZ real building work put in place



Aus Aug CoreLogic home value index

Sep 2, Last: 0.1%, WBC f/c: 1.0%

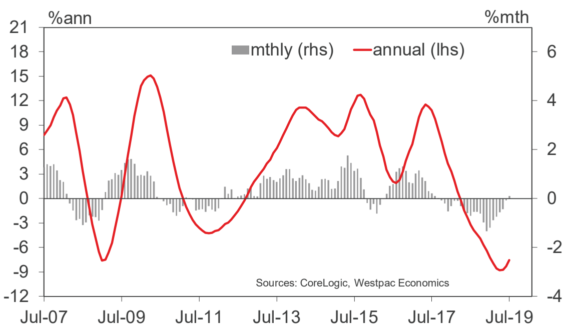
- The correction in Australian dwelling prices that began in late 2017 ended in mid-2019. The CoreLogic home value index, covering the eight major capital cities, rose 0.1% in July following a 0.1% dip in June – essentially flat over the two months. Prices are still down 7.3%yr but the annualised pace over the last three months has slowed to just –1.7%.
- August looks set to see a solid monthly rise in prices, the first since early 2017. The daily index points to a gain of 1.0% nationally with Sydney and Melbourne posting gains in the 1.4-1.6% range but patchier results elsewhere. Housing related consumer sentiment points to a further lift in demand in the months ahead. That said, sales are coming from extreme lows and a likely pick up in new listings may start to cap price gains.

Aus Jul retail trade

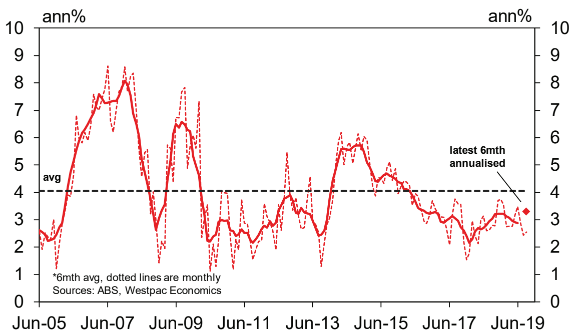
Sep 3, Last: 0.4%, WBC f/c: 0.3%
Mkt f/c: 0.2%, Range: -0.3% to 0.5%

- Monthly retail sales posted a reasonable 0.4% gain in June. However, the wider picture is still weak, with annual sales growth running at just 2.5%yr and virtually flat for underlying volumes.
- Coming months will see a boost from recent policy measures – two 25bp cuts in interest rates in June and July and tax offsets for low to middle income earners. Even if much of this is saved, the portion spent is likely to give a sizeable lift to retail sales. However, the direct impact is likely to be small in July with tax refunds only starting from around mid-month. Given the very clear headwinds still affecting consumer demand, we expect the net impact in July to result in another lacklustre 0.3% gain.

Australian dwelling prices



Retail sales: annual growth



The week ahead

Aus Q2 current account, AUDbn

Sep 3, Last: –2.9, WBC f/c: +1.0
Mkt f/c: +1.5, Range: +0.0 to +4.0

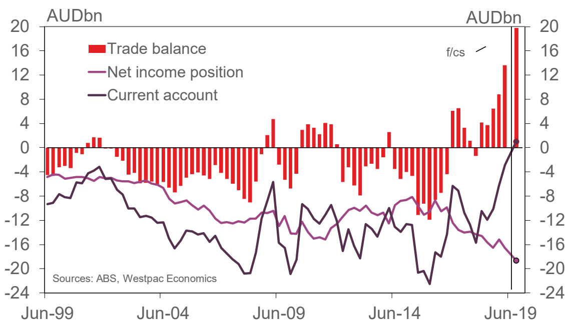
- The nation is on the cusp of an historic moment - potentially recording the first current account surplus since June 1975!
- In Q1, the current account deficit narrowed to $2.9bn, down sharply from $10.5bn a year earlier. For Q2 we expect a current account surplus of $1.0bn.
- Export earnings have jumped on higher commodity prices. Imports are soft on weak demand.
- The net income deficit is anticipated to widen sharply, from $16.5bn to a forecast $18.7bn, as higher commodity prices boost returns to foreign investors in the mining sector.

Aus Q2 public demand

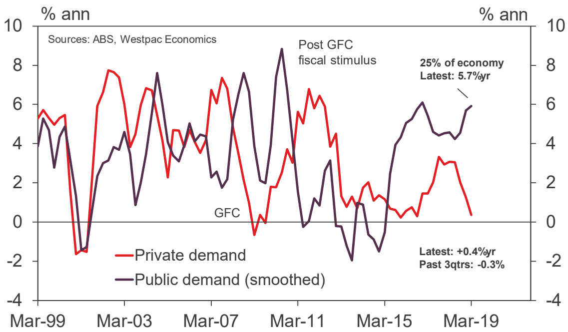
Sep 3, Last: 1.1%, WBC f/c: 1.1%

- Public sector spending, in the form of public demand (directly accounting for a quarter of the economy) has been expanding at a brisk pace. It is a key growth driver and a key generator of jobs.
- Public demand grew by: 4.8% in 2015, 5.9% in 2016, 4.5% in 2017 and accelerated to 6.1% in 2018. The focus is on health care (the introduction of the NDIS and the pharmaceutical benefit scheme) and on investment (including transport infrastructure).
- For the June quarter, we anticipate a robust 1.1% increase in public demand, matching the Q1 result - with both consumption and investment expected to advance in the period.

Current account: a surplus, Q2 f/c +$1.0bn



Domestic demand: private / public – stark divide



Aus Sep RBA policy decision

Sep 3, Last: 1.00%, WBC f/c: 1.00%
Mkt f/c: 1.00%, Range: 0.75% to 1.00%

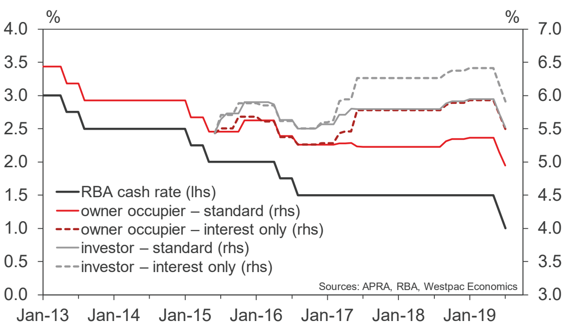
- We expect rates will be on hold in September and continue to expect the next rate cut to occur in October. A key signal around the Governor's Statement following the decision next week will be whether he continues with the wording "ease monetary policy further if needed".
- We are aware that the Governor is concerned about global developments and probably would like to retain some flexibility to respond to an unexpected global shock – better to cut rates in October and allow flexibility to move again in December rather than delay until November and have to do consecutive November/December moves.

Aus Q2 GDP

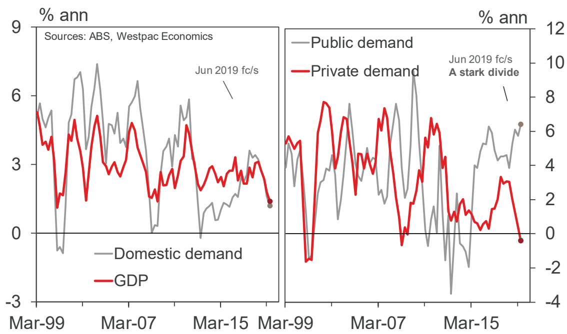
Sep 4, Last: 0.4%qtr, 1.8%yr, WBC f/c: 0.5%qtr, 1.4%yr
Mkt f/c: 0.5, Range: 0.2% to 0.7%

- The Australian economy has lost considerable momentum, with annual growth slowing from an above trend 3.1% in mid-2018 to a forecast 1.4% in mid-2019 - the slowest pace since the GFC (September 2009).
- Key dynamics are: cyclical weakness, centred on construction (notably housing, with lending standards tightened); structural headwinds around wages and productivity; and a slowing global economy.
- For Q2, we expect real GDP growth of 0.5%qtr, 1.4%yr. The arithmetic is: domestic demand, 0.2%; total inventories, broadly flat; and net exports, +0.4ppts.

RBA cash rate and mortgage interest rates



Australian economic conditions



The week ahead

Aus Jul trade balance, AUDbn

Sep 5, Last: 8.0, WBC f/c: 7.8
Mkt f/c: 7.2, Range: 5.8 to 8.8

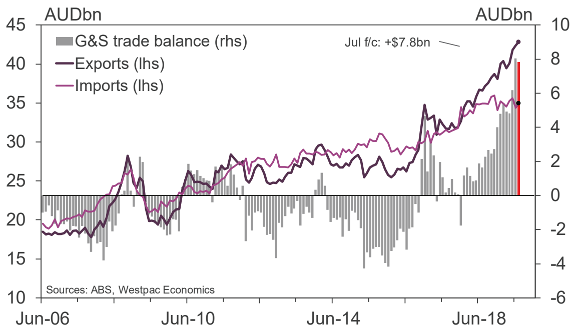
- Australia's trade surplus has surged, climbing to record highs as higher commodity prices boost export earnings.
- The surplus printed at $8.0bn in the month of June and $19.7bn for the June quarter, representing 4.0% of GDP.
- For July, the surplus is expected to remain elevated, at a forecast $7.8bn.
- Export earnings are forecast to rise by 1.0%, $0.4bn. Iron ore export earnings rose further as the spot price spiked to US$120/t, up 10% in the month. Subsequently, the iron ore price has pulled-back, which will trim the surplus in coming months.
- For imports, a partial rebound is anticipated, +1.8%, up $0.6bn, after a sharp $1.3bn drop in June. The underlying trend is one of soft volumes at a time of sluggish domestic demand.

US Jul employment report

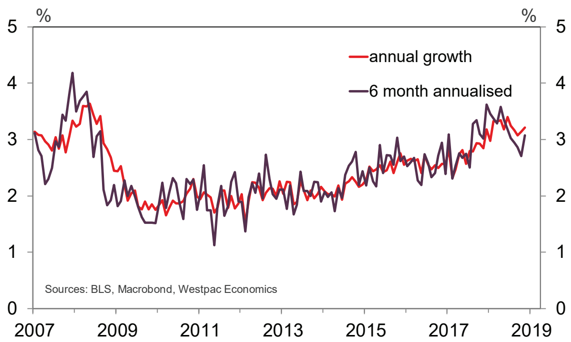
Sep 6, nonfarm payrolls, last: 164k, WBC: 140k
Sep 6, unemployment rate, last: 3.7%, WBC: 3.6%
Sep 6, hourly earnings, last 0.3%, WBC: 0.3%

- In 2019, employment growth has throttled back to 165k. This is still ahead of the monthly pace necessary to keep the unemployment rate steady, but is a material deceleration from the strong 200k per month gains of the past 8 years.
- We look for job growth to slow further in coming months, forecasting a 140k gain for August and an average circa 130k through H2 2019. If this occurs, then the unemployment rate will stabilise around its 50-year low.
- For wages, the tight labour market should be enough to sustain growth between 3.0% and 3.5%yr. However, a renewed uptrend above the top end of this range seems increasingly unlikely.

Australia's trade balance



Hourly earnings growth stabilising

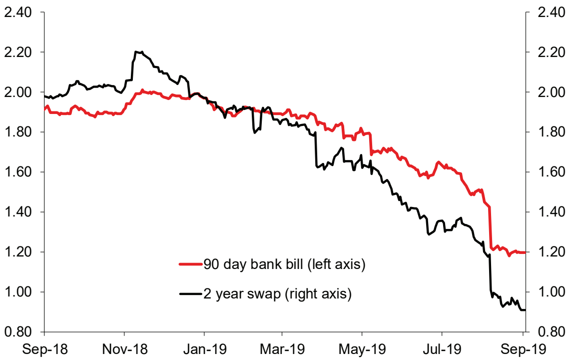


New Zealand forecasts

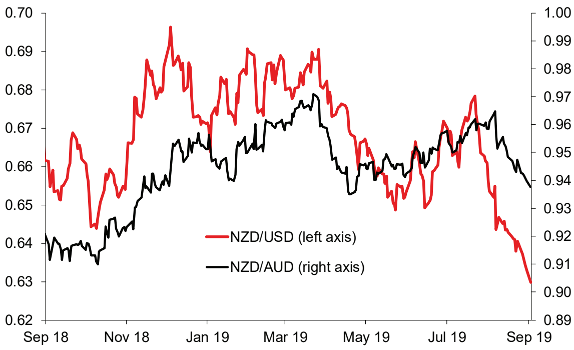
Economic Forecasts	Quarterly				Annual			
	2019							
% change	Mar (a)	Jun	Sep	Dec	2018	2019f	2020f	2021f
GDP (Production)	0.6	0.5	0.4	0.5	2.9	2.1	2.3	2.8
Employment	-0.1	0.8	0.2	0.4	2.3	1.3	1.8	2.0
Unemployment Rate % s.a.	4.2	3.9	4.1	4.2	4.3	4.2	4.2	3.8
CPI	0.1	0.6	0.6	0.3	1.9	1.6	1.7	1.8
Current Account Balance % of GDP	-3.6	-3.4	-3.3	-3.2	-3.8	-3.2	-2.9	-2.7

Financial Forecasts	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Cash	1.00	0.75	0.75	0.75	0.75	0.75
90 Day bill	1.00	0.90	0.90	0.90	0.90	0.90
2 Year Swap	0.90	0.80	0.80	0.80	0.85	0.90
5 Year Swap	1.00	1.00	1.00	1.05	1.10	1.15
10 Year Bond	1.05	1.00	1.05	1.10	1.15	1.20
NZD/USD	0.64	0.64	0.63	0.63	0.64	0.64
NZD/AUD	0.96	0.96	0.95	0.95	0.96	0.96
NZD/JPY	67.8	67.8	67.4	68.0	70.4	71.0
NZD/EUR	0.59	0.59	0.58	0.58	0.59	0.58
NZD/GBP	0.54	0.54	0.53	0.52	0.52	0.51
TWI	71.9	72.2	71.4	71.0	71.6	71.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 2 September 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.00%	1.00%	1.50%
30 Days	1.18%	1.15%	1.43%
60 Days	1.18%	1.18%	1.44%
90 Days	1.20%	1.22%	1.45%
2 Year Swap	0.91%	0.93%	1.20%
5 Year Swap	0.93%	0.93%	1.23%

NZ foreign currency mid-rates as at 2 September 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6298	0.6433	0.6537
NZD/EUR	0.5730	0.5801	0.5885
NZD/GBP	0.5183	0.5294	0.5382
NZD/JPY	66.76	68.46	69.67
NZD/AUD	0.9376	0.9473	0.9618
TWI	70.62	71.71	72.56

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 02					
NZ	Q2 terms of trade	1.0%	1.0%	1.0%	Bounce in dairy prices outweighing higher fuel prices.
Aus	Q2 company profits	1.7%	2.0%	2.0%	Profits up further on higher commodity prices.
	Q2 inventories	0.7%	0.3%	0.2%	Only a small rise after Q1 boosted by temporary factors.
	Aug CoreLogic home value index	0.1%	–	1.0%	Stabilisation; pace picking up in August.
	Aug ANZ job ads	0.8%	–	–	Starting to trend down.
	Aus AiG PMI	51.3	–	–	Conditions varied, moderating overall - construction downtrend.
Chn	Aug Caixin China PMI	49.8	49.9	–	Trade tensions are taking its toll.
Eur	Aug Markit manuf. PMI final	47.0	47.0	–	Manufacturing is very weak, particularly in Germany.
UK	Aug Markit manufacturing PMI	48.0	–	–	Domestic and global headwinds weighing on activity.
US	Labor Day	–	–	–	Public holiday - unofficial end to summer.
Tue 03					
Aus	Jul retail sales	0.4%	0.2%	0.3%	Too soon to see the effects of new stimulus measures.
	Q2 net exports, ppts cont'n	0.2	0.3	0.4	Export uptrend resumed in 2019, imports down - weak demand.
	Q2 current account balance, $bn	–2.9	+1.5	+1.0	Potentially a current a/c surplus - the 1st since June 1975!!
	Q2 public demand	1.1%	–	1.1%	Brisk growth continues - health & investment focus.
	RBA policy decision	1.00%	1.00%	1.00%	A pause, after cuts in June and July - easing to resume in Oct.
US	Aug Markit manuf. PMI final	49.9	–	–	Dropped to post-GFC lows...
	Aug ISM manufacturing	51.2	51.5	–	... pointing to material softening in the growth pulse.
	Jul construction spending	–1.3%	0.3%	–	LIkely to deteriorate from already weak level in coming months.
Wed 04					
NZ	GlobalDairyTrade auction	-0.2%	–	–	Trade war uncertainty may weigh on prices.
	Aug ANZ commodity prices	–1.4%	–	–	Higher meat prices likely to feature.
Aus	Q2 GDP	0.4%	0.5%	0.5%	Conditions soft. Growth centred on public & exports.
	Q2 GDP, %yr	1.8%	1.4%	1.4%	Private demand contracting, consumer spend subdued.
	Aug AiG PSI	43.9	–	–	Weakness extending into Q3 - index slumped 8.3pts in July.
Chn	Aug Caixin China PMI services	51.6	51.7	–	In expansion but trailing the NBS measure.
Eur	Aug Markit services PMI final	53.4	53.4	–	Has been resilient against manufacturing weakness.
	ECB speak	–	–	–	Chief Economist Lane in London.
UK	Aug Markit services PMI	51.4	–	–	Economic uncertainty weighing on business activity.
US	Jul trade balance US$bn	–55.2	–55.2	–	Deficit to remain elevated.
	Federal Reserve's Beige book			–	Conditions across the 12 districts.
	Fedspeak	–	–	–	Rosengren (7 am AEST), Williams in NY, Bowman and Bullard...
	Fedspeak	–	–	–	... at 'Fed Listens' event, Kashkari at Townhall, Evans on trade.
Thu 05					
NZ	Q2 building work put in place	6.2%	1.3%	0.9%	Continued strength in res, some easing in non-res.
Aus	Jul trade balance $bn	8.0	7.2	7.8	Surplus to hold near record high, exports up on iron ore price.
US	Aug ADP employment change	156k	143k	150k	Employment growth decelerating.
	Q2 productivity	2.3%	2.2%	–	Remains supportive of robust growth.
	Initial jobless claims	215k	–	–	Remain low.
	Jul factory orders	0.6%	0.8%	–	Core durable orders soft again in Jul.
	Aug Markit services PMI final	50.9	–	–	Tracking below the ISM but nevertheless...
	Aug ISM non–manufacturing	53.7	53.6	–	... services look to be coming under pressure as well.
Fri 06					
Aus	Aug AiG PCI	39.1	–	–	Construction sector in a sharp downtrend, including housing.
Eur	Q2 GDP 3rd estimate	0.2%	0.2%	–	3rd estimate contains expenditure detail.
UK	Aug Halifax house prices	–0.2%	–	–	After a brief recovery, the market has cooled again.
US	Aug non–farm payrolls	164k	165k	140k	Job growth is easing amid headwinds and uncertainty.
	Aug unemployment rate	3.7%	3.7%	3.6%	Downtrend in unemployment likely near end.
	Aug avg hourly earnings %mth	0.3%	0.3%	–	A base looks to be forming for hourly earnings growth.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	2.8	1.8	2.4
CPI inflation % annual	1.7	1.5	1.9	1.8	1.7	1.9
Unemployment %	5.8	5.7	5.5	5.0	5.4	5.6
Current Account % GDP	-4.7	-3.1	-2.6	-2.1	-0.2	-1.5
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.3	1.7
Consumer Prices %yr	0.1	1.4	2.1	2.4	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	1.2	0.6	1.9	0.8	0.7	0.3
Euro zone						
Real GDP %yr	2.1	2.0	2.4	1.8	1.1	1.2
United Kingdom						
Real GDP %yr	2.3	1.8	1.8	1.4	1.2	1.4
China						
Real GDP %yr	6.9	6.7	6.8	6.6	6.1	5.8
East Asia ex China						
Real GDP %yr	3.8	4.0	4.6	4.3	3.8	4.0
World						
Real GDP %yr	3.4	3.4	3.8	3.6	3.2	3.3
Forecasts finalised 9 August 2019						

Interest Rate Forecasts	Latest	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Australia							
Cash	1.00	1.00	0.75	0.50	0.50	0.50	0.50
90 Day BBSW	0.97	0.95	0.85	0.70	0.70	0.70	0.70
10 Year Bond	0.89	0.90	0.90	1.00	1.00	1.10	1.10
International							
Fed Funds	2.125	1.875	1.375	1.375	1.375	1.375	1.375
US 10 Year Bond	1.51	1.55	1.55	1.60	1.60	1.65	1.65
ECB Deposit Rate	-0.40	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60

Exchange Rate Forecasts	Latest	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/USD	0.6717	0.67	0.67	0.66	0.66	0.67	0.67
USD/JPY	106.48	106	106	107	108	110	111
EUR/USD	1.1045	1.09	1.08	1.08	1.08	1.09	1.11
GBP/USD	1.2176	1.18	1.19	1.20	1.22	1.24	1.26
AUD/NZD	1.0661	1.05	1.05	1.05	1.05	1.05	1.05

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