Weekly Commentary

22 July 2019

Stone Store, Kerikeri

The shine is coming off

For some time now we've been noting the slowdown in the domestic economy. This has been led by a deepening malaise in the business sector, weaker growth in retail spending and a subdued housing market. Until recently, some of this weakness had been offset by the strength of the export sector with high prices for many export commodities supporting sentiment and activity in regional New Zealand in particular. This has started to change in recent weeks as cracks have begun to appear in the outlook for the some exporters.

We recently lowered our farm gate milk price forecast for this season to $6.90 (from $7.20) on the back of disappointing dairy auction outturns over the last few months. While a $6.90 milk price still looks attractive from an historical perspective, it's not quite as healthy as things were shaping up a few months ago. Last week the news was a little more positive, with dairy prices bucking the recent trend to climb 2.7% (including a 3.6% lift in the all-important whole milk powder category). Whole milk powder prices are now back above $US3000/tonne.

The plunge in log prices in recent weeks has been much more dramatic. A standout of the New Zealand export scene in recent years, export log prices dropped 25% between June and July. We have been expecting log prices to moderate from their high levels for a while now, but the speed and magnitude of the recent falls caught us by surprise.

Much of the blame for the sharp fall in prices has been attributed to a lift in supply. Log exports from New Zealand have been elevated for some time as forest owners have looked to take advantage of the high prices on offer. But a recent slowing in demand, perhaps related to the US/China trade war, has reportedly seen inventories in China start to build. What's more, there's been an increase in log exports to China from other parts of the world (in particular Europe) helped by falling transport costs. Chinese saw millers are also reportedly facing stiffer competition from cheaper sawn timber imports.

Tumbling log prices will impact the New Zealand economy quickly. In other agricultural sectors a sharp fall in prices can take time to feed through to spending decisions and the broader economy. But in forestry, when prices drop some forest owners simply stop harvesting. Leaving trees in the ground quickly reduces demand for labour with anecdotal reports already suggesting that up to 1,000 jobs may be at risk.

If there's a silver lining, it's that this comes at a time when the unemployment rate is relatively low meaning some workers may be able to pick up work elsewhere. Indeed, one anecdote we have been hearing a lot of lately is difficulty finding enough workers to plant trees under the Government's "Billion Tree" plan. With many plantings likely to be in regions where there are existing forestry operations, this could be one sector that could pick up a few more workers. Local saw millers may also benefit from lower log prices, at a time when construction activity in New Zealand remains very strong.

The shine is coming off

The stronger NZ dollar in recent weeks comes as another unwelcome development for New Zealand exporters. The NZD/USD has climbed more than 1.5 cents from its recent lows and is now sitting above to 67.5 cents. Markets have become increasingly confident that the Fed will cut its policy rate later this month and are pricing in a further 3 cuts by the middle of next year and this has weighed on the US dollar. We think this is overstating the case and are only factoring two rate cuts by Fed into our own outlook. Consequently, we expect the NZD/USD to lose some ground later in the year as markets pare back their views.

In the meantime, however, the stronger NZ dollar will put further downward pressure on tradables inflation. Indeed, last week's inflation data reinforced the familiar theme that inflation pressures, particularly in the tradables sector, remain modest (a short-term spike in fuel prices aside). And while domestically generated non-tradables inflation has been gradually grinding higher as spare capacity in the economy has been eroded, this hasn't been enough to lift annual CPI inflation out of the lower half of the RBNZ's 1-3% range. Annual inflation was 1.7% in the June quarter with most measures of core inflation in the 1.5-1.7% range.

Concerns about the outlook for global growth, combined with a patchier outlook for the export sector and lacklustre momentum in the domestic economy, should give the RBNZ the go-ahead to proceed with a rate cut in August. Beyond this however, the outlook is more uncertain. While we don't think a third rate cut in November is the most likely outcome, the odds are increasing. Certainly it won't be the outlook for inflation that stops the RBNZ taking the OCR to 1%. Rather, we think it will be a pickup in the housing market on the back of sharply lower mortgage rates that stays the RBNZ's hand. As we noted last week, we've recently seen the first evidence of this happening with an estimated 10% seasonally adjusted lift in house sales over the past two months. With house sales traditionally a reliable leading indicator of house prices, we expect a pickup in house price inflation to be more evident by year-end.

Fixed vs Floating for mortgages

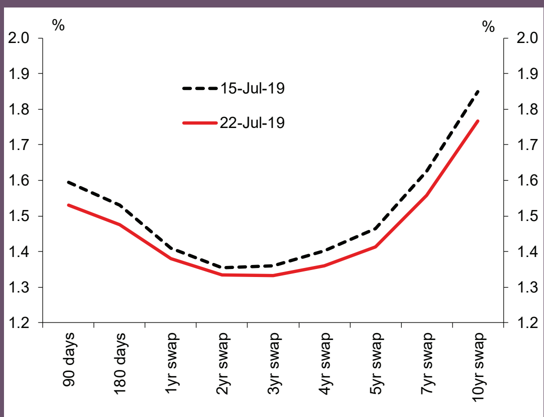
We expect the Reserve Bank will lower the OCR in August. If that is correct, both floating and fixed mortgage rates may fall over the coming month or two. However, we expect the OCR to rise again in the early 2020s, pushing mortgage rates up at that time.

Based on our OCR forecasts, three-year fixed mortgage rates seem the best value on offer today. However, opportunities to fix at an even lower rate might emerge over the coming month or two. Today's one- and two-year rates are also fairly good value, with neither strongly preferred to the other.

Four- and five-year fixed rates are higher than where we expect shorter-term rates to go over the relevant timeframe, but longer-term fixed rates do offer insurance against the risk of future interest rate increases.

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

US Q2 GDP, annualised

Jul 26, Last: 3.1%, WBC: 1.6%

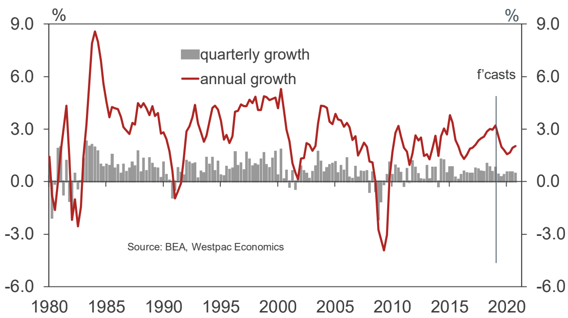
- The US economy started 2019 strongly as GDP surged 3.1% annualised. Inventories were however responsible for half of this growth.
- Come Q2, this situation looks set to reverse. While we anticipate just a 1.6% headline gain, domestic demand is set to strengthen, thanks to a near doubling of consumption growth, and as government spending continues to provide support. Business investment should also grow, but likely at a softer pace than in Q1.
- Looking ahead, growth in the second half is likely to be weaker still as global uncertainties weigh before growth bounces back to a near-trend pace in 2020, thanks to continued strength in the labour market and easier financial conditions. Risks around trade and fiscal policy will remain though.

Euro Area ECB policy decision

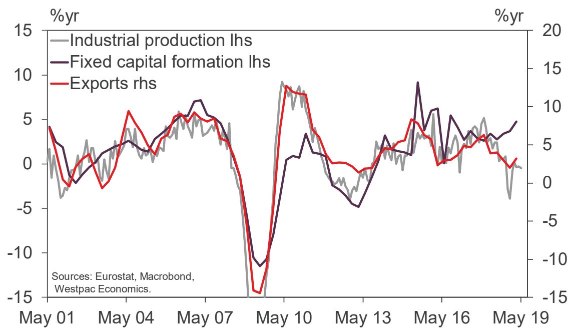
Jul 25, deposit rate, Last: -0.4%, WBC: -0.4%

- At the June meeting, the ECB were "ready to act" if "adverse contingencies" materialise. Two weeks later at Sintra, President Draghi moved to in "the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required."
- As such, the July meeting is likely to open the door to a cut in the deposit rate at the September meeting. The ECB are also likely to reiterate that they are willing and able to restart the asset purchase program and move to a tiered deposit rate. At this stage, we believe the cut and merely showing the market that the ECB can ease further will be sufficient stimulus. However, if manufacturing weakness persists - or worse, spreads - the ECB will need to deliver.

US GDP growth to slow but remain above trend



Will (or when) weak exports slow investment?

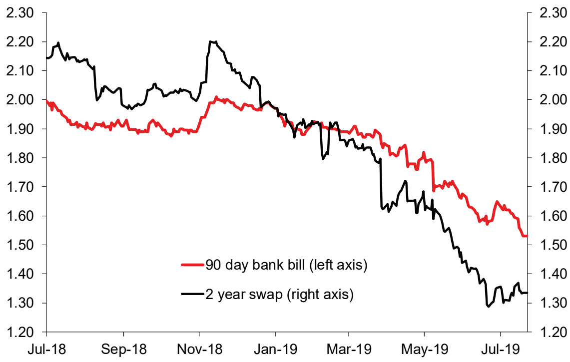


New Zealand forecasts

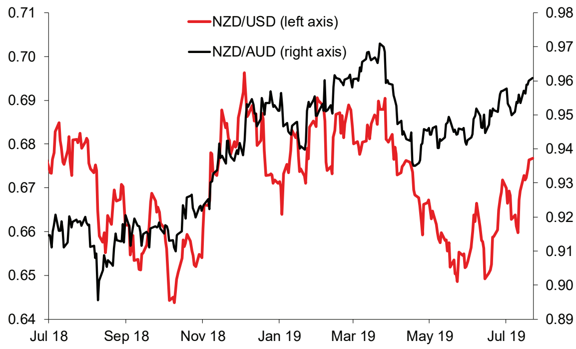
Economic Forecasts	Quarterly				Annual			
	2019							
% change	Mar (a)	Jun	Sep	Dec	2018	2019f	2020f	2021f
GDP (Production)	0.6	0.4	0.6	0.8	2.9	2.3	3.0	2.4
Employment	-0.2	0.8	0.3	0.3	2.3	1.3	2.0	1.8
Unemployment Rate % s.a.	4.2	4.3	4.3	4.2	4.3	4.2	3.9	3.7
CPI	0.1	0.6	0.7	0.3	1.9	1.7	1.9	2.1
Current Account Balance % of GDP	-3.6	-3.4	-3.4	-3.4	-3.8	-3.4	-3.4	-3.6

Financial Forecasts	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Cash	1.25	1.25	1.25	1.25	1.25	1.50
90 Day bill	1.40	1.40	1.40	1.40	1.55	1.65
2 Year Swap	1.25	1.30	1.40	1.50	1.60	1.70
5 Year Swap	1.40	1.50	1.60	1.70	1.80	1.90
10 Year Bond	1.55	1.60	1.65	1.75	1.85	1.90
NZD/USD	0.65	0.65	0.65	0.66	0.66	0.66
NZD/AUD	0.96	0.96	0.98	0.99	0.99	0.99
NZD/JPY	68.9	68.3	69.6	71.0	72.4	73.0
NZD/EUR	0.57	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.52	0.52	0.52	0.52	0.51	0.51
TWI	71.8	71.6	72.0	72.5	72.4	72.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 22 July 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.50%	1.50%	1.50%
30 Days	1.54%	1.63%	1.61%
60 Days	1.53%	1.63%	1.60%
90 Days	1.53%	1.62%	1.58%
2 Year Swap	1.34%	1.31%	1.29%
5 Year Swap	1.41%	1.38%	1.35%

NZ foreign currency mid-rates as at 22 July 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6767	0.6625	0.6584
NZD/EUR	0.6035	0.5904	0.5787
NZD/GBP	0.5410	0.5288	0.5169
NZD/JPY	72.93	71.80	70.68
NZD/AUD	0.9608	0.9498	0.9498
TWI	74.17	72.74	72.11

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 22					
US	Jun Chicago Fed activity index	–0.05	–	–	Composite of other measures.
Tue 23					
Aus	RBA Assist' Gov. Fin Mkts speaks	–	–	–	Chris Kent, "The Committed Liquidity Facility", Sydney, 8:30am
Eur	Jul consumer confidence advance	–7.2	–7.1	–	Declined in recent months but still at an above average level.
UK	Conservatives Leadership Ballot	TM	BJ	BJ	Likely to announce results for the new British PM.
US	May FHFA house prices	0.4%	–	–	Momentum has slowed.
	Jul Richmond Fed index	3	5	–	Manufacturers facing uncertain times.
	Jun existing home sales	2.5%	0.1%	–	Supply remains the issues for existing market.
Int	IMF WEO update	–	–	–	Uncertainty around the global expansion persists.
Wed 24					
NZ	Jun trade balance $m	264	100	100	Dairy exports to slow sharply after a dry autumn.
Eur	Jul Markit manuf' PMI flash	47.6	47.8	–	Will manufacturing weakness...
	Jul Markit services PMI flash	53.6	53.3	–	... spill over to the services sector?
	Jun M3 money supply %yr	4.8%	–	–	Robust credit growth remains supported by ECB policy.
US	Jul Markit manufacturing PMI	50.6	50.9	–	Manufacturers facing uncertain times.
	Jul Markit services PMI	51.5	–	–	Domestic demand aiding performance of services sector.
	Jun new home sales	–7.8%	5.3%	–	Housing market supported by low rates and employment.
Thu 25					
Aus	RBA Governor Lowe speaks	–	–	–	"Inflation Targeting & Economic Welfare", Sydney, 1:05pm
Eur	ECB policy decision	–0.4%	–0.4%	–0.4%	Likely to pave the way for September easing.
US	Jun wholesale inventories	0.4%	–	–	Q1 contribution to growth to partially reverse in Q2.
	Jun durable goods orders	–1.3%	0.8%	–	Underlying trend weak.
	Initial jobless claims	216k	–	–	Very low.
	Jul Kansas City Fed index	0	–	–	Manufacturers facing uncertain times.
Fri 26					
US	Q2 GDP, annualised	3.1%	1.8%	1.6%	Growth has slowed despite jump in consumer demand.
Sat 27					
Chn	Jun industrial profits %yr	1.1%	–	–	Manufacturing is in a soft spot.

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	1.8	1.6
Unemployment %	5.8	5.7	5.5	5.0	5.4	5.6
Current Account % GDP	-4.7	-3.1	-2.6	-2.1	-0.3	-1.2
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.4	1.8
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	3.5	3.5
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	0.4
Euro zone						
Real GDP %yr	2.1	2.0	2.4	1.8	1.2	1.4
United Kingdom						
Real GDP %yr	2.3	1.8	1.8	1.4	1.4	1.4
China						
Real GDP %yr	6.9	6.7	6.8	6.6	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	4.0	4.6	4.3	4.0	4.0
World						
Real GDP %yr	3.4	3.4	3.8	3.6	3.3	3.4
Forecasts finalised 5 July 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	0.75	0.75	0.75	0.75
90 Day BBSW	1.12	1.10	1.00	1.00	1.00	1.00	1.00
10 Year Bond	1.34	1.30	1.40	1.45	1.60	1.70	1.75
International							
Fed Funds	2.375	2.125	1.875	1.875	1.875	1.875	1.875
US 10 Year Bond	2.04	2.00	2.05	2.10	2.20	2.25	2.30
ECB Deposit Rate	−0.40	−0.50	−0.50	−0.50	−0.50	−0.50	−0.50

Exchange Rate Forecasts	Latest	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/USD	0.7071	0.68	0.68	0.66	0.66	0.67	0.67
USD/JPY	107.54	106	105	107	108	109	110
EUR/USD	1.1263	1.14	1.14	1.13	1.13	1.12	1.12
GBP/USD	1.2547	1.26	1.25	1.26	1.27	1.29	1.30
AUD/NZD	1.0426	1.05	1.04	1.02	1.01	1.01	1.01

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