Weekly Commentary

25 February 2019


Larnach Castle, Dunedin

Extraordinarily ordinary

The drivers of demand in the New Zealand economy are shifting. While a temporary reacceleration of growth is on the cards for 2019, that's likely to give way to a period of soft activity in the early 2020s. On top of that, some big changes in New Zealand's tax system have been mooted, including the potential introduction of a capital gains tax.

We recently released our latest *Economic Overview*.[1] In it we point out that the New Zealand economy clearly lost some steam in late 2018. However, we expect that the economy will regain some of its earlier momentum over 2019, with annual GDP growth set to reaccelerate to 3.1% by year's end. In part that's due to the 20% fall in petrol prices since October, which has put money back into households' wallets. The coming year will also see increases in government spending, a lift in construction activity, and firmness in farm incomes. On top of those factors, labour incomes are also set to rise over the coming year.

But while the above factors are helping to boost demand for now, the firming in economic growth we expect over 2019 will be temporary. Several of the other factors that have supported growth in recent years are now moving into new phases, and going forward they won't provide the same support for demand that they once did. As we head into the early 2020s this will see growth slowing to low levels of around 2% per annum – a sharper slowdown than previously expected.

A key reason why we expect GDP growth to cool, and also the major contributor to our lower longer-term growth forecasts, is slower population growth. Annual population growth rose to 2% in recent years underpinned by record levels of net migration. However, population growth has already slowed to around 1.5%, and we expect that it will slow to around 1% in 2021. That signals a substantial reduction in the economy's rate of potential GDP growth.

This decline in population growth has been starker than we previously anticipated and comes on the back of a marked slowdown in long-term migration. Stats NZ's recent updates have revealed that net migration actually peaked back in 2016 and is now down 20% from its peak (previous estimates indicated that migration had continued to climb through 2017). We expect this decline will continue over the next few years.

Slower population growth will reduce the need to build houses. That comes atop of the continuing wind-down in post-earthquake reconstruction in Canterbury and Kaikoura. The combination of those factors means the peak in the construction cycle is now clearly in sight.

The coming years will also see much slower growth in household spending (which accounts for around 60% of GDP). After solid gains of 5% to 6% per annum in recent years, we expect that spending growth will drop to 2% in the early part of next decade. In part, that's because of the slowdown in population growth discussed above. In addition, a weak outlook for house price growth over the coming years also signals a drag on spending. While recent falls in mortgage rates and an easing in borrowing

[1] Available here: https://www.westpac.co.nz/assets/Business/Economic-Updates/2019/Bulletins-2019/Westpac-QEO-February-2019-WEB.pdf

Extraordinarily ordinary continued

restrictions will boost house prices in the very near term, policy changes (including those affecting the tax system) are likely to see modest price declines over the coming years.

With firm growth in recent years and the economy now running around trend, inflation is sitting just slightly below the mid-point of the Reserve Bank's target band. We expect to see a temporary dip in inflation this year as a result of the pull-back in petrol prices. But with economic growth set to slow again next decade, we still expect overall inflation to remain well contained around 2%. Importantly, the pick-up in inflation over the coming year isn't expected to be strong enough to prompt an RBNZ response. We're forecasting no change in the OCR for the coming three years, with the risks around that profile evenly balanced.

Taxing times

The other big news over the past week was the final report from the Government's Tax Working Group (TWG) which has been looking at possible reforms to New Zealand's tax system. The TWG's findings were largely as expected. The key recommendation was the introduction of a broad-based capital gains tax excluding the family home. The Group also recommended offsetting reductions to income taxes at the lower end of the scale.

We believe the benefits of introducing a capital gains tax outweigh the costs. New Zealand currently suffers from a heavy skew towards investments that yield capital gain, such as farms and property. Meanwhile, we tend to underinvest in other productive assets such as factories and service firms, which yield income. A CGT would help to right this imbalance in the country's investments. That should lead to a more diverse national balance sheet and a more efficient economy. We also expect CGT to make home ownership more affordable, leading to a higher rate of home ownership.

When it is first introduced, a CGT would dampen economic growth for a period. That's because of its impact on house prices. A CGT would erode the incentives for investors to purchase residential property, and that would flow through to lower house price inflation. Ups and downs in the economy tend to follow the swings in the housing market, so we'd expect the introduction of a CGT would also result in a period of softer household spending. This would be a transitional slowdown, and the impact could partially be offset if there is a related reduction in income tax (which would also improve the incentives to engage in paid work).

The Government will decide in April which (if any) of the TWG's recommendations it will pursue. The required legislation will be passed before the 2020 election, but will not take effect until 2021. This sets the 2020 election up as a referendum on whatever version of a capital gains tax is proposed, as the incoming Government could cancel the tax. Of the partners that make up the current government, the Labour Party and Green Party are both in favour of capital gains tax, but the New Zealand First Party is generally thought to be opposed. Consequently, we expect the TWG's recommendations to be watered down substantially. Our forecast for roughly 3% house price decline in 2021 assumes some mild version of a capital gains tax is introduced. Should the TWG's full recommendation be introduced instead, we would forecast greater house price decline than that. Alternatively, if CGT gets cancelled, house prices would hold up.

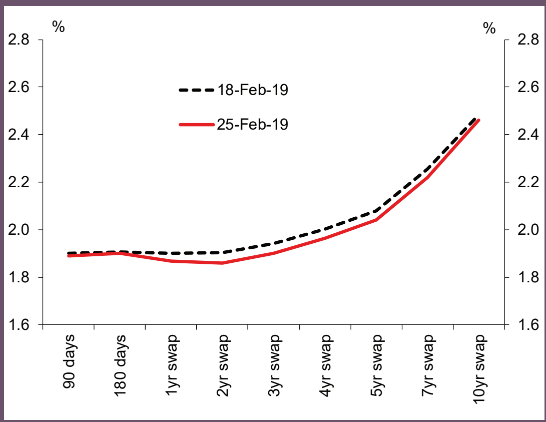
Fixed vs Floating for mortgages

The rise in wholesale interest rates following the Reserve Bank's February Monetary Policy Statement has reduced the downward pressure on retail mortgage rates. With cash rate hikes still a distant prospect, we expect retail fixed mortgage rates to remain relatively steady in the near term.

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 real retail sales

Feb 25, Last: flat, WBC f/c: +0.7%, Mkt f/c: +0.5%

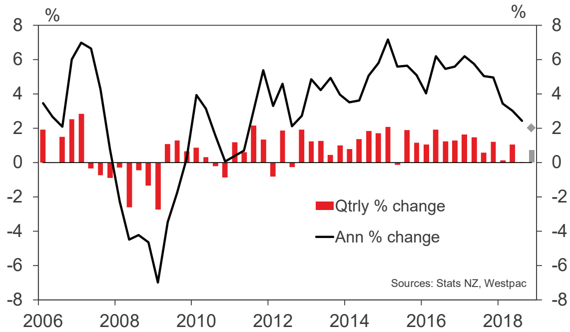
- Retail spending was weaker than expected in the September quarter. While increases in petrol prices pushed up spending on fuel, this crowded out spending in other areas, leaving overall spending volumes flat for the quarter.
- The sharp falls in petrol prices through November and December will have put money back into households' wallets. Combined with the earlier increase in government transfer payments to households, we expect to see a 0.7% rise in volumes, underpinned by a solid lift in core (ex-fuel) categories.
- Monthly spending gauges posted unusually large swings in December and January (potentially due to delays with data processing). If that volatility is captured in the quarterly figures, it could tilt the Q4 result to the downside.

NZ Feb ANZ business confidence

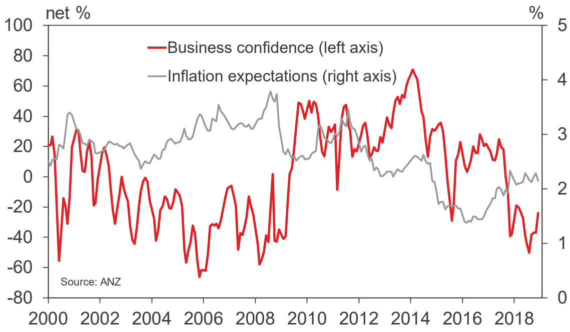
Feb 28, Last: -24.1

- With no January survey, it's been a while since we've had an update on how business confidence is faring. Back in December, we saw an improvement in both the headline measure and own-activity expectations of this survey.
- Concern about the downside risks to growth posed by very weak business confidence have eased in recent months as confidence has improved and the economy has trundled along. However, confidence still remains at historically low levels and out of step with the pace of growth we're seeing in the economy.
- There was some easing in price measures in the last survey following sharp falls in petrol prices however, pricing intentions remain elevated relative to history. Inflation expectations have continued to linger a little above 2%.

Real retail sales



NZ business confidence and inflation expectations



NZ Jan dwelling consents

Mar 1, Last: +5.1%, WBC f/c: -2.0%

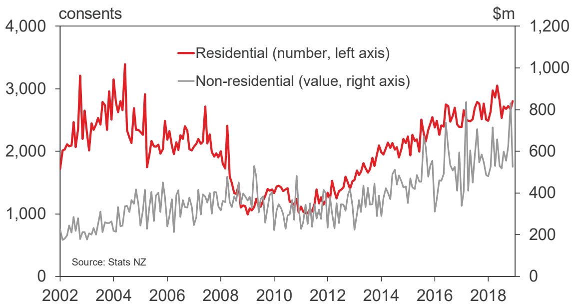
- Dwelling consent issuance rose by 5.1% in December, buoyed by a gain in the apartments/multiples category. On an annual basis, consent numbers have risen to a high level, with 33,000 new dwellings consented over 2018 (the highest level since 2004). However, it's not obvious that issuance will continue to push higher over the coming year. In fact, after picking up in late 2017, consent numbers have essentially been flat, with numbers in Auckland (which drove much of the earlier increase) easing back a little.
- We expect January's report will record a 2% drop following last month's rise in the volatile multiples category. That will leave the annual consents count largely unchanged.

NZ Q4 terms of trade

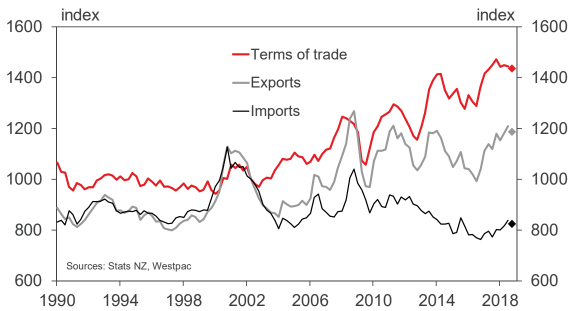
Mar 1, Last: -0.3%, WBC f/c: -0.5%, Mkt f/c: -1.0%

- New Zealand's terms of trade edged back slightly over 2018 after reaching an all-time high in 2017. There were mixed results for export commodity prices over the year, while rising oil prices added to the import bill.
- We estimate that the terms of trade fell by 0.5% in the December quarter. This comprises a 2% drop in export prices and a 1.5% drop in import prices, with the higher New Zealand dollar acting as a drag on both sides.
- Dairy export prices fell about 6%, reversing a jump in the previous quarter. Other export prices look to be little changed. World oil prices fell sharply in late 2018, though due to the timing of shipments this will likely have more impact on the March quarter trade figures.

NZ building consents



NZ terms of trade



The week ahead

Aus Q4 construction work

Feb 27, Last: -2.8%, WBC f/c: 0.4%, Mkt f/c: 0.9%

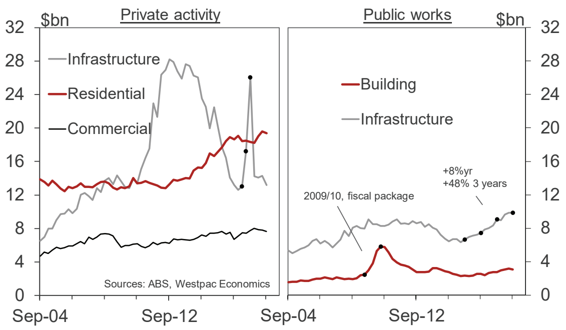
- Construction work weakened in Q3, contracting by 2.8%. Falls were widespread, across new home building, commercial building, private infrastructure and public works.
- For the December quarter, we anticipate a consolidation, with activity to edge 0.4% higher.
- Public works likely resumed its upward trend, following the Q3 dip, supported by a sizeable and growing work pipeline.
- Private infrastructure activity is expected to stabilise after a sharp fall in Q3 - a decline which was over and above that associated with the finalisation of the major gas projects.
- The new home building downturn, which emerged in Q3, likely extended in to Q4 and beyond.

Aus Q4 private business capex

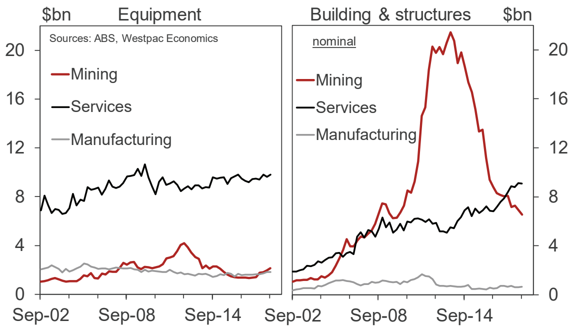
Feb 28, Last: -0.5%, WBC f/c: flat, Mkt f/c: 1.0%

- Private business spending on capex trended lower over the past year, with a Q3 outcome of -0.5%qtr, -0.6%yr. Weakness was in building & structures (-2.8%qtr, -6.9%yr), more than offsetting a lift in equipment (+2.2%qtr, 7.7%yr).
- For Q4, we anticipate a flat result.
- Building & structures is expected to move lower still, -0.5%qtr, with underlying softness in both commercial building and infrastructure (with gas projects being completed).
- Equipment spending is forecast to rise by 0.8% with gains across the sectors (mining, services and manufacturing). Spare capacity has been reduced over recent years, hence the need to add new capacity. In mining, spending on maintenance is up associated with the new projects.

Construction work: by segment



CAPEX: by industry by asset



Aus 2018/19 & 2019/20 capex plans

Feb 28, Last: Est 4 for 2018/19: $114bn, +4.4%

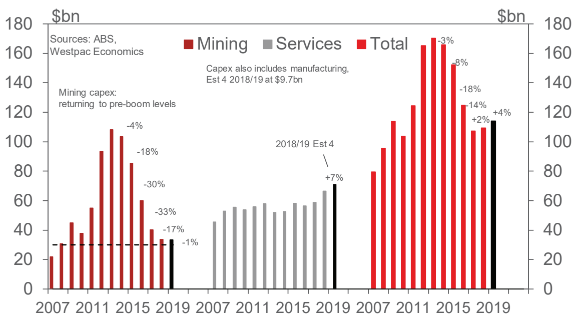
- This survey, conducted in January and February, includes the 5th estimate of capex spending plans for 2018/19 and the initial estimate for 2019/20 plans. Recall Est 4, of $114bn, was a positive one, some 4.4% above Est 4 a year earlier.
- Historically, Est 5 is a 2% upgrade on Est 4, although the past 2 years saw an upgrade of 4.5% - adjustments which point to a figure this year between $116 to $119bn.
- This update may be less upbeat, but not substantially so. Business conditions have weakened, so too global growth. However, services investment strength is in transport (spill-overs from public infrastructure) and power generation (renewable energy) - and these are largely locked-in. Also, mining is benefitting from higher commodity prices.

Aus Jan private credit

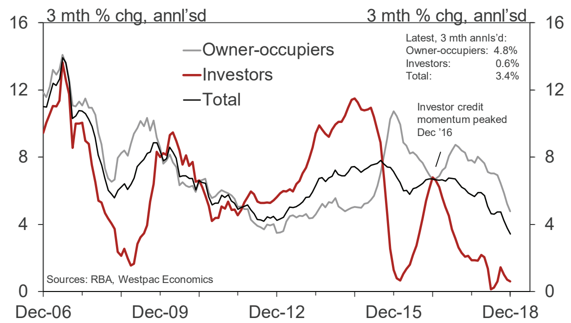
Feb 28, Last: 0.2%, WBC f/c: 0.2%
Mkt f/c: 0.5%, Range: -1.0% to 2.5%

- In December, credit grew by only 0.2% to be 4.3% above the level of a year ago (the 3 month annualised pace is 3.6%). For January, we anticipate another rise of only 0.2%.
- Housing credit also grew by 0.2% in December, to be 4.7% higher over the year. The 3 month annualised pace is 3.4% (0.6% for investors and 4.8% for owner-occupiers). Tighter lending conditions and weaker demand is weighing on the sector.
- Business credit, 4.8% above the level of a year ago, is volatile around a modest uptrend as businesses increase investment in the real economy. December saw a rise of 0.3%, while the January update may be a little softer than this with commercial finance weakening late in 2018.

Capex plans, by industry: Estimate 4



Housing credit: sharp slowdown



The week ahead

Aus Feb CoreLogic home value index

Mar 1, Last: –1.2%, WBC f/c: –0.6%

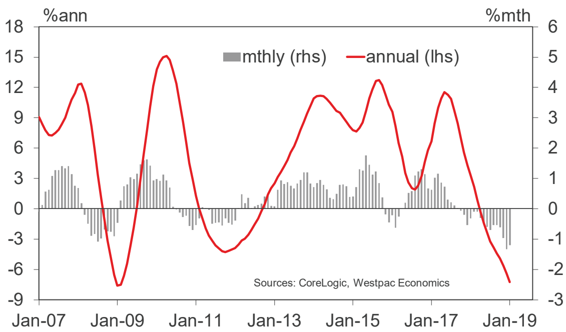
- The Australian housing market's very weak finish to 2018 carried into early 2019 with the CoreLogic home value index recording a 1.2% fall in January. Given the low levels of activity over the holiday period, the result speaks more to the weakness through late last year.
- The February update will have a similar skew with the market effectively only reopening in the final week of the month. The daily index points to a 0.6% decline for the month taking the cumulative fall since the late 2017 peak to –8.4% nationally.

US Q4 GDP

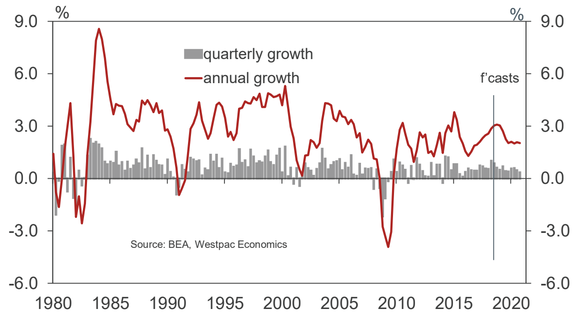
Feb 28, Last: 3.5% annls'd, WBC f/c 2.5%, Mkt f/c: 2.5%

- The long-delayed first release for Q4 GDP is now due February 28.
- Through 2018, growth remained strong, particularly mid-year as it averaged close to 4.0% annualised. Central to these outcomes has been strength in the consumer, with annualised consumption growth over the six months to September an outsized 4.0%.
- Following this strength and the significant downside surprise for retail sales in December, the consumer is arguably the most significant risk to our and the market's forecast for Q4. If a downside surprise in this category of spending is seen, it will likely prove fleeting given labour market strength.
- Elsewhere in the accounts, business and residential investment are softening. However, government spending remains strong, and will do so till late 2019.

Australian dwelling prices



US GDP to remain above trend into 2019

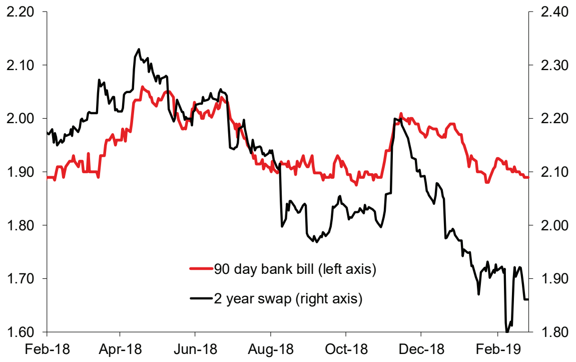


New Zealand forecasts

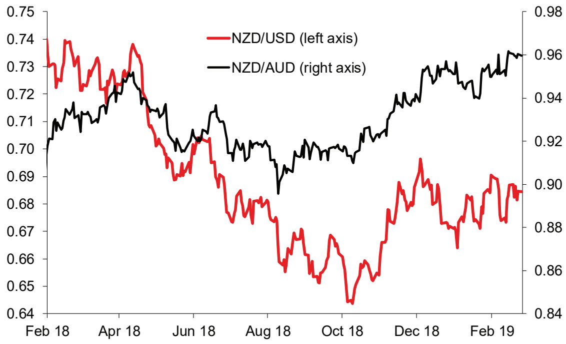
Economic Forecasts	Quarterly				Annual			
	2018		2019					
% change	Sep (a)	Dec	Mar	Jun	2017	2018f	2019f	2020f
GDP (Production)	0.3	0.3	0.8	0.8	3.1	2.7	2.6	2.8
Employment	1.1	0.1	0.2	0.3	3.7	2.3	1.1	1.7
Unemployment Rate % s.a.	4.0	4.3	4.4	4.3	4.5	4.3	4.2	4.0
CPI	0.9	0.1	0.2	0.5	1.6	1.9	1.8	2.1
Current Account Balance % of GDP	-3.6	-3.7	-3.3	-3.0	-2.9	-3.7	-2.9	-2.8

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	0.65
NZD/AUD	0.94	0.94	0.94	0.94	0.94	0.94
NZD/JPY	73.7	73.3	72.3	71.7	72.2	71.5
NZD/EUR	0.59	0.59	0.58	0.58	0.59	0.57
NZD/GBP	0.53	0.52	0.49	0.48	0.49	0.49
TWI	73.4	73.0	71.3	71.0	71.2	70.6

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 25 February 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.85%	1.83%
60 Days	1.87%	1.88%	1.87%
90 Days	1.89%	1.91%	1.91%
2 Year Swap	1.86%	1.80%	1.92%
5 Year Swap	2.04%	1.95%	2.13%

NZ foreign currency mid-rates as at 25 February 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6844	0.6741	0.6835
NZD/EUR	0.6034	0.5952	0.5976
NZD/GBP	0.5238	0.5208	0.5192
NZD/JPY	75.76	74.03	74.67
NZD/AUD	0.9595	0.9508	0.9536
TWI	74.26	73.41	74.03

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 25					
NZ	Q4 real retail sales	0.0%	0.5%	0.7%	Reversal of earlier petrol price rises to boost spending levels.
US	Jan Chicago Fed activity index	0.27	–	–	Broadly around trend.
	Feb Dallas Fed index	1.0	5.4	–	Regional surveys currently volatile, off highs.
Tue 26					
NZ	RBNZ Deputy Governor Bascand	–	–	–	Discussing RBNZ review of banks' capital requirements.
US	Dec FHFA house prices	0.4%	–	–	House price growth continues to show...
	Dec S&P/CS home price index %yr	4.7%	–	–	... robust momentum.
	Feb Richmond Fed index	–2	8	–	Regional surveys currently volatile, off highs.
	Feb Conf. Board consumer confid.	120.2	124.1	–	Remains at an elevated level.
	Dec housing starts	3.2%	–0.5%	–	Housing investment coming under pressure...
	Dec building permits	5.0%	–2.9%	–	... after supply increase and given uncertainties.
	Fed Chair Powell testimony	–	–	–	Semi-annual testimony before Senate Banking Panel.
Wed 27					
NZ	Jan trade balance $m	264	–300	–500	Export volumes easing back after a December burst.
Aus	Q4 construction work	–2.8%	0.9%	0.4%	Rising public works a support but housing in a downtrend.
Eur	Jan M3 money supply %yr	4.1%	–	–	Has held up at a robust pace despite...
	Feb economic confidence	106.2	–	–	... significant weakening in business surveys...
	Feb business climate indicator	0.69	–	–	... which have so far persisted...
	Feb consumer confidence (final)	–7.4	–	–	... in contrast to the stabilisation in consumer sentiment.
US	Dec factory orders	–0.6%	1.4%	–	Core data pointing to soft outlook for investment.
	Jan pending home sales	–2.2%	–	–	Lead for existing sales; should show pick up.
	Jan wholesale inventories	0.3%	0.4%	–	Volatile.
	Fed Chair Powell testimony	–	–	–	Semi-annual testimony before House Panel.
Thu 28					
NZ	Feb ANZ business confidence	–24.1	–	–	First read on how confidence is faring in 2019.
Aus	Q4 private new capital expenditure	–0.5%	1.0%	flat	Further fall in building & structures, equipment up modestly.
	2018/19 capex plans, AUDbn	114	–	–	Est 4 on 4 was +4.4%. Est 5 may be a little less upbeat.
	2019/20 capex plans, AUDbn	–	–	–	Est 1 for 2019/20 - initial (two) estimate(s) can be unreliable.
	Jan private sector credit	0.2%	0.3%	0.2%	Weak growth as housing slows further.
Chn	Feb non-manufacturing PMI	54.7	–	–	Broad-based deceleration has been seen...
	Feb manufacturing PMI	49.5	49.6	–	.... across manufacturing and services.
UK	Feb GfK consumer sentiment	–14	–15	–	Brexit uncertainty dampening sentiment...
	Feb Nationwide house prices	–	–		...and has been a major drag on house prices.
US	Q4 GDP % annualised	3.4%	2.5%	2.5%	Retail sales points to downside risk.
	Fedspeak	–	–	–	Vice Chair Clarida gives remarks at policy conference.
	Fedspeak	–	–	–	Bostic, Harker and Kaplan at various events.
Fri 01					
NZ	Feb ANZ consumer confidence	121.7	–	–	Has picked up from earlier lows, still at moderate levels.
	Jan residential building consents	5.1%	–	–2.0%	Annual level elevated, but has flattened off.
	Q4 terms of trade	–0.3%	–1.0%	–0.5%	Lower dairy export prices offsetting cheaper fuel imports.
Aus	Feb AiG PMI	52.5	–	–	Manuf'g sector lost momentum in 2018, but up 2.5pts in Jan.
	Feb CoreLogic house prices	–1.2%	–	–0.6%	Very weak finish to 2018. Market mostly still only holiday in Feb.
Chn	Feb Caixin manufacutirng PMI	48.3	48.5	–	Dated versus NBS measures.
Eur	Feb CPI core %yr	1.1%	–	–	Remains sticky around 1%.
US	Jan personal income	0.3%	–	–	Shutdown continues to cause delays in some data...
	Dec personal spending	0.4%	0.3%	–	... with income but not spending data due for Jan.
	Dec PCE deflator %yr	1.8%	1.7%	–	Inflation remains under control despite wage gains.
	Feb ISM manufacturing	56.6	56.4	–	Off highs, but still robust.
	Feb Markit manuf. PMI (final)	–	–	–	Flash pointed to weaker month for manufacturers...
	Feb Uni. of Mich. sentiment (final)	95.5	96.0	–	... offset by gains for services.
	Fedspeak	–	–	–	Bostic on the economy.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	2.7	2.2	2.2
CPI inflation % annual	1.7	1.5	1.9	1.8	1.8	1.9
Unemployment %	5.8	5.7	5.5	5.0	5.5	5.7
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 22 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	1.25	1.00	1.00	1.00	1.00
90 Day BBSW	1.89	2.05	2.05	1.75	1.50	1.45	1.45	1.40
10 Year Bond	2.10	2.10	1.95	1.85	1.90	1.90	1.90	1.95
International								
Fed Funds	2.375	2.375	2.375	2.375	2.625	2.625	2.625	2.625
US 10 Year Bond	2.68	2.70	2.70	2.75	2.80	2.75	2.70	2.60
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	0.7090	0.71	0.70	0.68	0.68	0.69	0.69	0.70
USD/JPY	110.70	110	111	113	112	111	110	106
EUR/USD	1.1340	1.13	1.11	1.10	1.10	1.11	1.14	1.20
AUD/NZD	1.0470	1.06	1.06	1.06	1.06	1.06	1.06	1.06

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