Weekly Commentary

6 May 2019

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On a knife edge

Last week Stats NZ released its quarterly roundup on the labour market, which was a mixed bag. The rate of unemployment fell slightly to 4.2%, lower than our expectation and continuing the trend of slowly falling unemployment. But employment indicators were generally weak.

The Household Labour Force Survey (HLFS) registered a 0.2% drop in employment, but that probably reflects a degree of survey volatility. It seems that the survey sample captured an unusually high number of retirees this time, causing both employment and participation to fall (the participation rate dropped from 70.9% to 70.4%).

Nevertheless, there is widespread evidence that the pace of jobs growth has slowed over the past year. The Quarterly Employment Survey (QES) recorded weak employment growth this quarter, and annual growth in both full-time equivalent jobs and hours paid has dropped below 2%. The slowdown in employment corresponds with the slowdown in GDP growth over the last year or so, and today's results point to the likelihood of another subdued GDP outturn in the March quarter (our current forecast is 0.5% growth).

It was also a mixed picture for earnings growth. The official Labour Cost Index (LCI) was very soft this quarter, as it has been for some time. However other wage measures haven't been quite as subdued. The unadjusted LCI, which includes pay rises based on experience or promotions, has accelerated to 3.4% growth on an annual basis, and the QES measure of average hourly earnings is up 3.7% over the past year.

The fairest summary is that wage growth has accelerated to some degree, but not as much as we might have expected given that unemployment has dropped to 4.2%.

Lacklustre employment and wage growth may, to some extent, reflect low business confidence. Last week's ANZBO confidence survey registered another poor month, with rock-bottom confidence in the economy and low expectations of business activity. But most responses to that survey came in before the Government cancelled its capital gains tax. It will be interesting to see whether business confidence picks up next month.

This week the Reserve Bank will deliver the May *Monetary Policy Statement*, and the OCR decision is on a knife edge. We think the odds of an OCR cut are about 55%, versus a 45% chance of no change.

Whether or not the OCR is cut this week, we expect the RBNZ to reduce its OCR forecast to around 1.4%, due to concerns that the domestic economy may not have the juice to push inflation up to 2%. In the event of an OCR cut, that would imply that a follow-up cut was possible but not definite. The accompanying rhetoric might be something like *"Any further move in the OCR will depend on the data."*

In the event that the OCR remains on hold, an RBNZ OCR forecast of 1.4% would keep markets on high-alert for a future OCR cut. The RBNZ would probably emphasise the risk of a future cut by saying something like *"If domestic economic growth remains slow, or if the global economy falters, we may need to reduce the OCR later this year."*

On a knife edge

This week's decision will be the first taken by the RBNZ's new Monetary Policy Committee (MPC), and there have been management changes at the RBNZ. The RBNZ will be taking a fresh look at the situation, so our analysis revolves around what the best move for a new committee should be, rather than focussing on what the RBNZ has said in the past. Good cases can be made for either cutting the OCR or keeping it on hold, but we think the case for a cut is more convincing.

Inflation is currently 1.5%, and has been below the 2% mid-point of the RBNZ's target range for almost all of the past seven years. Back in February the RBNZ was forecasting that inflation would struggle back towards 2%, reaching that mark at the end of 2020 and then sitting there. But that was based on the RBNZ's assumption that GDP growth would pick up substantially, which has not happened. If GDP growth stays slow, then there just won't be enough juice in the economy to push inflation up to 2%. The RBNZ may conclude that the economy needs a helping hand to return inflation to target.

The case for keeping the OCR on hold relies on keeping the faith about an economic upturn this year. Domestically, fiscal stimulus must eventually impact the economy, the recent drop in mortgage rates will stimulate the housing market, and net migration appears to be rising again. Globally, the latest data has been stronger and equity markets have submitted a clear vote of confidence. Meanwhile, global prices for New Zealand products such as dairy and beef are clearly rising.

In light of these more positive recent developments, the MPC might decide that it is wiser to wait and see before cutting the OCR – after all, the need to cut the OCR is not urgent. In the meantime, the RBNZ can keep fixed mortgage rates and the exchange rate low by signalling that it may cut in the future and publishing a lower OCR forecast.

We think the case for cutting the will be more persuasive to the MPC, because it relies on historical data rather than *forecasts* of the economy improving – a bird in the hand is worth two in the bush.

Mortgage rates have plunged recently, and if the RBNZ does cut the OCR, they will fall further. That, combined with the cancellation of capital gains tax, is very stimulatory for the housing market. The housing market data due for release later this month will probably be weak. However, we are bracing for a pickup in the housing market starting in a few months' time.

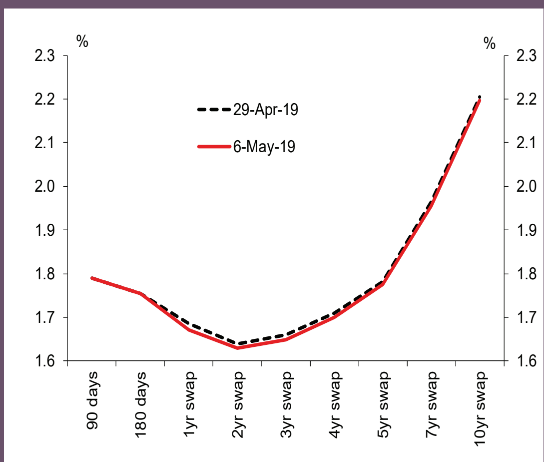
Fixed vs Floating for mortgages

Fixed mortgage rates have fallen recently, but they could fall even further in the near future. If the RBNZ cuts the OCR later this week, fixed rates may drop soon afterward.

We expect floating and one-year fixed mortgage rates to fall over the next year, but to gradually rise again in subsequent years. Based on that expectation, we regard three-year rates at the best on offer at present. One- and two-year rates are also fairly good value, with neither particularly preferred to the other.

Four- and five-year fixed rates have fallen sharply, and are becoming better value. These rates are only slightly higher than where we expect shorter-term rates to go over the relevant timeframe, but they offer the borrower certainty. Floating mortgage rates are 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 RBNZ May Monetary Policy Statement

May 8, Last 1.75%, market 1.5%, Westpac 1.5%

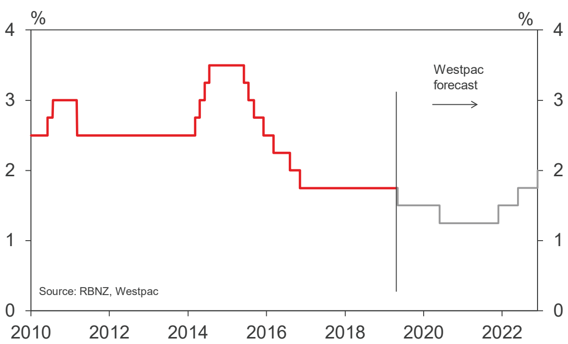
- This week's RBNZ OCR decision is a very close call. We think there is a 55% chance of an OCR cut, and a 45% chance of an on hold decision.
- GDP growth has fallen well short of the RBNZ's lofty expectations. If the economy stays slow, inflation will be stuck below 2%.
- Regardless of the OCR decision, we expect the RBNZ to drop its OCR forecast to around 1.4%.
- In the event of a cut, the RBNZ will leave the door open to further cuts without making promises. But if the OCR is kept on hold, we expect the RBNZ will strengthen its easing bias.

NZ Apr retail card spending

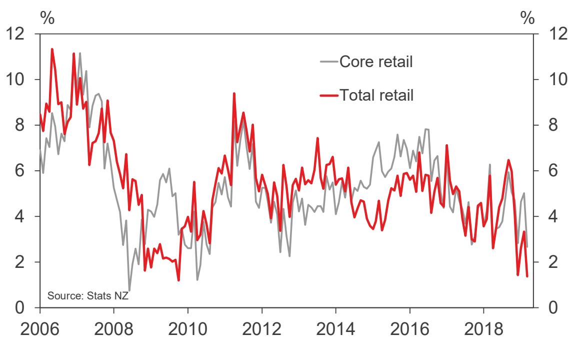
May 10, Last: -0.2%, WBC: +0.8%

- Retail spending was weaker than expected in March falling by 0.2%. In part, that softness was due to the increase in fuel prices over March which siphoned money out of households' wallets and constrained spending in other areas.
- We expect a 0.8% rise in nominal spending in April. In part, that's due to increases in petrol prices, with moderate spending gains in other areas.
- One key source of risk is the close timing of the Easter and ANZAC day holidays this year. That's likely to boost spending on hospitality. However, there is associated downside risk for spending on durables.

RBNZ Official Cash Rate



Card transactions, annual % change



Aus Mar retail trade

May 7, Last: 0.8%, WBC f/c: 0.1%
Mkt f/c: 0.2%, Range: -0.3% to 0.5%

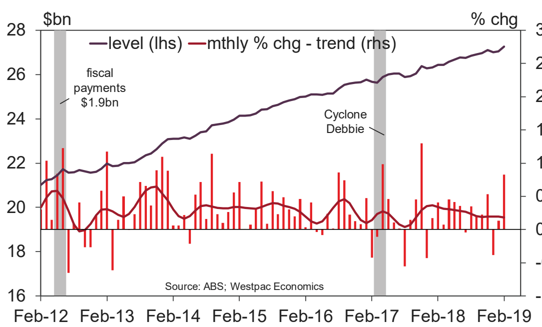
- Retail sales surprised to the upside with a 0.8% gain in Feb, coming very much against the run of play with weak results over the previous two months and private sector business surveys suggesting conditions remained very difficult for retailers. Some of the gain may be due to problems with adjusting for changing seasonality around 'Black Friday' and post-Christmas sales although that would imply previous weakness was also being overstated.
- Consumer sentiment has been patchy in early 2019, the detail pointing to continued pressure on family finances and elevated risk aversion. Private sector business surveys have been a little more mixed in recent months.

Aus Q1 real retail sales

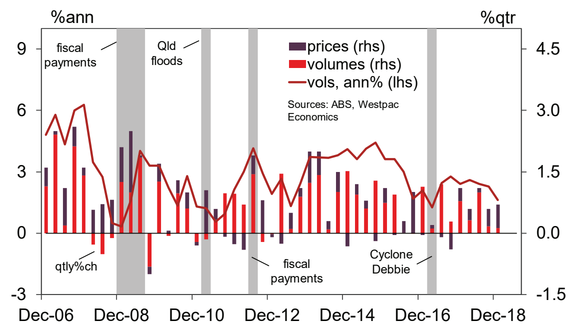
May 7, Last: 0.1%, WBC f/c: 0.3%
Mkt f/c: 0.3%, Range: -0.5% to 0.7%

- Retailers recorded a weak finish to 2018 sales volumes inching up just 0.1% for the final quarter, after a 0.2% increase in Q3. This proved to be a good guide to weakness in the wider consumer spending measure in the Q4 national accounts.
- The Q1 update is shaping as another soft read, albeit not quite as weak as the previous quarter. Nominal sales are tracking towards a 0.6% gain for the quarter, down slightly on the 0.7% gain in Q4. However, the Q1 CPI suggests retail prices have seen a much softer gain this quarter, the detail pointing to a retail price rise of around 0.3% vs 0.6% in Q4. That in turn implies slightly more of the nominal sales gain is due to volumes rather than prices. Overall we expect volumes to post a 0.3% gain for the quarter leaving annual growth at a dismal 1.6%yr pace.

Monthly retail sales



Quarterly retail volumes and prices



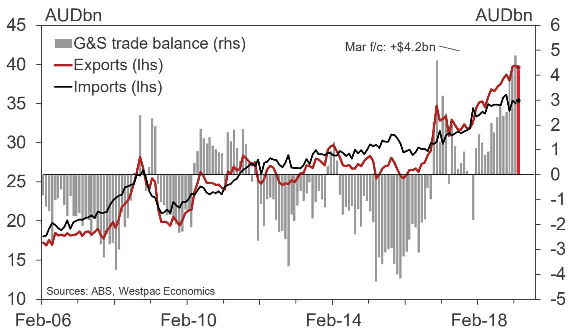
The week ahead

Aus Feb trade balance, AUDbn

May 7, Last: 4.2, WBC f/c: 4.8
Mkt f/c: 4.5, Range: 3.5 to 5.0

- In February, the trade surplus hit a record high of $4.8bn, up from $4.35bn, as imports fell 1.1% and exports rose 0.2%. The surplus trended higher through 2018 and into 2019 as export earnings were boosted by higher commodity prices.
- For March, we expect the surplus to narrow to $4.2bn.
- Export earnings are forecast to slip by 0.6%, -$0.2bn. The key negative is iron ore, down $1.5bn we estimate, with shipments delayed by Cyclone Veronica. This was likely largely offset by a rebound in coal volumes and a lift in LNG.
- For imports, we anticipate a rebound of 1.0%, reversing the drop in February. That would still see volumes soft in the quarter, against the backdrop of weaker domestic demand.

Australia's trade balance

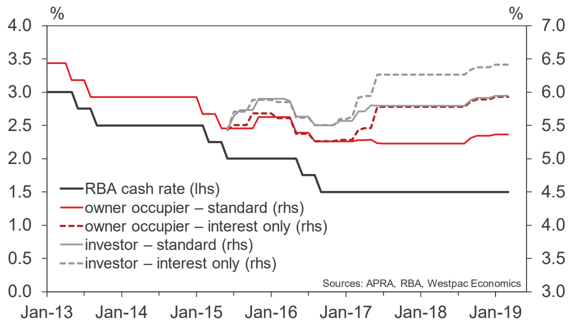


Aus RBA policy decision

May 7, Last: 1.50%, WBC f/c: 1.50%
Mkt f/c: 1.25%, Range: 1.25% to 1.50%

- Westpac Economics sees the case for two RBA rate cuts in 2019 - with the likely timing of August and November. The economy slowed sharply in 2018, to a well below trend pace over the second half. Annual inflation softening from 1.8% to 1.3% in Q1, moving further away from the 2-3% target, adds to the case for a policy response.
- The debate is around the timing of the first move. Market pricing implies around a 40% chance of a cut at the May meeting, while market economists are leaning towards a cut (14-12 in the Bloomberg Survey).
- We expect the RBA to adopt an easing bias at this meeting, ahead of a cut in August. Tthe RBA is likely to downgrade their inflation and growth forecasts in the Statement on Monetary Policy, to be released on May 10, consistent with the shift to an easing bias.

RBA cash rate and mortgage interest rates

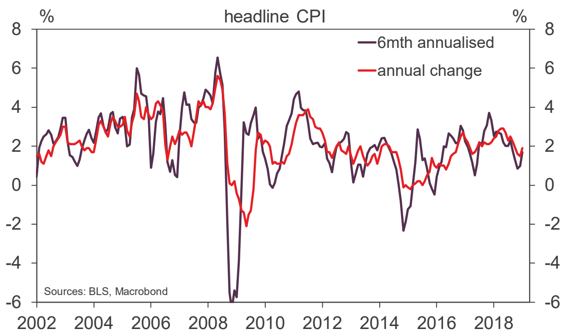


US Apr CPI

May 10, headline CPI, last 0.4%, WBC 0.4%

- Headline CPI inflation has slowed materially over the past year, from a peak of 2.9%yr in Jul 2018 to just 1.9%yr at Mar 2019 due to the sharp fall in energy prices and the abating of core price pressures – price growth excluding food and energy having eased from 2.4%yr to 2.0%yr over the same period.
- However, the turn for energy prices is now well and truly in, the six-month annualised gain for this sub component rising from −13.5% at February to −5.5% in March. This trend is set to persist in April, with another headline gain of 0.4% expected.
- Core inflation meanwhile is anticipated to strengthen a touch in Apr, a 0.2% gain to follow Mar's 0.1% rise.
- The end result for annual inflation is expected to be a 2.1%yr outcome for both headline and core measures.

Energy now a material contributor to CPI

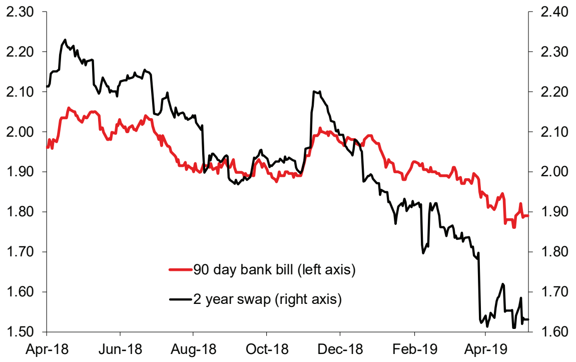


New Zealand forecasts

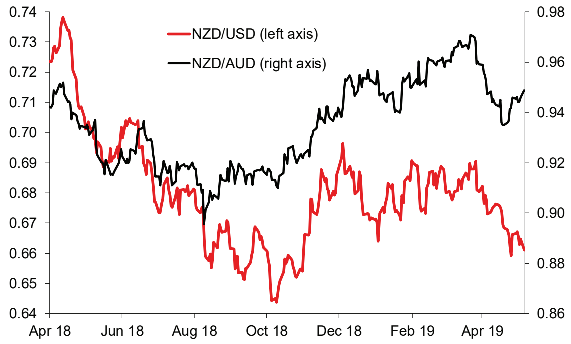
Economic Forecasts	Quarterly				Annual			
	2018	2019						
% change	Dec (a)	Mar	Jun	Sep	2018	2019f	2020f	2021f
GDP (Production)	0.6	0.5	0.8	0.8	2.8	2.5	2.8	2.0
Employment	0	0.2	0.8	0.3	2.3	1.2	1.7	1.3
Unemployment Rate % s.a.	4.3	4.2	4.3	4.3	4.3	4.2	4.0	4.0
CPI	0.1	0.1	0.6	0.6	1.9	1.6	2.0	2.1
Current Account Balance % of GDP	-3.7	-3.4	-3.1	-3.0	-3.7	-2.9	-2.7	-2.7

Financial Forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Cash	1.50	1.50	1.50	1.50	1.25	1.25
90 Day bill	1.60	1.60	1.60	1.50	1.40	1.40
2 Year Swap	1.50	1.50	1.60	1.60	1.50	1.50
5 Year Swap	1.70	1.75	1.85	1.85	1.85	1.85
10 Year Bond	1.80	1.85	1.90	1.85	1.85	1.90
NZD/USD	0.65	0.65	0.66	0.66	0.65	0.65
NZD/AUD	0.93	0.96	0.97	0.96	0.94	0.93
NZD/JPY	72.8	73.5	74.6	73.9	72.2	71.5
NZD/EUR	0.59	0.59	0.60	0.59	0.58	0.57
NZD/GBP	0.50	0.49	0.50	0.50	0.49	0.49
TWI	71.4	72.1	73.0	72.3	70.8	70.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 6 May 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.81%	1.84%	1.85%
60 Days	1.79%	1.81%	1.83%
90 Days	1.79%	1.78%	1.82%
2 Year Swap	1.63%	1.65%	1.65%
5 Year Swap	1.78%	1.81%	1.83%

NZ foreign currency mid-rates as at 6 May 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6610	0.6675	0.6733
NZD/EUR	0.5919	0.5927	0.6002
NZD/GBP	0.5034	0.5141	0.5163
NZD/JPY	73.14	74.71	75.22
NZD/AUD	0.9487	0.9358	0.9477
TWI	72.49	72.65	73.28

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 06					
NZ	Apr ANZ commodity prices	1.4%	–	–	Likely to be boosted by improving meat prices.
Aus	Apr MI inflation gauge	2.1%	–	–	Nothing to indicate an inflation regime shift.
	Apr ANZ job ads	–1.7%	–	–	Declining in contrast to ABS vacancies data.
Chn	Apr Caixin China PMI services	54.4	54.2	–	In line with official measure.
Eur	Apr Markit services PMI final	52.5	–	–	Resilient while manufacturing is in a soft spot.
	May Sentix investor confidence	–0.3	–	–	Sentiment has stabilised in recent months.
	Mar retail sales	0.4%	–	–	Volatile of late.
US	Fedspeak	–	–	–	Harker on the economic outlook.
Tue 07					
NZ	Q2 RBNZ inflation expectations	2.0%	–	–	Low headline inflation is limiting the upside for expectations.
Aus	Mar retail sales	0.8%	0.2%	0.1%	Nominal sales to edge after Feb jump…
	Q1 real retail sales	0.1%	0.3%	0.3%	… still amounting to another soft quarter for volumes.
	Mar trade balance, $bn	4.8	4.5	4.2	To narrow from record high as imports rebound.
	Apr AiG PCI	45.6	–	–	Up 1.8pts in Mar but down 11.6pts on yr ago as housing weakens.
	RBA policy decision	1.50%	1.25%	1.50%	With RBA rate cuts expected in 2019 this meeting is 'live'.
Chn	Apr foreign reserves $bn	3099	3102	–	Large and stable.
Eur	EU Commission forecasts	–	–	–	Will be sensitive for fiscal monitoring.
UK	Apr Halifax house prices	–1.6%	–	–	Ongoing weakness in response to economic uncertainty.
US	Mar JOLTS job openings	7087	–	–	Hires; fires; quits and job openings detail.
	Mar consumer credit	15.2	17.0	–	Shift lower in term rates should be supportive.
	Fedspeak	–	–	–	Kaplan in Beijing; Quarles discuss financial regulation.
Wed 08					
NZ	GlobalDairyTrade auction	0.5%	–	–	The pace of improvement in prices has slowed
	RBNZ policy decision	1.75%	1.50%	1.50%	A close call, as discussed in this week's essay.
Chn	Apr trade balance USDbn	32.6	–	–	Volatile of late due to tariffs.
US	Fedspeak	–	–	–	Brainard at a Fed Listens event.
Thu 09					
Chn	Apr CPI %yr	2.3%	2.5%	–	Inflation remains muted…
	Apr PPI %yr	0.4%	0.6%	–	… with a lack of upstream pressures.
US	Apr PPI	0.6%	0.2%	–	Upstream price pressures limited.
	Mar trade balance US$bn	–49.4	-51.4	–	Has narrowed in 2019 following tariff-led pull forward.
	Initial jobless claims	230k	–	–	Remain very low.
	Mar wholesale inventories	–	–	–	Q1 support for growth to reverse in Q2.
	Fed Chair Powell speaks	–	–	–	Opening remarks at community development conference.
	Fedspeak	–	–	–	Bostic on outlook, Evans at community event.
Fri 10					
NZ	Apr card spending	–0.2%	–	0.8%	Risk of holiday related volatility.
Aus	RBA Statement on Monetary Policy	–	–	–	Inflation and growth forecasts to be downgraded.
Chn	Q1 current account balance	54.6	–	–	Remains in surplus.
	Apr M2 money supply %yr	8.6%	8.5%	–	Tentative date 10-15.
	Apr new loans, CNYbn	1690	1150	–	Tentative date 10-15.
UK	Mar trade balance £bn	–4860	–4600	–	Pre-Brexit stocking up could boost imports.
	Q1 GDP	0.2%	0.5%	0.5%	A temporary rise following weakness in late 2018.
US	Apr CPI	0.4%	0.4%	0.4%	Energy a positive in Apr; 0.2% core gain in line with target.
	Apr monthly budget statement	–146.9	-165.0	–	Deficit to continue growing year after year.
	Fedspeak	–	–	–	Brainard, Bostic, and Williams at separate events.

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	2.2
CPI inflation % annual	1.7	1.5	1.9	1.8	1.8	1.6
Unemployment %	5.8	5.7	5.5	5.0	5.5	5.7
Current Account % GDP	-4.7	-3.1	-2.6	-2.1	-0.9	-2.2
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.4	2.1
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	0.8	0.7
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	1.2	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	4.5	4.4	4.2	4.3
World						
Real GDP %yr	3.4	3.4	3.8	3.6	3.5	3.5
Forecasts finalised 10 April 2019						

Interest Rate Forecasts	Latest	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Australia								
Cash	1.50	1.50	1.25	1.00	1.00	1.00	1.00	1.00
90 Day BBSW	1.55	1.60	1.55	1.40	1.40	1.40	1.40	1.40
10 Year Bond	1.79	1.80	1.80	1.80	1.80	1.80	1.85	1.90
International								
Fed Funds	2.375	2.375	2.375	2.375	2.375	2.375	2.375	2.375
US 10 Year Bond	2.54	2.60	2.65	2.70	2.65	2.60	2.55	2.55
ECB Deposit Rate	-0.40	–0.40	–0.40	–0.40	–0.40	–0.30	–0.20	–0.10

Exchange Rate Forecasts	Latest	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/USD	0.6995	0.70	0.68	0.68	0.69	0.69	0.70	0.70
USD/JPY	111.48	112	113	113	112	111	110	110
EUR/USD	1.1173	1.11	1.10	1.10	1.11	1.12	1.14	1.15
GBP/USD	1.3039	1.31	1.32	1.33	1.33	1.33	1.34	1.34
AUD/NZD	1.0567	1.06	1.05	1.03	1.05	1.06	1.08	1.08

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