Fiordland National Park, New Zealand

Weekly Economic Commentary.

Blowing over.

The spread of Coronavirus, now officially named COVID-19, continued to cast a shadow over economic developments this week. Our view remains that the measures taken to contain the virus will have a sharp, but only temporary impact on the New Zealand economy. The Reserve Bank took a similar view in its *Monetary Policy Statement* last week, leaving it comfortable with adopting a more on-hold stance as the outlook for the domestic economy improves.

Markets have been watching the spread of the virus closely, with investors no doubt keen to jump on any signs that the worst has passed. This was complicated somewhat last week by a change in the reporting method for cases in the Hubei province, which led to a sharp jump in the number of identified cases. Setting that aside, there are tentative signs that the daily rate of new infections has peaked.

However, the success of the containment measures is coming at an extreme cost to short-term economic activity. For New Zealand that has included a halt to arrivals of foreign citizens travelling via China, cancelled or delayed export orders, and sharp falls in agricultural commodity prices. Our assessment remains that this will have a sharp but only temporary impact on the New Zealand economy, with GDP growth slowing to near-zero in the March quarter but picking up strongly in the following quarters.

For markets, there was particular interest in how the Reserve Bank would deal with the Coronavirus outbreak in its latest *Monetary Policy Statement*. The RBNZ's approach turned out to be much in line with our own, basing its economic forecasts on a short, sharp disruptive impact followed by a rapid recovery. On that basis, the RBNZ issued a fairly neutral outlook for the OCR, and noted that there was time to adjust policy if needed as more information became available.

That neutral OCR outlook was a step up from the previous statement in November, which indicated a 50/50 chance of an OCR cut in the near future. That was best captured in the RBNZ's assessment of its two policy goals. Whereas in November it said that employment was "around" the maximum sustainable level, it is now described as "at or slightly above", while inflation has gone from being "below" to "close to" the midpoint of the target range.

The most prominent rationale for the RBNZ's change of stance was fiscal policy. The Government's plan, announced at the end of last year, to spend an extra $12bn on infrastructure over the coming years was rightly seen as stimulating the economy, reducing the need for the OCR to stay low.

The RBNZ was also influenced by signs of stabilisation in the global economic environment, recent stronger data on the labour market, and the stronger housing market and associated signs of stronger consumer spending. What was surprising to us was that the RBNZ avoided mentioning house prices in its press release or the record of meetings. The recent turnaround in the housing market is the most obvious consequence of lowering interest rates, and is a key channel through which monetary policy is currently working.

Despite the RBNZ's on-hold projections for the OCR, we continue to pencil in an OCR cut in August, based on our view that the RBNZ will be surprised on certain aspects of the economy. That said, the timing and extent of any OCR reduction is highly uncertain.

The first point of difference is that we think global economic sentiment will deteriorate later this year, and a slowdown in US economic growth will lead to renewed interest rate reductions from the Federal Reserve. The RBNZ seems heavily influenced by the ebb and flow of global economic sentiment, so this would be important.

Second, the RBNZ has effectively flat-lined its exchange rate projections for the next few years. Notwithstanding the near-term softness engendered by the Coronavirus outbreak, we think the exchange rate is more likely to rise this year as New Zealand outperforms economies like the US and Australia. That in turn would lead to less tradables inflation over this year, and would see the overall inflation rate drop further below the 2% target midpoint than the RBNZ is expecting.

We also see downside risks to the RBNZ's forecast of 2.5% GDP growth this year. In particular, the RBNZ is forecasting that the Government's infrastructure program will start with a hiss and a roar, whereas we are more inclined to expect delays.

What holds us back from being more adamant about the likelihood of an OCR cut is the housing market. The RBNZ is forecasting a peak of 7.7% house price growth this year, but it continues to forecast an unrealistically rapid cooling in the market. That is not going to happen as long as mortgage rates remain low. We expect a higher peak rate of house price inflation, and a longer-lasting period of rising prices.

That said, a hot housing market alone would not be enough to deter the RBNZ from cutting the OCR in an environment of weaker global economic sentiment. And the RBNZ retains the option to tighten macroprudential policy settings, such as loan-to-value ratios, to deal with risks that stem specifically from the housing market.

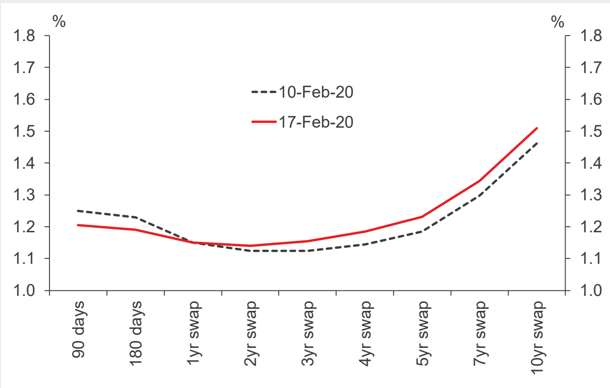
Fixed vs Floating for mortgages.

Now is a good time to take a fixed mortgage. Fixed mortgage rates have tumbled over the past six months, but they are now starting to creep higher again as the chances of further OCR cuts fade.

Among the fixed rates on offer, we think the best value is in the one- and two-year rates. Longer-term rates are high relative to where we think future short-term rates will go. 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



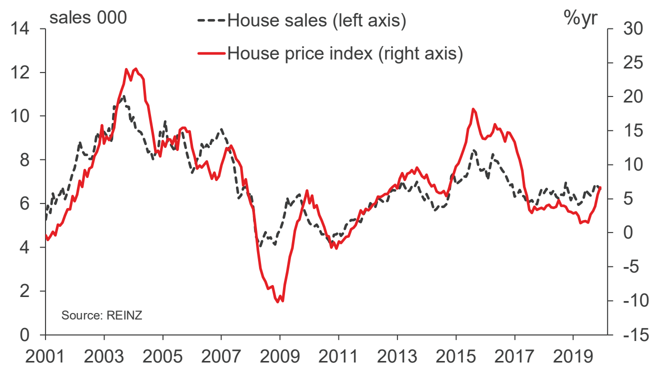
The week ahead.

NZ Jan REINZ House Price Index

Feb 18, Last: +1.2%

- The December housing market update from the REINZ confirmed Westpac's long-held view that currently low interest rates would see house prices rocketing upwards. Based on our seasonal adjustment, house prices rose 1.2% in December with widespread gains. That continues the run of strong gains we've seen in recent months, leaving nationwide house prices up 6.6% over the past year.
- We have been forecasting low interest rates and resurgent demand would see annual house price inflation rising to 7% by April. That now looks likely to occur even sooner than we expected.
- We expect another month of solid price increases in January. Reports indicate that the number of homes available for sale remains low. At the same time, low mortgage interest rates are encouraging demand from both owner-occupiers and investors.

REINZ house prices and sales

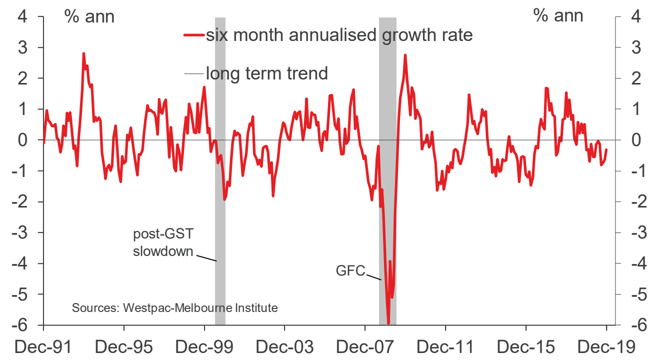


Aus Jan Westpac–MI Leading Index

Feb 19, Last: –0.32%

- The Leading Index growth rate rose from –0.62% in Nov to –0.32% in Dec. Despite the lift, the growth rate remains below zero, indicating momentum is tracking well below trend heading into the first half of 2020
- Despite bushfires and the coronavirus the January read looks set to be slightly positive with the ASX200 posting a decent gain in the month (+5% vs -2.4% last month); the Westpac-MI Consumer Expectations Index up a touch (+3.1% vs -2.6% last month) and commodity prices firming ahead of the more recent shock from the virus outbreak (+1% in AUD terms in Jan vs a 1.6% decline in Dec). Dwelling approvals also held on to their previous month's gain, the latest read up 0.5% vs 11.8% in the month prior. Labour market components have also been broadly steady.

Aus Westpac-MI Leading Index

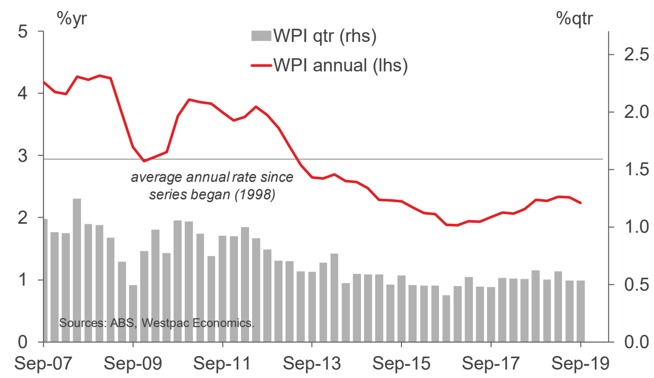


Aus Q4 Wage Price Index

Feb 19, Last: 0.5%, WBC f/c: 2.2%
Mkt f/c: 0.5%, Range: 0.5% to 0.6%

- Wages continued their lacklustre performance in the September quarter, the Wage Price Index (WPI) lifting 0.5%qtr to be up 2.2%yr, the annual pace easing a touch from the 2.3%yr rate recorded over the previous four quarters. That is despite an observed tightening in labour market conditions in Victoria and a 3% lift in the minimum wage. Generating a lift in wages growth clearly remains very difficult for policymakers.
- We expect wage inflation to show little variation in 2020 with any residual lift from a slight drift higher in EBAs last year, the 3% rise in minimum wages and a marginal tightening in labour markets through 2017-18 to be offset by a more recent and prospective softening in labour market conditions – particularly in what had up until last year been tightening markets in Vic and NSW. For the September quarter, we expect the WPI to show a 0.5% rise holding the annual pace at 2.3%yr.

Aus wage inflation



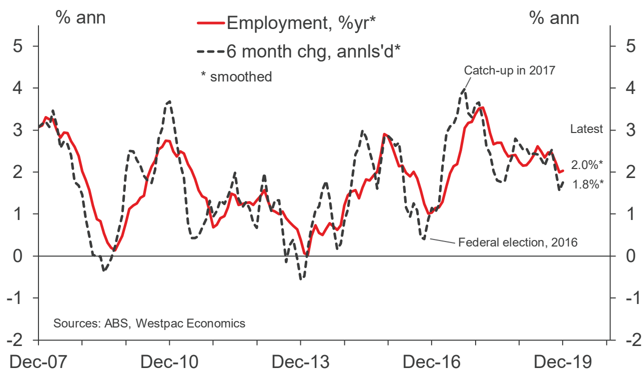
The week ahead.

Aus Jan employment

Feb 20, Last: 28.9k, WBC f/c: 15k
Mkt f/c: 7.5k Range: –16k to 15k

- Job creation has slowed, mirroring the loss of momentum in the broader economy. We expect job gains to continue at this slower pace, as suggested by business surveys and with GDP growth stuck at around a 2%yr pace.
- Over the past three months, employment rose by an average 14.5k/month, including a +28.9k in December. That represents a material step-down from +25k a month in mid-2019.
- For January, we expect employment to rise by 15k. We caution, there is an added uncertainty in January with the ABS updating population estimates.
- In growth terms, the 6 month annualised pace of job gains has throttled back from 2½% in the first half of 2019 to 1.7% for January, on our forecast.
- Disruptions due to the bushfires is a potential downside for January, although any impact may be more evident in hours worked than in numbers employed.

Aus employment

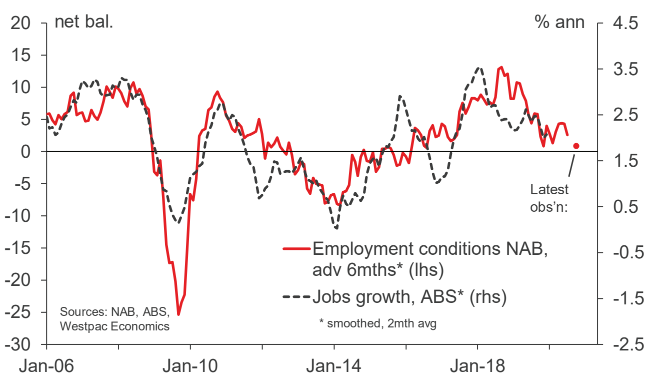


Aus Jan unemployment rate

Feb 20, Last: 5.1%, WBC f/c: 5.2%
Mkt f/c: 5.2% Range: 5.1% to 5.3%

- The unemployment rate began the 2019 year at 5.1%, edged higher to 5.3% in June and held around this level to October.
- The surprise, unemployment then slipped to 5.2% in November and then to 5.1% in December.
- Employment gains - typically volatile month to month - were sizeable in the past two months, at 38.5k and 28.9k.
- By way of context, employment needs to expand by around 19k a month to keep up with working age population growth.
- On our job forecast of +15k we expect a partial rebound in the unemployment rate, rounding up to 5.2%.
- That factors in a participation rate of 66.0%, up slightly from 65.98% in December but still down from an average of 66.05% over the months May to September. The participation rate for women continues its structural uptrend.

Aus employment conditions & jobs

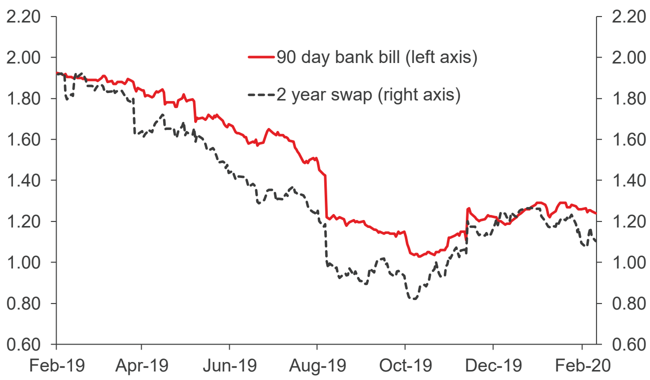


New Zealand forecasts.

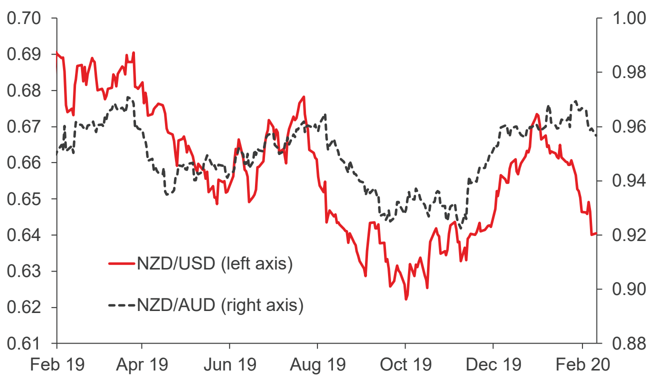
Economic forecasts	Quarterly				Annual			
	2019		2020					
% change	Sep (a)	Dec	Mar	Jun	2018	2019f	2020f	2021f
GDP (Production)	0.7	0.6	0.1	0.9	3.2	2.3	2.3	3.3
Employment	0.2	0.0	0.4	0.4	1.9	1.0	1.8	2.0
Unemployment Rate % s.a.	4.1	4.0	4.1	4.3	4.3	4.0	4.2	3.9
CPI	0.7	0.5	0.5	0.4	1.9	1.9	1.8	1.7
Current Account Balance % of GDP	-3.3	-3.0	-3.0	-3.2	-3.8	-3.0	-3.4	-3.3

Financial forecasts	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
Cash	1.00	1.00	0.75	0.75	0.75	0.75
90 Day bill	1.20	1.10	0.90	0.90	0.90	0.90
2 Year Swap	1.10	1.05	1.00	1.00	1.00	1.05
5 Year Swap	1.25	1.20	1.20	1.25	1.30	1.35
10 Year Bond	1.35	1.25	1.25	1.25	1.35	1.40
NZD/USD	0.66	0.66	0.66	0.66	0.66	0.66
NZD/AUD	0.97	0.99	0.99	0.99	0.97	0.96
NZD/JPY	70.6	69.4	69.3	69.3	70.0	70.6
NZD/EUR	0.61	0.60	0.59	0.59	0.58	0.58
NZD/GBP	0.50	0.50	0.50	0.50	0.50	0.50
TWI	73.1	72.7	72.6	72.3	72.0	71.5

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 17 February 2020

Interest rates	Current	Two weeks ago	One month ago
Cash	1.00%	1.00%	1.00%
30 Days	1.14%	1.21%	1.21%
60 Days	1.18%	1.24%	1.25%
90 Days	1.21%	1.26%	1.29%
2 Year Swap	1.14%	1.09%	1.22%
5 Year Swap	1.23%	1.16%	1.35%

NZ foreign currency mid-rates as at 17 February 2020

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6440	0.6471	0.6615
NZD/EUR	0.5947	0.5828	0.5966
NZD/GBP	0.4940	0.4895	0.5083
NZD/JPY	70.74	70.06	72.87
NZD/AUD	0.9580	0.9652	0.9625
TWI	71.73	71.63	72.64

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 17					
NZ	Jan BusinessNZ services PSI	51.9	–	–	Softened again in recent months.
	Dec net migration	2610	–	–	Trending lower, but subject to revisions in near term.
UK	Feb Rightmove house prices %yr	2.7%	–	–	Solid momentum, aided by labour market.
US	Presidents Day	–	–	–	Federal holiday – markets are closed.
Tue 18					
NZ	Jan REINZ house sales	–1.7%	–	–	Tight listings are limiting sales ...
	Jan REINZ house prices %yr	6.6%	–	–	... while low interest rates are boosting demand.
Aus	RBA minutes	–	–	–	Board's discussion of (downside) risks of interest.
Eur	Feb ZEW survey of expectations	25.6	–	–	Market participants to remain optimistic despite risks.
UK	Dec ILO unemployment rate	3.8%	3.8%	–	Labour market remains strong.
US	Feb Fed Empire state index	4.8	5.0	–	US manufacturers facing uncertain times.
	Feb NAHB housing market index	75	75	–	Home builders benefitting from labour market & rates.
Wed 19					
Aus	Jan Westpac–MI Leading Index	–0.32%	–	–	Sub-trend. Bushfire/coronavirus impacts likely to impact Feb.
	Q4 wage cost index	0.5%	0.5%	0.5%	More of the same lacklustre growth.
UK	Jan CPI %yr	1.3%	1.5%	–	Has fallen well below target, giving scope for rate cut.
US	Dec total net TIC flows	73.1	–	–	Treasuries remain in strong demand given global risks.
	Jan PPI	0.1%	0.1%	–	Upstream price pressures absent.
	Jan housing starts	16.9%	–12.9%		A partial reversal of Dec strength highly likely.
	Jan building permits	–3.7%	2.1%	–	Upturn for housing investment modest.
	FOMC January minutes	–	–	–	Discussion of risks and inflation key at this time.
	Fedspeak	–	–	–	Bostic, Mester, Kaskari and Kaplan.
Thu 20					
Aus	Jan employment, '000	28.9k	7.5k	15k	Average pace of job creation has moderated since mid-2019.
	Jan unemployment rate	5.1%	5.2%	5.2%	Participation rate & unemployment – partial rebound in both.
Eur	Feb consumer confidence	–	–	–	Labour market prime determinant of sentiment.
UK	Jan retail sales	–0.6%	–	–	Despite low unemployment, consumer spending is weak.
US	Feb Phily Fed index	17	10	–	US manufacturers facing uncertain times.
	Initial jobless claims	205k	–	–	Very low.
	Jan leading index	–0.3%	0.4%	–	Pointing to growth around trend.
	Fedspeak	–	–	–	Barkin, Kaplan, Brainard, Bostic, Clarida and Mester.
Fri 21					
Eur	Feb Markit manufacturing PMI	47.9	47.3	–	External demand to continue weighing on manufacturers.
	Feb Markit services PMI	52.5	52.3	–	Domestic demand becoming more uncertain.
	Jan CPI, %yr	1.4%	1.4%	–	Inflation remains well away from target. Final estimate.
UK	Feb Markit manufacturing PMI	50.0	–	–	Brexit process will continue to affect industry through ...
	Feb Markit services PMI	53.9	–	–	... 2020, and global uncertainties will also figure.
US	Feb Markit manufacturing PMI	51.9	51.5	–	Has been more positive than ISMs, showing benefit of ...
	Feb Markit service PMI	53.4	53.5	–	... domestic demand to smaller manufacturers and services.
	Jan existing home sales	3.6%	–1.2%	–	Supply remains the main impediment to sales.

International forecasts.

Economic forecasts (Calendar years)	2016	2017	2018	2019f	2020f	2021f
Australia						
Real GDP % yr	2.8	2.5	2.7	1.8	1.8	2.6
CPI inflation % annual	1.5	1.9	1.8	1.8	1.8	2.0
Unemployment %	5.7	5.5	5.0	5.2	5.4	5.2
Current Account % GDP	-3.1	-2.6	-2.1	0.6	-0.4	-2.0
United States						
Real GDP %yr	1.6	2.4	2.9	2.3	1.6	1.5
Consumer Prices %yr	1.4	2.1	2.4	1.8	1.9	1.9
Unemployment Rate %	4.9	4.4	3.9	3.7	3.4	3.5
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	0.6	1.9	0.8	0.8	0.4	0.4
Euro zone						
Real GDP %yr	1.9	2.5	1.9	1.2	1.0	1.2
United Kingdom						
Real GDP %yr	1.8	1.8	1.4	1.3	0.8	1.5
China						
Real GDP %yr	6.7	6.8	6.6	6.1	5.3	6.1
East Asia ex China						
Real GDP %yr	4.0	4.5	4.3	3.6	3.3	3.9
World						
Real GDP %yr	3.4	3.8	3.6	3.0	2.8	3.2
Forecasts finalised 12 February 2020						

Interest rate forecasts	Latest	Mar–20	Jun–20	Sep–20	Dec–20	Mar–21	Jun–21	Dec–21
Australia								
Cash	0.75	0.75	0.50	0.25	0.25	0.25	0.25	0.25
90 Day BBSW	0.92	0.85	0.70	0.45	0.45	0.50	0.50	0.50
10 Year Bond	1.06	1.00	0.95	0.90	0.80	0.80	0.85	1.05
International								
Fed Funds	1.625	1.625	1.375	1.125	0.875	0.875	0.875	0.875
US 10 Year Bond	1.61	1.60	1.50	1.45	1.40	1.45	1.50	1.70
ECB Deposit Rate	-0.50	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60	-0.60

Exchange rate forecasts	Latest	Mar–20	Jun–20	Sep–20	Dec–20	Mar–21	Jun–21	Dec–21
AUD/USD	0.6727	0.67	0.66	0.67	0.67	0.68	0.69	0.72
USD/JPY	109.85	107	106	105	105	106	107	109
EUR/USD	1.0836	1.09	1.10	1.11	1.12	1.13	1.14	1.15
GBP/USD	1.3049	1.30	1.30	1.30	1.30	1.31	1.31	1.32
USD/CNY	6.9832	6.95	6.90	6.85	6.80	6.80	6.75	6.60
AUD/NZD	1.0451	1.05	1.01	1.02	1.02	1.03	1.05	1.07

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(ii) physical separation of various Business/Support Units;

(iii) and well defined wall/cell crossing procedures;

(iv) a "need to know" policy;

(v) documented and well defined procedures for dealing with conflicts of interest;

(vi) steps by Compliance to ensure that the Chinese Wall/Cell arrangements remain effective and that such arrangements are adequately monitored.

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