

Nelson Lakes National Park, New Zealand

Weekly Economic Commentary.

Party like it's 2007.

The New Zealand housing market is booming, and the overwhelming reason is low interest rates. That raises questions about just how much monetary stimulus the Reserve Bank really needs to deliver. However, we argue that the inflation outlook warrants this stimulus, and that the alternative would have been worse for the economy. The results of the general election suggest no significant change in the direction of Government policy.

The REINZ's house sales report showed that the housing market continued to run hot in September. Seasonally adjusted house sales were the highest in any month since March 2007, the hottest time of the hottest boom in recent history. House prices rose by another 1.8% for the month and are now 11.1% higher than a year ago.

Some of the recent strength in sales could represent catch-up from the Level 4 lockdown earlier in the year. The number of sales over the past six months in total have been roughly equal to the same six months a year earlier. But even if some sales reflect pent-up activity, this is still a hot market.

Back in July we upgraded our house price forecast to an 8% increase over 2021, and in September we shifted again to a forecast of 6.3% house price inflation for 2020 and 8% in

2021. Even this now seems too timid – the lift-off in house prices is playing out earlier and faster than we expected.

We expect the current strength in the housing market to continue well into next year. We have long been pointing out that interest rates are the key driver of house prices, and if anything, interest rates are going to fall even further in the coming months.

Other factors like housing supply are currently, if anything, working against house prices. Homebuilding activity is booming, with building consents quickly returning to pre-Covid levels. Meanwhile the requirement to build has actually lessened, with net migration plunging from 70,000 last year to near-zero as a result of the international border closures.



The resurgence in house prices will come as a big surprise to the RBNZ. As recently as August the RBNZ was forecasting a 7.7% house price decline over the six months to September, and was predicting further declines in the December quarter. The RBNZ is going to have to make a major adjustment to its house price forecast, and therefore to its consumer spending forecast (because one reliably influences the other).

This may call into question how much monetary stimulus the RBNZ really needs to deliver in order to meet its inflation and employment goals. We're forecasting that the OCR will be cut to -0.5% in April next year, but we acknowledge that the strength of the housing market is a mark against that view.

Indeed, there have been questions around whether the RBNZ has already overcooked it. Asset prices are an important channel for the transmission of monetary policy in New Zealand, but over the years ballooning house prices have led to social problems and political angst. Why would the RBNZ want to put the economy through that again?

The simple answer, as we noted in our recent overview of unconventional monetary policy¹, is that the alternative would be even worse. During an economic shock such as the Covid recession there is a tendency for households and businesses to save rather than invest, expand, borrow or spend. This causes an economy-wide lack of demand, which in turn leads to a reduction in the overall price level, or deflation. For example, during the Great Depression New Zealand experienced an average inflation rate of -7% over a four-year period.

During deflation, prices for firms' products tend to fall, but wages do not, so many businesses fail. The values of businesses and other assets decline, but the nominal value of

debt does not, so when households and businesses default on loans due to the weak economy, banks suffer losses. This makes banks loath to lend, and when credit becomes scarce interest rates for loans rise. This deepens the recession and the deflation. And so on.

The remedy is to reduce interest rates before deflation takes hold. Lower interest rates discourage people from saving, and encourage them to invest or spend, which corrects the initial imbalance between savings and loans. This shores up demand in the economy, preventing deflation from taking hold.

Given the scale of the Covid shock, the level of interest rates required to balance inflation (and by extension balance savings and loans) is much lower than most New Zealanders are used to. In fact, it's lower than could be achieved with a positive OCR, so for now the Reserve Bank is using other methods of bringing interest rates down. But we think that the RBNZ will need to adopt further measures, such as a negative OCR, in order to keep interest rates low for as long as is needed.

Election results.

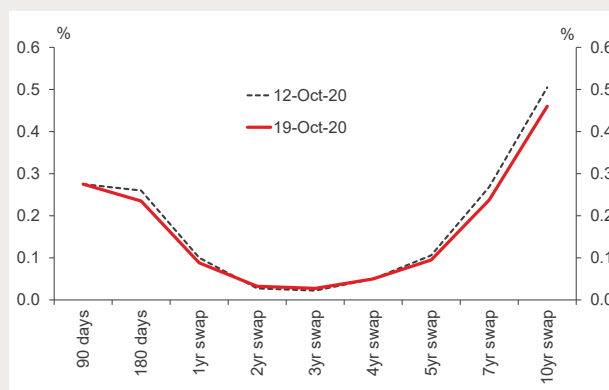
The general election on Saturday resulted in the Labour Party gaining a majority of seats, the first time this has happened under the MMP voting system. While being able to govern alone, it's possible that Labour will seek some sort of support agreement with the Green Party, which means that the actual formation of the next Government could be a few weeks away. Labour did not campaign on any significant policy changes and has no need to make major concessions, so the final outcome is unlikely to affect financial markets.

¹ Available at <https://www.westpac.co.nz/assets/Business/Economic-Updates/2020/Bulletins-2020/Economic-Insight-RBNZ-Oct-2020-Westpac-NZ.pdf>

Fixed vs Floating for mortgages.

Fixed mortgage rates fell sharply over May and June, but are stable now and don't look likely to move much in the short run. However, in November we expect the Reserve Bank will introduce a Funding for Lending Programme, the aim of which is to reduce retail interest rates. At that time, we expect that both fixed and floating mortgage rates will fall. How far they fall will depend on the details of the Reserve Bank's programme, which are not known at this stage.

NZ interest rates



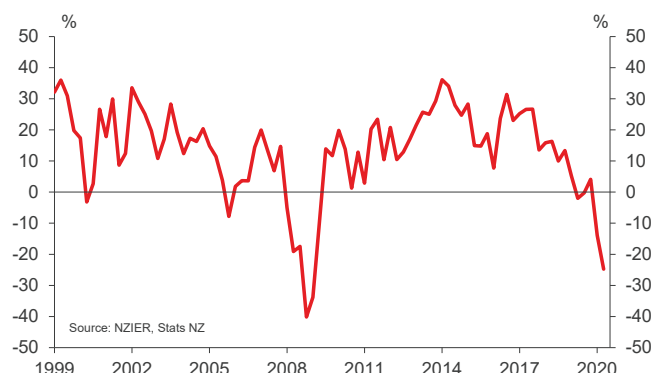
The week ahead.

NZ Q3 Survey of Business Opinion

Oct 20, General business situation, Last: -58.8
Domestic trading activity (past 3 mths), Last: -37.1

- Business confidence fell sharply in the June quarter as Covid-19 and related health restrictions dampened activity. Against that backdrop, businesses also scaled back their plans for investment and hiring.
- Since the June survey, activity restrictions have been rolled back and economic activity has been bouncing back faster than expected. We expect that those developments will be reflected in a sharp rise in business conditions in the September QSBO survey. Nevertheless, activity and confidence are still expected to remain below pre-Covid levels. Hiring and investment intentions are also likely to remain subdued.
- The survey period for this report was pushed out due to the second lockdown.

QSBO domestic trading activity (next 3 mths)

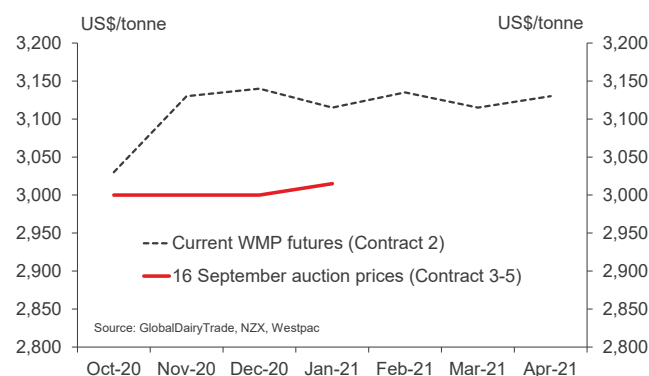


NZ GlobalDairyTrade auction, whole milk powder prices

Oct 21, Last: +1.7%, Westpac: +1.0%

- We expect whole milk powder prices will lift a touch at this auction and thus build on the previous increases. Prices have risen a cumulative 5% or so over the last two auctions.
- We are marginally more bearish than the dairy futures market. It is pointing to a slightly larger price lift of around 2% as at the time of writing.
- Global dairy prices continue to prove resilient as evidenced by Fonterra's 2020/21 milk price forecast range upgrade to \$6.30/kg to \$7.30/kg. The strength or otherwise of New Zealand production, though, remains a swing factor.

Whole milk powder prices

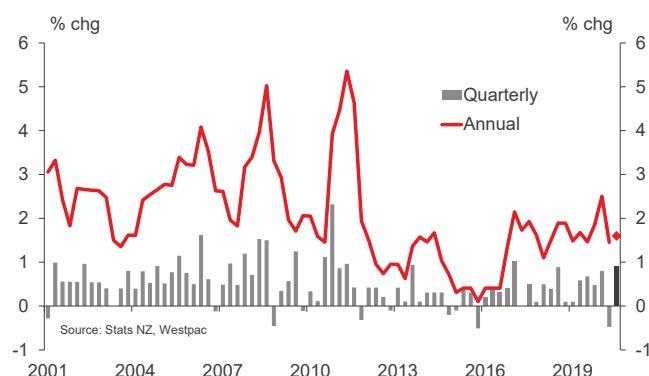


NZ CPI inflation

Oct 23, Last: -0.5%, Westpac: +0.9%,
Mkt f/c: +0.9% Range: 0.5% to 1.1%

- We expect a 0.9% rise in consumer prices for the September quarter, lifting the annual inflation rate slightly to 1.6%.
- Food, fuel and local body rates made the biggest contributions to the quarter.
- We expect that Covid-19 will have a disinflationary impact over time, although the near-term impact may have been more mixed.
- Our forecast is below the Reserve Bank's estimate of 1.1%. An upside surprise would be the more meaningful risk in terms of future monetary policy moves.

NZ CPI inflation



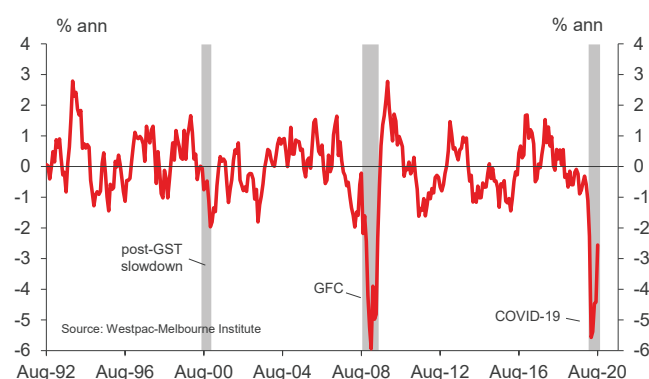
The week ahead.

Aus Aug Westpac-MI Leading Index

Oct 21, Last: -2.56%

- The Leading Index growth rate rose from -4.42% in July to -2.56% in August driven by big improvements in Consumer Sentiment, Unemployment Expectations and dwelling approvals. That said, the index growth rate remained deep in contractionary territory consistent with ongoing recession conditions in the economy.
- The September update is likely to see a further significant improvement. The read will include positive updates on the Westpac-MI Consumer Expectations Index, up a further 15.1% vs 21% last month and the Westpac-MI Unemployment Expectations Index, down -14.2% vs -14.8% last month (indicating an improved outlook for unemployment). Other components have shown smaller improvements as well, total hours worked, up 0.5% and commodity prices up 1.1% (in AUD terms). Note that part of the lift is due to the six month growth rate starting to cycle the big negative shock from the COVID outbreak back in March-April which is moving into the base of the calculation.

Aus Westpac-MI Leading Index

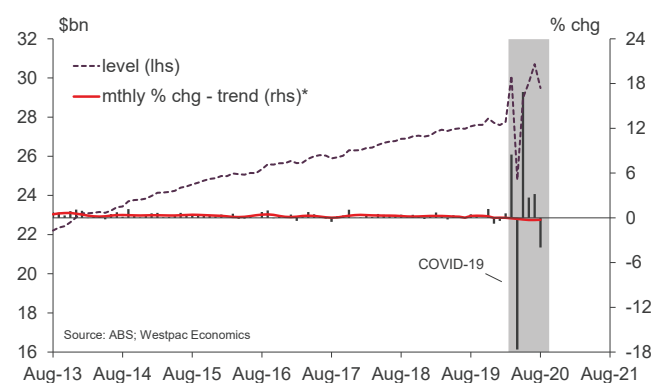


Aus Sep preliminary retail trade

Oct 21, Last: -4%, WBC f/c: 0.5%

- Retail sales fell sharply in August with a 4% decline led by a steep 12.6% drop in Victoria as the state entered its 'second wave' lockdown. While steep, the decline was milder than that seen during the 'first wave' lockdown back in April. Renewed virus concerns and an associated sharp falls in consumer sentiment also look to have weighed on sales elsewhere as well, sales ex Vic down 1.3% mth.
- Our Westpac Card Tracker suggests retail sales outside of Victoria recovered in September, as feared outbreaks never materialised and reopening rebounds regained traction. This looks to have more than offset some further softening in Victoria with sales nationally expected to be up about 0.5% mth. That would leave sales for Q3 as a whole up a whopping 7.5% qtr. This follows a 2.3% qtr contraction in Q2, reopening rebounds and expenditure switching combining to lift retail well above pre-COVID levels.

Aus monthly retail sales

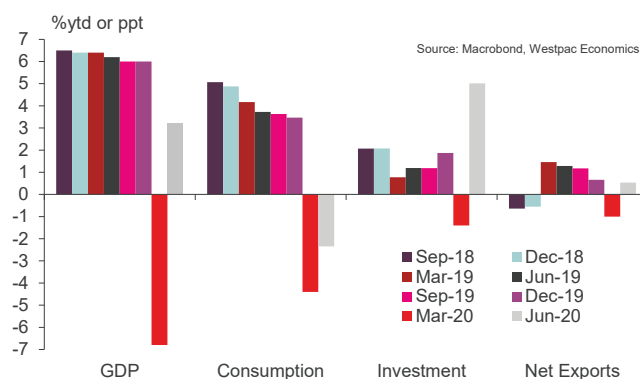


China Q3 GDP

**Oct 19, last %yr: 3.2%, WBC: 5.8%,
Mkt f/c: 5.5% Range: 2.5% to 6.2%**

- In the March quarter, China GDP plunged 10%. Three months later in June, activity had recovered back to end-2019 levels after an 11.5% rebound. As a result, while the rest of the world stabilises their economies and plan their respective recoveries, China is beginning a new growth cycle.
- While China's recovery was initially concentrated in production then investment, it is now broadening with support from consumption and external demand. The growth cycle ahead will see robust gains across the entire economy.
- While GDP is a helpful benchmark for long-term economic performance, the partial data to be released at the same time is more informative on current momentum. At September, we expect fixed asset investment will show the private sector increasing its contribution to the investment cycle, and consumer spending gaining strength and breadth.

China growth story has broad support

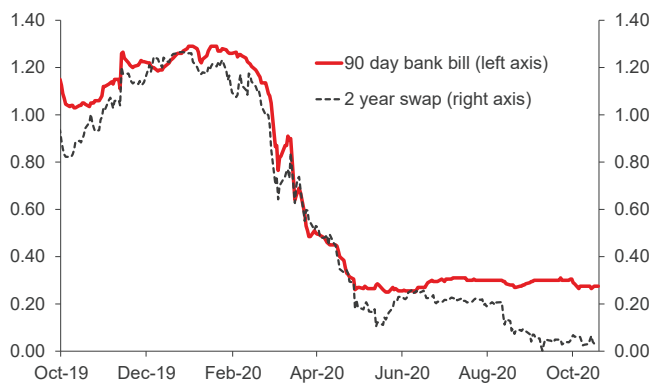


New Zealand forecasts.

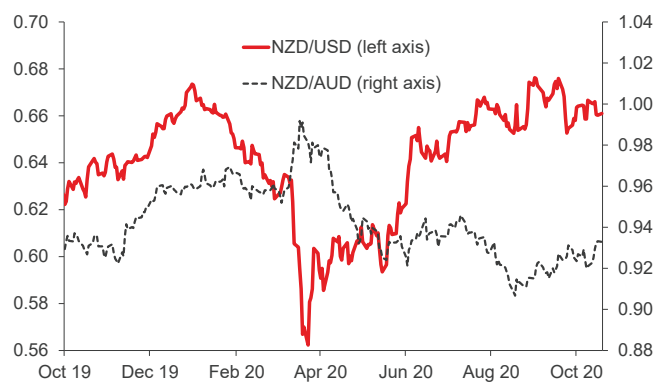
Economic forecasts	Quarterly				Annual			
	2020	2021			2019	2020f	2021f	2022f
% change	Jun (a)	Sep	Dec	Mar				
GDP (Production)	-12.2	8.5	3.7	0.5	2.3	-5.1	6.0	5.1
Employment	-0.3	-2.2	-1.2	-0.2	1.2	-2.6	1.1	3.3
Unemployment Rate % s.a.	4.0	5.5	6.2	6.6	4.1	6.2	6.5	5.6
CPI	-0.5	0.9	0.0	0.1	1.9	1.1	0.5	1.1
Current Account Balance % of GDP	-1.9	-1.2	-1.1	-1.6	-3.4	-1.1	-3.5	-2.9

Financial forecasts	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Jun-22
Cash	0.25	0.25	-0.50	-0.50	-0.50	-0.50
90 Day bill	0.25	-0.10	-0.20	-0.20	-0.20	-0.10
2 Year Swap	0.00	-0.05	-0.10	-0.10	-0.10	0.10
5 Year Swap	0.10	0.10	0.15	0.20	0.30	0.55
10 Year Bond	0.50	0.55	0.60	0.65	0.75	0.95
NZD/USD	0.67	0.66	0.66	0.68	0.70	0.70
NZD/AUD	0.89	0.87	0.87	0.87	0.88	0.88
NZD/JPY	70.4	69.3	70.0	72.1	74.2	74.9
NZD/EUR	0.55	0.54	0.54	0.55	0.56	0.56
NZD/GBP	0.51	0.49	0.49	0.50	0.50	0.50
TWI	71.5	69.9	69.5	70.7	72.0	71.7

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 19 October 2020

Interest rates	Current	Two weeks ago	One month ago
Cash	0.25%	0.25%	0.25%
30 Days	0.27%	0.28%	0.28%
60 Days	0.27%	0.26%	0.29%
90 Days	0.28%	0.29%	0.30%
2 Year Swap	0.03%	0.06%	0.05%
5 Year Swap	0.10%	0.14%	0.13%

NZ foreign currency mid-rates as at 19 October 2020

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6610	0.6630	0.6756
NZD/EUR	0.5636	0.5665	0.5703
NZD/GBP	0.5114	0.5131	0.5225
NZD/JPY	69.59	69.83	70.60
NZD/AUD	0.9329	0.9258	0.9271
TWI	71.33	71.73	72.70

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 19					
NZ	Sep BusinessNZ PSI	46.9	-	-	Covid restrictions were eased again over the month.
	RBNZ Assist. Gov Hawkesby speech	-	-	-	On the cash system.
Chn	Q3 GDP %/yr	3.2%	5.5%	5.8%	Robust recovery expected to have extended into Q3.
	Sep industrial production	0.4%	1.0%	-	Growth in domestic and external demand broad...
	Sep fixed asset investment ytd%/yr	-0.3%	0.9%	-	...private investment following SOE and gov't activity.
	Sep retail sales %/yr	0.5%	1.7%	-	Spending ahead of Golden Week likely aided sales.
Eur	ECB President Lagarde	-	-	-	Opening remarks, 'ECB Conference on Monetary Policy',
UK	Oct Rightmove house prices	0.2%	-	-	Up 5%/yr, boosted by tax break and regional demand.
US	Oct NAHB housing market index	83	83	-	Confidence rising on low interest rates and suburban shift.
	Fedspeak	-	-	-	Bostic and Harker to speak.
Tue 20					
NZ	Q3 QSBO survey of business opinion	-58.8	-	-	Expected to rebound after last quarter's Covid related fall.
Aus	RBA Assist. Gov Kent speech	-	-	-	At IFR Australia DCM roundtable webinar, 10:00 AEST.
	Oct RBA minutes	-	-	-	Superseded by RBA Gov's 'gamechanging' speech.
	Weekly Payrolls (to Oct 3)	0.3%	-	-	Continues to give a good early steer on job trends.
US	Sep housing starts	-5.1%	2.5%	-	Modest correction after 23% Jul spike...
	Sep building permits	-0.9%	3.0%	-	... with southern states showing considerable strength.
	Fedspeak	-	-	-	Williams and Evans to speak.
Wed 21					
NZ	GlobalDairyTrade auction (WMP)	1.7%	-	1.0%	Dairy prices likely to rise, continuing resilience.
Aus	Sep Westpac-MI Leading Index	-2.56%	-	-	Clear lift off bottom of cycle but still pointing to contractions.
	Sep Preliminary retail sales	-4.0%	-	0.5%	Likely to be up slightly but state trends diverging widely.
UK	Sep CPI	-0.4%	-	-	Drag to partially reverse as meal discount scheme rolls off.
US	Federal Reserve's Beige Book	-	-	-	View of conditions across the regions (05:00 AEST release).
	Fedspeak	-	-	-	Mester and Singh to speak.
Thu 22					
Aus	RBA Deputy Gov Debelle speech	-	-	-	The Future of Global Code at FX Week, 09:30am.
	Q3 NAB business survey	-15	-	-	Additional detail to monthly survey.
Eur	Oct consumer confidence	-13.9	-	-	Recovery moderated in Sep, small pick-up in eco outlook.
US	Initial jobless claims	898k	-	-	Hit highest level since Aug as labour market recovery stalls.
	Sep leading index	1.2%	0.8%	-	Suggests recovery will be modest.
	Sep existing home sales	2.4%	3.3%	-	Further gains expected for properties outside of big cities.
	Oct Kansas City Fed index	11	-	-	Manufacturing activity slowing as new orders fall.
Fri 23					
NZ	Q3 CPI	-0.5%	-	0.9%	Higher fuel prices and seasonal influences.
Eur	Oct Markit manufacturing PMI	53.7	53.1	-	Virus resurgence to weigh on business sentiment...
	Oct Markit services PMI	48.0	47.5	-	... with new business in question.
UK	Sep retail sales	0.8%	-	-	Online sales elevated; services consumption weak.
	Oct Markit manufacturing PMI	54.1	-	-	Improved inflows of new work and export business...
	Oct Markit services PMI	56.1	-	-	... but these gains could well be short lived.
US	Oct Markit manufacturing PMI	53.2	53.4	-	Rate of job creation and input costs positives...
	Oct Markit service PMI	54.6	54.6	-	... COVID-19's spread continues to be ignored.

International forecasts.

Economic forecasts (Calendar years)	2017	2018	2019	2020f	2021f	2022f
Australia						
Real GDP % yr	2.4	2.8	1.8	-3.3	2.5	3.4
CPI inflation % annual	1.9	1.8	1.8	0.1	1.9	2.1
Unemployment %	5.5	5.0	5.2	7.7	7.5	6.7
Current Account % GDP	-2.6	-2.1	0.6	2.6	0.1	-2.0
United States						
Real GDP %yr	2.4	2.9	2.3	-4.7	3.4	2.7
Consumer Prices %yr	2.1	2.4	1.9	1.1	1.8	1.9
Unemployment Rate %	4.4	3.9	3.7	8.4	6.8	5.8
Current Account %GDP	-2.3	-2.3	-2.6	-2.5	-2.4	-2.4
Japan						
Real GDP %yr	2.2	0.3	0.7	-5.3	2.2	1.7
Euro zone						
Real GDP %yr	2.5	1.9	1.2	-7.8	5.4	2.7
United Kingdom						
Real GDP %yr	1.9	1.3	1.4	-11.0	7.0	4.0
China						
Real GDP %yr	6.9	6.8	6.1	2.5	10.5	5.6
East Asia ex China						
Real GDP %yr	4.6	4.4	3.7	-2.6	5.2	4.7
World						
Real GDP %yr	3.9	3.6	2.8	-4.0	6.0	3.8

Forecasts finalised 13 October 2020

Interest rate forecasts	Latest	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Jun-22	Dec-22
Australia								
Cash	0.25	0.10	0.10	0.10	0.10	0.10	0.10	0.10
90 Day BBSW	0.09	0.04	0.04	0.04	0.04	0.04	0.10	0.15
10 Year Bond	0.74	0.80	0.90	1.00	1.05	1.15	1.25	1.45
International								
Fed Funds	0.125	0.125	0.125	0.125	0.125	0.125	0.125	0.125
US 10 Year Bond	0.73	0.60	0.65	0.75	0.75	0.85	0.95	1.10

Exchange rate forecasts	Latest	Dec-20	Mar-21	Jun-21	Sep-21	Dec-21	Jun-22	Dec-22
AUD/USD	0.7095	0.75	0.76	0.76	0.78	0.80	0.80	0.78
USD/JPY	105.38	105	105	106	106	106	107	107
EUR/USD	1.1708	1.21	1.22	1.23	1.24	1.25	1.25	1.24
GBP/USD	1.2903	1.32	1.34	1.35	1.37	1.39	1.40	1.40
USD/CNY	6.7254	6.75	6.75	6.70	6.60	6.50	6.40	6.30
AUD/NZD	1.0746	1.12	1.15	1.15	1.15	1.14	1.14	1.12

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