

# Weekly Commentary

9 July 2018



## Flagging momentum

Recent developments continue to highlight the flagging momentum in the New Zealand economy. While that's in line with our own forecasts, it has been a surprise to financial markets more generally. As a result, we've seen the New Zealand dollar losing ground in recent weeks. In addition, financial market pricing for the Official Cash Rate has been pushed out, and has now caught up with our forecasts for an extended pause from the Reserve Bank.

### Momentum in the economy has continued to ease

As we've been highlighting for some time, conditions in the New Zealand economy have come off the boil. That's been highlighted most recently in the latest Quarterly Survey of Business Opinion (QSBO). General business confidence has fallen to its lowest level since 2011. In addition, businesses across a number of sectors have reported a softening in activity recently, with gauges of trading conditions signalling some downside risk to our forecast for 0.7% GDP growth in the June quarter.

Looking to the back half of the year, businesses remain downbeat about their own prospects and conditions in the economy more broadly. This has seen them scaling back plans for capital expenditure, consistent with our expectations for a lull in investment activity this year.

The past week also saw a sharp 5% drop in dairy prices, effectively taking them to the lower bounds of what we were expecting to see over the course of this season. Prices can be volatile in the fortnightly auctions, and the size of this latest fall was a surprise. Consequently, we're treating this result with a degree of caution. Nevertheless, we have been warning of the prospect of weaker dairy prices on the back of slowing growth in China for some time. That's been the key reason our own payout forecast of \$6.40 has been sitting below Fonterra's \$7 estimate for the 2018/19 season.

While the wind is coming out of the economy's sails, that's not to say that the New Zealand economy is weak. As we've been highlighting for some time, the mixed nature of economic developments in recent months reflects that the economy has now moved into a more 'mature' phase of the economic cycle. In the wake of the financial crisis, the combination of lingering spare capacity and accelerating population growth provided ample capacity for expansion, with low interest rates helping to stoke demand. However, New Zealand is now into its eighth year of continued expansion, and the economy is encountering some growing pains. Those include difficulties sourcing staff and rising wage costs as the labour market has tightened. At the same time, some of the key drivers of recent economic growth, including rising house prices and construction activity, have moved into new phases, and are no longer providing the same boost to demand that they once did. Balanced against those headwinds, however, demand is continuing to be supported by strength in export earnings (including tourism). And looking ahead, increases in fiscal spending will also provide a significant boost over the coming years.

This changing mix of economic conditions has seen the pace of GDP growth taking a step down. Nevertheless, we still expect the economy will continue growing at a respectable pace over the coming years, with annual GDP growth expected to average a little below 3% through 2019/20.

# Flagging momentum ... continued

## Changing financial conditions

While the slowdown in the economy has been in line with our expectations, it has come as a surprise to financial markets more generally. As a result, we've seen the NZ dollar losing some altitude over the past few weeks, and at the time of writing it was trading around US\$0.68. We expect that it will fall further over the coming year, as interest rates offshore push higher and the RBNZ stays pat for some time yet.

Interest rates have also fallen, and financial market pricing is now broadly consistent with our long held expectation that the RBNZ will keep the Official Cash Rate on hold until the final quarter of 2019.

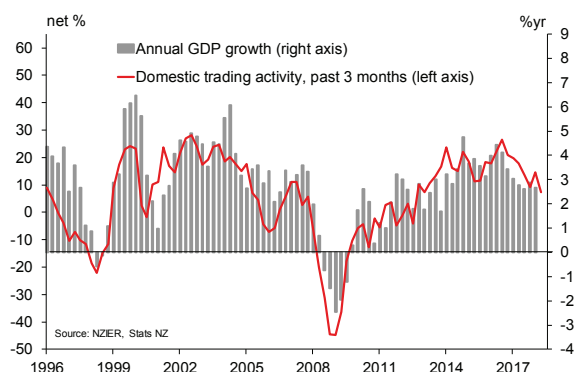
There have even been some suggestions that the RBNZ might look at cutting the OCR again over the coming year. However, we don't think that conditions in the economy warrant a further cut at this stage. Rather than weakness in economic activity, part of the reason that growth has slowed is that spare capacity has been eroded. Even so, GDP is still expanding at a moderate pace, and a substantial increase in fiscal stimulus is planned over the coming years. The drop in the NZ dollar is also helping to buffer the economy, boosting export returns and cushioning the effects of slowing activity in other sectors

The inflation backdrop also looks quite different from when the RBNZ last cut rates. Over the past decade, consumer price inflation often struggled to reach even 1%. However, inflation has now picked up again, and in last week's QSBO businesses reported a large increase in input costs. Some of this is no doubt related to the rise in petrol prices. More

generally, businesses are reporting stretched capacity. They are also reporting increases in wage costs as the labour market has tightened and minimum wage rate has risen.

This increase in cost pressures is consistent with our forecast for a near-term rise in consumer prices, with CPI inflation expected to briefly reach the 2% mid-point of the RBNZ's target band later this year. With much of this increase related to a rise in oil prices, we do expect that inflation will ease back again next year. Nevertheless, inflation is still expected to remain well within the RBNZ's target band.

## QSBO domestic trading activity and GDP growth

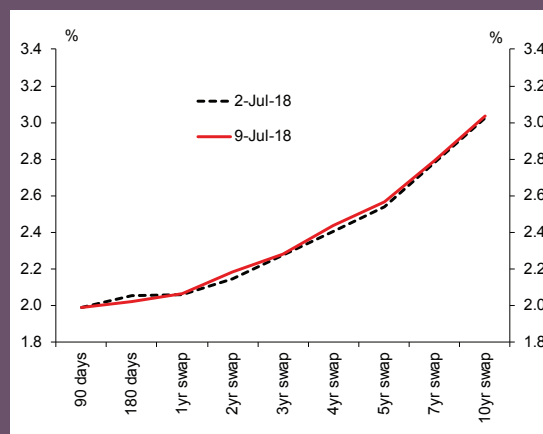


## Fixed vs Floating for mortgages

For borrowers with a deposit of 20% or more, the best value lies in the two-year rate or shorter fixed terms. Three-to-five-year rates seem high relative to where we think short-term rates are going to go over that time. Some lending and deposit rates have been falling recently, so it may be worth waiting to see if there are further modest reductions in fixed-term rates.

Floating mortgage rates usually work out to be more expensive for borrowers than short-term fixed rates such as the six-month rate. However, floating may still be the preferred option for those who require flexibility in their repayments.

## NZ interest rates



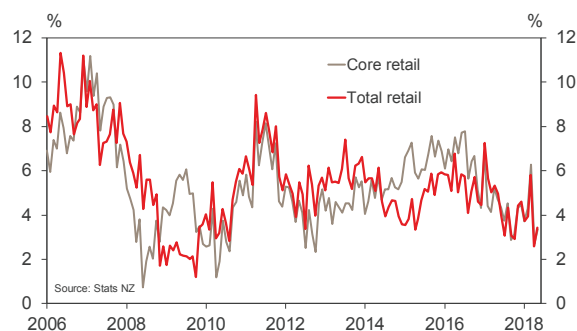
# The week ahead

## NZ Jun retail card spending

Jul 10 Last +0.4%, WBC f/c: +0.4%

- After a large 2.2% fall in April, retail spending only rose by a modest 0.4% in May. Smoothing through the month-to-month volatility, it looks like after a solid start to the year, the momentum in retail spending has faded. In fact, except for a holiday related rise in March, retail spending has essentially been flat since January.
- Much of the softness in household spending is likely to stem from policy changes aimed at cooling the housing market. We expect house price inflation will remain muted through mid-2018.
- We expect that spending growth will remain weak in June and are forecasting a 0.4% gain. That will leave us with a picture of essentially flat spending levels through the first half of the year.

## Card transactions, annual % change

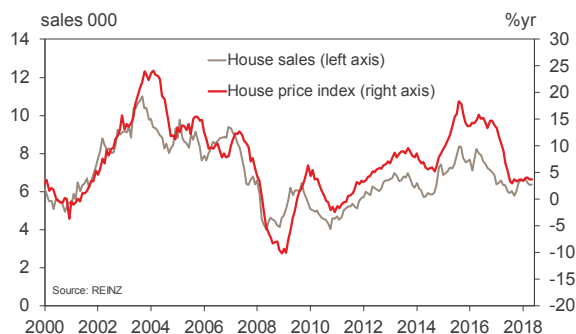


## NZ Jun REINZ House Price Index (s.a.)

Jul 10 (tentative date) Last: -0.2%

- After a brief resurgence around the turn of the year, the New Zealand housing market has cooled. Prices are now falling in Auckland, Wellington and Christchurch, and rising slowly elsewhere. Measured nationwide, house prices have been roughly flat.
- The Bright Line Test for taxing capital gains was extended to five years in late March, and this is impacting the market at present. The next negative factor for the market will be the foreign buyer ban, set to become law within a month. However, one offsetting positive for the market at present is falling mortgage rates.
- June REINZ data is expected to continue the recent trend of slowing sales and flat prices.

## REINZ house prices and sales

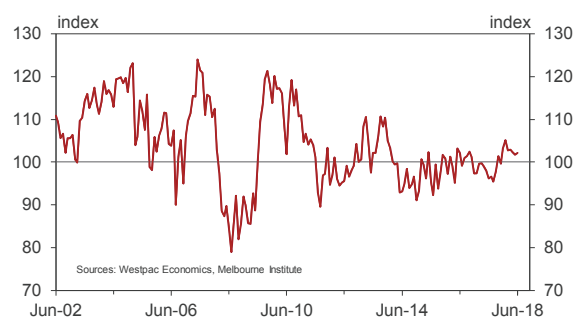


## Aus Jul Westpac-MI Consumer Sentiment

Jul 11 Last: 102.1

- The consumer mood improved marginally in 2018, the first half of the year marking the best run of sentiment reads since 2014. That said, the Index has not built on the gains seen at the start of the year and remains well below the levels typically associated with a robust consumer.
- The July survey is in the field from July 2-7. Factors that may influence this month include: the RBA's decision to leave official rates on hold, recent comments emphasising that any move is still a long way off; the passage of the Federal government's tax cuts into legislation and a proposed reconfiguration of GST allocations that sees 'no state worse off'; continued slippage in dwelling prices, now down 1.6%/yr. Financial markets have had a mixed, the ASX up 2.8% but the AUD down 2.3c vs the USD. Offshore, global trade tensions have again been to the fore.

## Consumer sentiment index



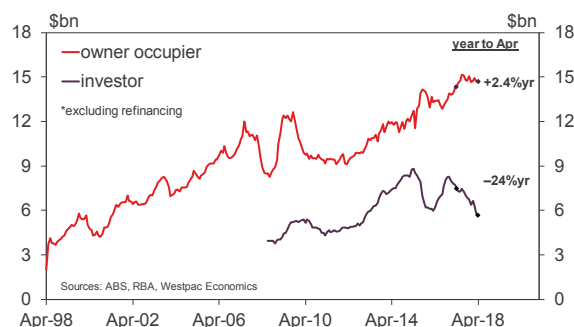
## Aus May housing finance (no.)

Jun 11, Last: -1.4%, WBC f/c: -2.0%

Mkt f/c: -2.0%, Range: -2.5% to -0.2%

- After holding relatively steady through most of 2017 and early 2018, Australian housing finance approvals showed a notable pull back in recent months. The total number of owner occupier approvals declined a further 1.4% in April with the value of investor loans down 0.9%. Conditions were soft across most of the detail. Combined, the total value of approvals ex refi fell 0.4%/mth to be down 5.8%/yr.
- Industry figures point to a further decline in owner occupier approvals in May - we expect the official figures to show a 2.0% drop. Auction data showed a clear further weakening in the Sydney and Melbourne markets through May and early June. Some of this likely reflects tightening lending standards.

## Housing finance approvals



# Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 09</b>					
<b>Chn</b>	Jun foreign reserves \$bn	3111	3103	-	US-China dispute to have an effect?
<b>Eur</b>	Jul Sentix investor confidence	9.3	-	-	Still good reason to be positive on Europe outlook.
<b>US</b>	May consumer credit	9.262	12.0	-	Non-revolving credit pulled back in Apr; bounce likely.
<b>Tue 10</b>					
<b>NZ</b>	Jun retail card spending	0.4%	0.5%	0.4%	Momentum in spending slowed as housing has cooled.
	Jun REINZ house prices, %yr	3.7%	-	-	Due this week. Expected to continue the recent trends...
	Jun REINZ house sales, %yr	1.3%	-	-	...of lacklustre sales and flat prices.
<b>Aus</b>	Jun NAB business survey	15	-	-	Conditions above avg levels, boosted by construction.
<b>Chn</b>	Jun PPI %yr	4.1%	4.4%	-	Commodities continue to support prices upstream...
	Jun CPI %yr	1.8%	1.9%	-	... but consumer prices remain subdued.
	Jun aggregate financing, CNYbn	760.8	1315.0	-	Tentative date. Will be closely watched.
	Jun new loans, CNYbn	1150.0	1550.0	-	Tentative date. Will be closely watched.
	Jun M2 money supply %yr	8.3%	8.4%	-	Slowing with credit growth.
<b>Eur</b>	Jul ZEW survey of expectations	-12.6	-	-	Still good reason to be positive on Europe outlook.
<b>UK</b>	May industrial production	-0.8%	0.8%	-	Earlier softness in manufacturing to reverse...
	May trade balance, £b	-5.3	-3.2	-	...supporting an improvement in the trade balance.
	May construction output	0.5%	0.7%	-	Activity has picked up following earlier inclement weather.
<b>US</b>	Jun NFIB small business optimism	107.8	105.5	-	Remains strong, aided by growth and fiscal policy.
	May JOLTS job openings	6698	-	-	Hires; fires; quits and job openings.
<b>Wed 11</b>					
<b>Aus</b>	Jul Westpac-MI Consumer Sentiment	102.1	-	-	Still in positive territory but only just.
	May housing finance	-1.4%	-2.0%	-2.0%	Could shed light on latest tightening in lending standards?
<b>UK</b>	BOE Governor Carney	-	-	-	Speaking at NBER conference on the financial crisis.
<b>US</b>	Jun PPI	0.5%	0.2%	0.2%	To soften after strong May.
	May wholesale inventories	0.5%	-	-	Will likely aid growth in Q2.
	Fedspeak	-	-	-	Williams speaking to community leaders in Brooklyn.
<b>Thu 12</b>					
<b>NZ</b>	Jun food price index	0.0%	-	0.7%	Some pressure from minimum wage hike. Otherwise muted.
<b>Aus</b>	Jul MI inflation expectations %yr	4.2%	-	-	Will rising petrol prices have an impact?
<b>Eur</b>	May industrial production	-0.9%	0.5%	-	Less positive than PMI's.
<b>UK</b>	Jun RICS house price balance	-3%	-	-	Price growth remains muted, especially in London.
<b>US</b>	Jun CPI	0.2%	0.2%	-	Stabilising near but above 2.0% target on core basis.
	Initial jobless claims	231k	-	-	Very low.
	Jun monthly budget statement	-146.8	-	-	Deficit slowly building.
	Fedspeak	-	-	-	Kashkari in panel discussion on immigration in Minnesota.
	Fedspeak	-	-	-	Harker at Rocky Mountain Economic summit in Idaho.
<b>Fri 13</b>					
<b>NZ</b>	Jun BusinessNZ PMI	54.5	-	-	Business conditions have moderated in recent months.
<b>Chn</b>	Jun trade balance USD bn	24.9	27.3	-	Surprise narrowing in May likely to reverse.
<b>US</b>	Jun import price index	0.6%	0.1%	-	To ease after strong May.
	Jul Uni. of Michigan sentiment	98.2	98.2	-	Remains very positive.
	Fed Monetary Policy Report	-	-	-	Fed releases Monetary Policy Report to Congress.
	Fedspeak	-	-	-	Bostic speaking at town hall event in Atlanta.

# New Zealand forecasts

Economic Forecasts	Quarterly				Annual			
	2018				Calendar years			
% change	Mar (a)	Jun	Sep	Dec	2016	2017	2018f	2019f
GDP (Production)	0.5	0.7	0.8	0.7	4.0	2.8	2.6	3.2
Employment	0.6	0.2	0.3	0.3	5.8	3.7	1.4	1.4
Unemployment Rate % s.a.	4.4	4.4	4.5	4.6	5.3	4.5	4.6	4.6
CPI	0.5	0.6	0.7	0.3	1.3	1.6	2.1	1.4
Current Account Balance % of GDP	-2.8	-3.1	-3.5	-3.6	-2.2	-2.7	-3.6	-3.7

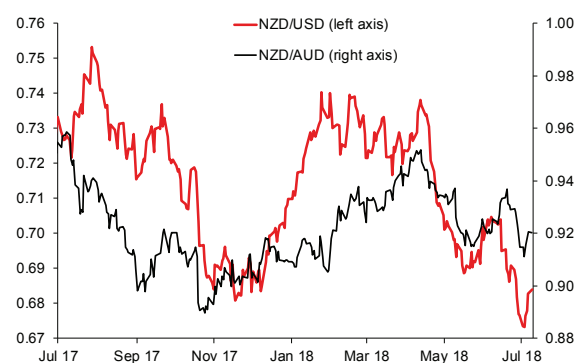
<sup>1</sup> Annual average % change

Financial Forecasts	Sep-18	Dec-18	Mar-18	Jun-18	Sep-19	Dec-19
Cash	1.75	1.75	1.75	1.75	1.75	2.00
90 Day bill	2.00	2.00	2.00	2.00	2.10	2.20
2 Year Swap	2.20	2.30	2.40	2.55	2.70	2.80
5 Year Swap	2.70	2.85	3.00	3.15	3.25	3.30
10 Year Bond	2.90	3.15	3.30	3.35	3.40	3.45
NZD/USD	0.68	0.67	0.65	0.65	0.64	0.65
NZD/AUD	0.92	0.91	0.90	0.90	0.91	0.93
NZD/JPY	76.2	75.0	74.1	73.5	71.7	71.5
NZD/EUR	0.58	0.58	0.57	0.56	0.54	0.54
NZD/GBP	0.52	0.53	0.53	0.53	0.52	0.53
TWI	73.4	72.7	71.2	70.9	70.1	70.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 9 July 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.87%	1.90%	1.90%
60 Days	1.93%	1.96%	1.95%
90 Days	1.99%	2.04%	2.02%
2 Year Swap	2.19%	2.25%	2.23%
5 Year Swap	2.57%	2.66%	2.71%

NZ foreign currency mid-rates as at 9 July 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6839	0.6915	0.7028
NZD/EUR	0.5824	0.5929	0.5967
NZD/GBP	0.5133	0.5217	0.5239
NZD/JPY	75.51	75.97	76.77
NZD/AUD	0.9203	0.9294	0.9259
TWI	73.16	73.60	73.88

# International forecasts

Economic Forecasts (Calendar Years)	2014	2015	2016	2017	2018f	2019f
<b>Australia</b>						
Real GDP % yr	2.6	2.5	2.6	2.2	2.7	2.5
CPI inflation % annual	1.7	1.7	1.5	1.9	1.8	1.8
Unemployment %	6.2	5.8	5.7	5.4	5.5	5.6
Current Account % GDP	-3.0	-4.7	-3.1	-2.5	-2.8	-4.0
<b>United States</b>						
Real GDP %yr	2.6	2.9	1.5	2.3	2.8	2.5
Consumer Prices %yr	1.6	0.1	1.3	2.1	2.6	2.0
Unemployment Rate %	6.2	5.3	4.9	4.4	3.9	3.7
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
<b>Japan</b>						
Real GDP %yr	0.4	1.4	0.9	1.7	1.2	1.0
<b>Euro zone</b>						
Real GDP %yr	1.3	2.1	1.8	2.3	2.1	1.6
<b>United Kingdom</b>						
Real GDP %yr	3.1	2.3	1.9	1.8	1.2	1.5
<b>China</b>						
Real GDP %yr	7.3	6.9	6.7	6.9	6.3	6.1
<b>East Asia ex China</b>						
Real GDP %yr	4.2	3.8	3.9	4.5	4.3	4.3
<b>World</b>						
Real GDP %yr	3.6	3.5	3.2	3.8	3.8	3.7

Forecasts finalised 6 July 2018

Interest Rate Forecasts	Latest	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
<b>Australia</b>								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day Bill	2.06	2.04	2.02	1.95	1.95	1.90	1.90	1.85
10 Year Bond	2.61	2.75	3.05	3.20	3.10	3.10	3.00	3.00
<b>International</b>								
Fed Funds	1.875	2.125	2.125	2.375	2.625	2.625	2.625	2.625
US 10 Year Bond	2.84	3.00	3.35	3.50	3.50	3.40	3.20	3.10
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20	-0.10

Exchange Rate Forecasts	Latest	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
AUD/USD	0.7384	0.74	0.74	0.72	0.72	0.70	0.70	0.72
USD/JPY	110.69	111	112	114	113	112	110	109
EUR/USD	1.1687	1.17	1.16	1.15	1.16	1.18	1.20	1.21
AUD/NZD	1.0867	1.09	1.10	1.11	1.11	1.09	1.08	1.09



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