

Weekly Commentary

21 January 2019



New Zealand Bush Giant Dragonfly (Kapokapowai)

Mixed messages

With New Zealanders gradually heading home from beaches and holiday spots around the country, the flow of data measuring activity in the New Zealand economy has resumed. Last week was a busy one, with some mixed messages emerging on how the New Zealand economy is tracking as we head into 2019. Separately, likely changes to Reserve Bank regulations have led us to tweak the projected pace of OCR hikes in the early 2020s. But that's a long way off yet.

The pace of GDP growth has gradually decelerated over the last couple of years and is currently trundling along at around 3%. While the 0.3% growth recorded in the September quarter disappointed relative to expectations, we think 2019 will see a temporary pickup in the pace of activity on the back of a short-lived pickup in the housing market, a lift in government spending and renewed growth in homebuilding. However, it's fair to say there's been mixed messages emerging from data released over the first couple of weeks of 2019.

On the soft side, electronic card spending data showed consumers kept a tight rein on their spending over the Christmas period. Electronic card spending shrank 2.3% in the month with core (non-fuel) spending down 1.5%. That's much weaker than we were expecting. We're a little suspicious of the extent of weakness in durable spending (where Stats NZ has had issues collecting data in the past) but we wouldn't entirely discount the possibility that the soft December data genuinely reflect a cooling in households' spending appetites. Indeed we would note that the weakness wasn't entirely attributed to durables spending. Spending on other categories, including apparel and hospitality was soft, and there was also a drop in online spending.

Also coming out on the softer side of the ledger last week was December housing market activity. REINZ data showed house sales fell sharply with house sales are now running

around 10% lower than a year ago on our estimates. A look at the regional breakdown suggests that the foreign buyer ban (which came into force in October) has played an important role in the fall. The big drop in sales this month was concentrated Auckland, where seasonally adjusted sales dropped 20% in December from a month earlier, and to a lesser extent in Wellington and Christchurch. That matches where foreign buyers are most active (Queenstown Lakes has a high proportion of foreign buyers, but these are often Australians who are exempt from the ban). With a drop in house sales usually a pretty reliable precursor to weaker prices, there's a risk that we could see house prices in Auckland start falling again in the next few months.

However, the foreign buyer ban is not the only game in town when it comes to the housing market. Indeed for some months now we've been expecting to see a modest and temporary pickup in the housing market in the early part of 2019 on the back of the late-2018 drop in fixed mortgage rates and looser LVR lending restrictions from January 1. House prices are rising rapidly and even accelerating in Otago and Southland, and that's even before the full force of the LVR and mortgage rate changes are felt.

On the more positive side of the ledger last week were a suite of confidence surveys. The influential Quarterly Survey of Business Opinion (QSBO) lifted from a nine year low in the December quarter, with firms noticeably less pessimistic

Mixed messages continued

about the outlook for the economy over the year ahead. What's more they also provided a more upbeat assessment of their own activity over recent months.

Although concern about the extreme downside risks to growth posed by plunging business confidence have dissipated somewhat lately, it's still worth noting that despite the improvement in confidence in the December quarter, the most useful gauges from the survey still suggest some downside risk to our forecast of 0.8% GDP growth in Q4. And it wasn't all good news for businesses coming out of the QSBO. In particular, profit margins remain under pressure with firms struggling to pass rising costs onto their customers.

Both firms and workers are reporting a tightening labour market. Firms reported difficulty finding both skilled and unskilled labour increased further in the December quarter which chimes with the Westpac McDermott Miller Employment Confidence Index reaching its highest level since early 2008 in the December quarter.

Rounding off the suite of upbeat confidence reports, was a widespread improvement in regional confidence in December. The Westpac McDermott Miller Regional

Economic Confidence Index improved across all 11 regions surveyed, with optimists now outnumbering pessimists even in Auckland. Strong rural incomes have been supporting regional confidence in many parts of the country of late and there was further positive news on that front this week. A series of stronger than expected dairy auctions has seen us nudge up our milk price forecast for this season to \$6.30 KgMs (previously \$6.10).

The final development worth a mention this week is a slight tweak to our projected timing of OCR hikes in the early 2020s. We're now predicting a slightly slower pace of OCR hikes at this horizon following the Reserve Bank's announcement late last year of proposed changes to the amount of capital New Zealand banks are required to hold. For those interested in the topic we published an in depth analysis of the impact of the changes¹ but the key point is that higher capital requirements will lead to a combination of upward pressure on bank lending rates, downward pressure on bank deposit rates, lower GDP and lower return on equity for bank shareholders. The RBNZ would soften the impact of some of these changes via a lower OCR than otherwise. But all this is a long way into the future. We still expect the first OCR hike will be in November 2020.

¹ Available here: <https://www.westpac.co.nz/assets/Business/Economic-Updates/2019/Bulletins-2019/Bank-Capital-Requirements-January-2019.pdf>

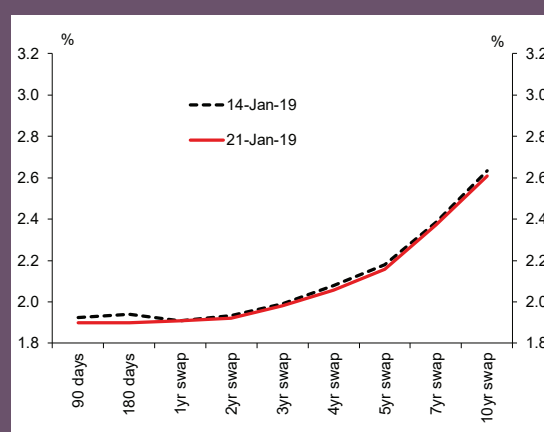
Fixed vs Floating for mortgages

Fixed-term mortgage rates fell sharply during spring, but have now settled down. From here, we expect wholesale fixed interest rates to remain stable or rise slowly. This means that retail fixed mortgage rates are more likely to rise than fall, although there are uncertainties around any forecast.

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



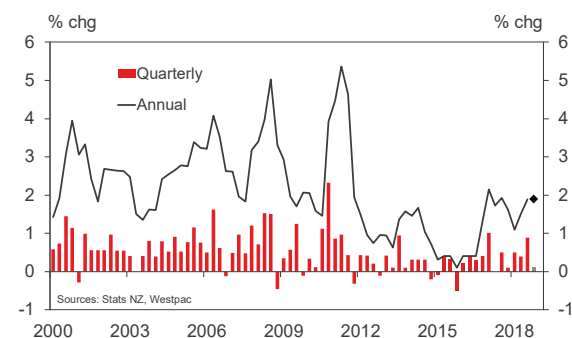
The week ahead

NZ Q4 CPI

Jan 23, Last: 0.9%, Westpac f/c: 0.1%, Mkt f/c: 0.0%

- We expect a 0.1% rise in the Consumer Price Index for the December quarter, which would maintain annual inflation at 1.9%.
- The recent volatility in fuel prices will end up having little bearing on the December quarter figures, with the average price over the quarter close to unchanged.
- While we expect headline inflation to come in a little below the Reserve Bank's November MPS forecast, that's entirely due to the subsequent drop in fuel prices. In contrast, we think underlying inflation will be stronger than the RBNZ's forecast, reflecting the tightening labour market and the lower New Zealand dollar.

NZ CPI inflation



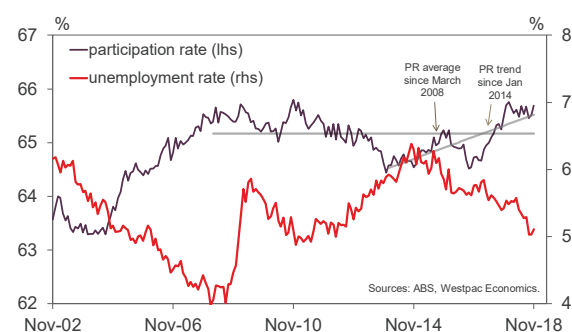
Aus Dec Labour Force Survey - Employment '000

Jan 24, Last: 37.0k, WBC f/c: 5k

Mkt f/c: 20k, Range: 1k to 30k

- Employment was holding a solid pace of growth into year-end with a robust 37.0k gain in November. In the year, total employment lifted 286.0k or 2.3% but the six month annualised pace has lifted to 2.9%.
- Sample volatility has appeared of late with the ABS noting that the incoming rotation group had a higher employment to population ratio than the group it replaced while the unemployment rate of the incoming rotation group was also higher than the whole sample and the group it replaced.
- Business survey's employment indicators, and jobs ads, have eased back in the last few months but our Jobs Index is still consistent with employment growth of around 2½%/yr. Our forecast 5k gain will see a three month average gain of 23.6k (it was 25.4 in Nov) for an annual pace of 2.1%/yr.

Unemployment and participation rates

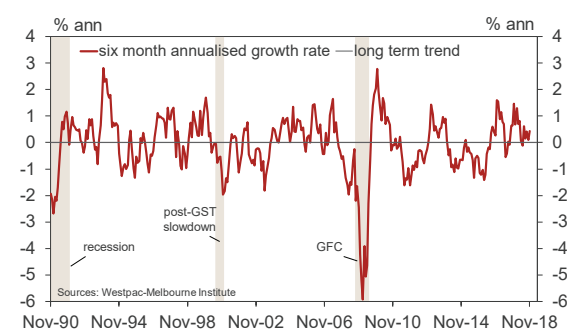


Aus Dec Westpac-MI Leading Index

Jan 23, Last: 0.43%

- The six month annualised growth rate in the Westpac-Melbourne Institute Leading Index, which indicates the likely pace of economic activity relative to trend three to nine months into the future, rose from +0.10% in October to +0.43% in November. Despite the lift, the broader picture from the measure has been of a slowing in momentum over 2018 from well above trend reads averaging 0.89% over the six months to April 2018 to a more moderately positive 0.24% average in the six months since.
- The December index is likely to show a further weakening, with notable declines in both dwelling approvals (-9.4%) and sentiment-based components (Westpac-MI Consumer Expectations Index down 5.6%). With a dip in hours worked and the yield spread narrowing as well, the Leading Index growth rate could even move into negative.

Westpac-MI Leading Index



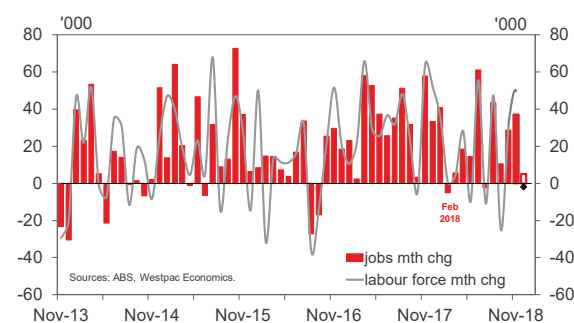
Aus Dec Labour Force Survey - Unemployment %

Jan 24, Last: 5.1%, WBC f/c: 5.1%

Mkt f/c: 5.1%, Range: 5.0% to 5.1%

- In Nov there was a surprising jump in unemployment to 5.1% from 5.0% (market median was for 5.0%) due to a 0.2ppt lift in participation to 65.7% (65.69% at two decimal places) which drove a solid 49.5k gain in the labour force.
- Again, sample volatility appears to have had a role with the ABS noting the unemployment rate of the incoming rotation group was higher than the whole sample and the group it replaced while the participation rate of the incoming group was higher than the group it replaced.
- With the return to more average participation we are looking for the reported participation rate to fall to 65.6%, driving a small fall in the labour force (-2k) and holding the unemployment rate flat at 5.1%.

Volatility in both employment & labour force



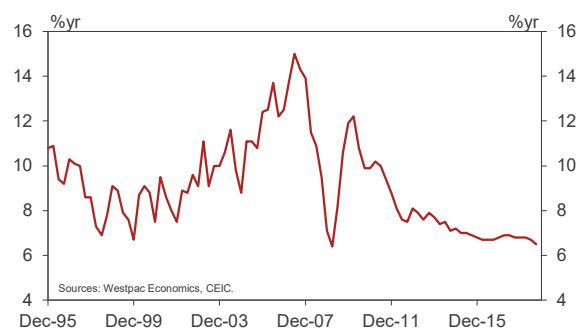
The week ahead

China Q4 GDP

Jan 21, last 6.5%_{yr}, WBC 6.4%_{yr}

- China's growth pulse has decelerated through 2018. However, it seems likely that the authorities' target of 6.5% growth will still be achieved, with annual growth to December forecast at 6.4% and the year-average gain expected to come in at 6.6%. In contrast, quarterly growth is likely to be 1.5% (6.0% annualised) or below, as weak investment weighs.
- Of course, as is often the case, before the Q4 detail is known, the focus has already shifted to the year to come. Growth then is most likely to be around 6.0% – in line with the anticipated Q4 quarterly outcome.
- As evinced by recent real economy partial data and the credit detail, in the months ahead, investment is likely to struggle to accelerate from its current pace. Meanwhile, the strong consumption growth of early-2018 continues to decelerate.

China real GDP slowly decelerating

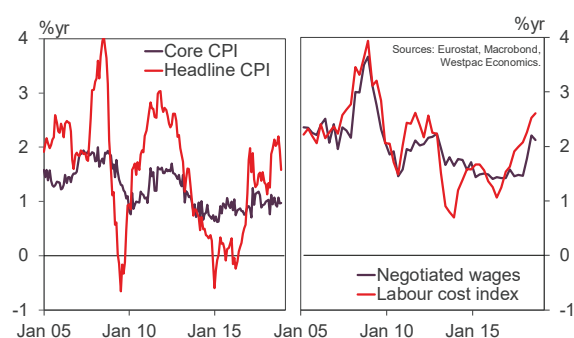


Euro Area ECB policy decision

Jan 24, deposit rate: -0.4%

- In December, the ECB ended net asset purchases and repeated the forward guidance that key policy rates will remain on hold "at least through the summer of 2019, and in any case for as long as necessary". Reinvestment of their stock of assets will be made in full "for an extended period of time past the date... [of] raising the key ECB interest rates". The ECB emphasised that guidance is "date contingent" and "state contingent" in a time of "great uncertainty".
- In 2019, the ECB remains cautiously confident. Earlier this week, Draghi gave an upbeat description of the economy. Yet, he also noted geopolitical uncertainties may continue to weigh on sentiment and drag growth below trend. The ECB will likely need further information before giving more guidance. We see a straightbat ahead of March's meeting and projection update.

Core inflation sticky; wages on the move?

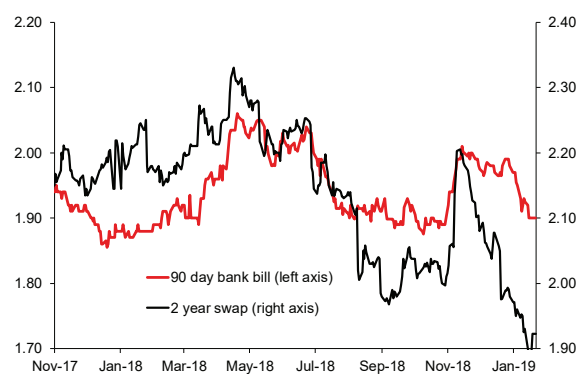


New Zealand forecasts

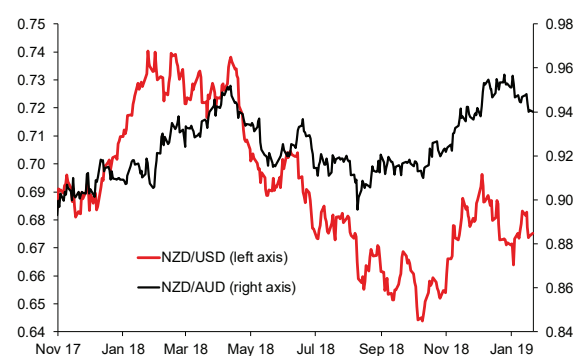
Economic Forecasts	Quarterly				Annual			
	2018		2019					
% change	Sep (a)	Dec	Mar	Jun	2017	2018f	2019f	2020f
GDP (Production)	0.3	0.8	0.7	0.9	3.1	2.9	3.0	3.1
Employment	1.1	0.0	0.2	0.4	3.7	2.3	1.3	1.7
Unemployment Rate % s.a.	3.9	4.3	4.4	4.3	4.5	4.3	4.2	4.0
CPI	0.9	0.1	0.3	0.5	1.6	1.9	2.0	2.1
Current Account Balance % of GDP	-3.6	-3.9	-3.6	-3.7	-2.9	-3.9	-3.6	-3.1

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	1.90	1.95	2.00	2.05	2.10
5 Year Swap	2.20	2.25	2.30	2.35	2.40	2.50
10 Year Bond	2.40	2.45	2.50	2.60	2.65	2.75
NZD/USD	0.66	0.64	0.62	0.62	0.64	0.65
NZD/AUD	0.93	0.91	0.91	0.90	0.90	0.89
NZD/JPY	75.2	73.0	71.3	70.7	71.7	71.5
NZD/EUR	0.59	0.58	0.57	0.56	0.58	0.57
NZD/GBP	0.53	0.52	0.50	0.49	0.50	0.50
TWI	73.0	71.2	69.5	68.9	70.2	70.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 21 January 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.83%	1.85%	1.86%
60 Days	1.87%	1.89%	1.93%
90 Days	1.90%	1.93%	1.99%
2 Year Swap	1.92%	1.95%	1.99%
5 Year Swap	2.16%	2.18%	2.23%

NZ foreign currency mid-rates as at 21 January 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6753	0.6733	0.6726
NZD/EUR	0.5935	0.5901	0.5912
NZD/GBP	0.5252	0.5287	0.5316
NZD/JPY	74.14	73.04	74.70
NZD/AUD	0.9399	0.9463	0.9533
TWI	73.39	73.40	73.86

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
Chn	Q4 GDP	6.5%	6.4%	6.4%	Consumption has held up g'th as investment slowed.
	Dec retail sales ytd %yr	9.1%	9.0%	-	PMI's point to weakening employment, a weight on spending.
	Dec industrial production ytd %yr	5.4%	5.3%	-	External demand will remain a negative for some time yet.
	Dec fixed asset investment ytd %yr	5.9%	6.0%	-	Looks to be stabilising.
UK	Jan Rightmove house prices	-1.5%	-	-	Economic uncertainty continuing to dampen prices, esp. in London.
Int	IMF World Economic Outlook	-	-	-	Forecast update.
Tue 22					
NZ	Dec BusinessNZ PSI	53.5	-	-	Business sentiment has picked up, but remains low.
Eur	Jan ZEW survey of expectations	-21	-	-	Geopolitical uncertainties weighing on confidence.
UK	Nov ILO unemployment rate	4.1%	4.1%	-	Risk that uncertainty delays hiring.
	Dec public sector borrowing Ebn	6.3	1.4	-	Borrowing requirements have remained moderate thus far.
US	Dec existing home sales	1.9%	-0.9%	-	Supply arguably still the biggest issue for sales.
Int	Davos World Economic Forum	-	-	-	From the 22nd to the 25th.
Wed 23					
NZ	Q4 CPI	0.9%	0.0%	0.1%	Core inflation continuing to edge higher.
Aus	Dec Westpac-MI Leading Index	0.43%	-	-	Momentum slowed in 2018. Latest component updates weak.
US	Nov FHFA house prices	0.3%	-	-	Growth remains robust.
	Jan Richmond Fed index	-8	-	-	Regional surveys have been mixed of late.
Thu 24					
Aus	Dec employment	37k	20k	5k	Sample volatility boosted both emp & unemp in Nov...
	Dec unemployment rate	5.1%	5.1%	5.1%	... we see a risk for soft emp being offset by falling part. rate.
Eur	Jan Markit manufacturing PMI flash	51.4	51.3	-	Eased back to trend over 2018...
	Jan Markit services PMI flash	51.2	51.2	-	... recent impact from gilets jaunes.
	ECB policy decision	-0.4%	-0.4%	-0.4%	Likely a straight-bat ahead of Mar meeting and projections.
US	Initial jobless claims	213k	-	-	Very low despite effect of shutdown.
	Jan Markit manufacturing PMI flash	53.8	-	-	Momentum in manufacturing has clearly slowed.
	Jan Markit services PMI flash	54.4	-	-	Domestic demand supportive of services.
	Dec leading index	0.2%	-0.1%	-	Points to growth around trend.
	Jan Kansas City Fed index	3	-	-	Regional surveys have been mixed of late.
Fri 25					
NZ	Nov net migration	4660	-	4760	Annual downtrend remains in place, set to continue over 2019.
US	Dec durable goods orders	-	-	-	Data likely to be delayed owing to shutdown.
	Dec new home sales	-	-	-	Data likely to be delayed owing to shutdown.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	3.0	2.4	2.8
CPI inflation % annual	1.7	1.5	1.9	1.7	1.8	1.7
Unemployment %	5.8	5.7	5.5	5.0	5.0	4.8
Current Account % GDP	-4.7	-3.1	-2.6	-2.4	-2.4	-3.0
United States						
Real GDP %yr	2.9	1.5	2.3	2.9	2.5	2.1
Consumer Prices %yr	0.1	1.4	2.1	2.4	1.9	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	0.9	1.7	0.9	0.8	0.7
Euro zone						
Real GDP %yr	2.1	1.8	2.5	1.9	1.5	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	6.4	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	3.9	4.5	4.3	4.1	4.1
World						
Real GDP %yr	3.5	3.2	3.8	3.8	3.5	3.5

Forecasts finalised 12 December 2018

Interest Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
Australia								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day BBSW	2.07	1.93	1.91	1.90	1.90	1.87	1.85	1.83
10 Year Bond	2.33	2.50	2.60	2.80	2.70	2.60	2.60	2.50
International								
Fed Funds	2.375	2.625	2.875	3.125	3.125	3.125	3.125	3.125
US 10 Year Bond	2.75	3.00	3.20	3.40	3.10	3.00	2.90	2.80
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.30	-0.20	-0.10	0.00	0.20

Exchange Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
AUD/USD	0.7202	0.71	0.70	0.68	0.69	0.71	0.73	0.74
USD/JPY	109.29	114	114	115	114	112	110	106
EUR/USD	1.1397	1.11	1.10	1.09	1.10	1.11	1.14	1.20
AUD/NZD	1.0639	1.08	1.09	1.10	1.11	1.11	1.12	1.11

Contact the Westpac economics team

Dominick Stephens, Chief Economist +64 9 336 5671

Michael Gordon, Senior Economist +64 9 336 5670

Satish Ranchhod, Senior Economist +64 9 336 5668

Anne Boniface, Senior Economist +64 9 336 5669

Paul Clark, Industry Economist +64 9 336 5656

Any questions email: economics@westpac.co.nz

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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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