



Len Lye Centre, New Plymouth

Weekly Economic Commentary.

Upside inflation pressures (and where to find them).

Over the past few weeks a number of key economic indicators have surprised to the upside. Importantly, these surprises have been in areas which we have been expecting to respond to earlier reductions in the Official Cash Rate. The economy is still facing some headwinds (especially in the business sector) and we expect that the RBNZ will cut the cash rate again in November. However, as we go into the new year, recent developments are likely to leave the RBNZ feeling a lot more comfortable that they have done enough to support demand.

After a run of downbeat news in previous weeks, recent economic developments have struck a decidedly more positive tone. First up has been a strengthening in the housing market. Data from REINZ have shown a strong pickup in house price growth over the past two months, with nationwide prices rising by 2.6% over August and September combined. That's a marked acceleration from the middle part of the year. The turn around has been particularly stark in Auckland where prices are up 2% since August, breaking the run of price declines that we saw over much of the past three years.

This pickup in the housing market has been largely as we predicted. Back in May we said that the cancellation of the proposed capital gains tax combined with tumbling mortgage rates would give the housing market a powerful shot in the

arm, and we forecast that house price inflation would climb to 7% over 2020. Now, with two months of solid price rises behind us, as well as signs that sales are starting to lift, we feel very comfortable with that forecast. The RBNZ, however, would have been surprised – their last set of published forecasts assumed the housing market would remain listless through 2019 and 2020.

The strengthening in the housing market is particularly important for the broader economic outlook. As we have often highlighted, New Zealanders hold a large proportion of their wealth in housing assets, and changes in the housing market have a big impact on sentiment and demand more generally. With the housing market acceleration in train, we're also seeing a resurgence in households' spending appetites.



Following very sluggish growth earlier in the year, the past two months have seen a solid 2% rise in retail spending, with gains spread across categories.

In addition to strengthening demand, we are also seeing signs that inflation is at long last starting to stir. Annual consumer price inflation did slip to 1.5% in the September quarter, down from 1.7% in June. However, that was mainly due to last year's sharp rise in oil prices dropping out of the annual figures. Looking beneath the surface, quarterly consumer prices rose by 0.7% in the September quarter. That was a little stronger than our forecast for a 0.6% rise and was also ahead of the RBNZ's forecast for a 0.5% gain.

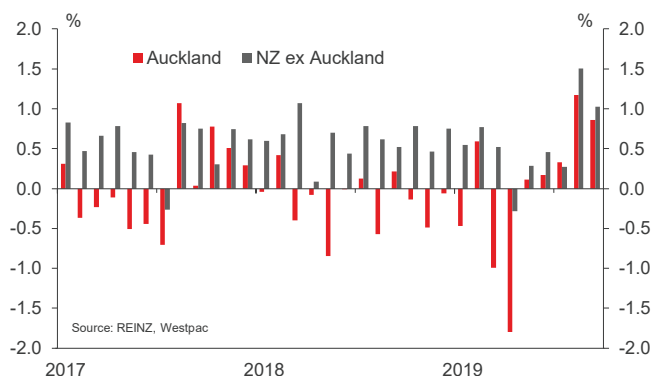
Importantly, all of the surprise in September's inflation report was in the more persistent non-tradable components which were much stronger than the RBNZ had been expecting. Non-tradables inflation tends to be closely related to the strength of domestic demand, and consequently is a key focus for monetary policy. These prices have been gradually trending higher over the past year, with inflation in this group rising to an eight year high of 3.2% in September.

On top of those developments in the domestic economy, we've also had some positive news on the export front. Export log prices have stabilised after their earlier sharp falls. We've also seen milk auction prices holding up better than expected, and that's prompted us to revise up our forecast for Fonterra's farmgate milk price for this season, from \$6.50 to \$6.80 per kilo of milksolids (that's in the middle of Fonterra's forecast range of \$6.25 to \$7.25).

Of course, the economic news flow hasn't all been in one direction. A range of recent indicators have pointed to only muted GDP growth and a softening in the labour market in the September quarter. On top of that, many New Zealand businesses are very down in the mouth, with concerns about the regulatory environment and pressure on margins weighing on plans for hiring and new investment. Against this backdrop, we continue to think that a November cut in the cash rate to 0.75% is most likely (though we think that the chances of this are less certain than market pricing currently implies).

But looking further ahead, signs that the economy is responding to interest rate cuts are mounting. And that means that the RBNZ will be feeling a lot more comfortable that they have done enough to support the economy as we go into the new year. If we continue to see the housing market and consumer demand improving – and we expect that they will – then 0.75% is likely to be the low in the cash rate.

Monthly seasonally adjusted increase in House Price Index



Fixed vs Floating for mortgages.

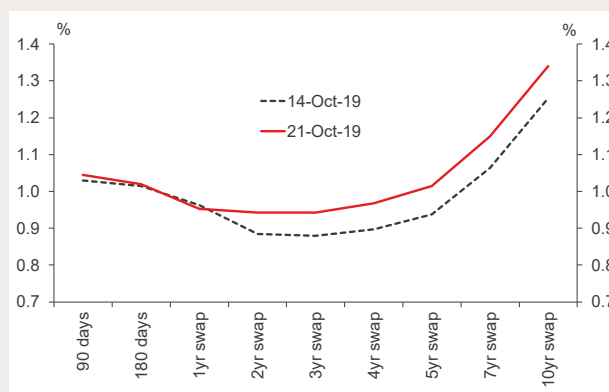
Mortgage rates are falling, and with the Reserve Bank expected to cut the OCR once more, we think they will keep falling. This means there is no hurry to fix.

Among the fixed rates on offer, we think the best value at present is the one-year rate. It is lower than the floating or six-month rates, yet it may still allow borrowers to roll onto lower rates at the end of the fixed term. Fixing for a longer term may mean that borrowers miss out on re-fixing at the lowest rates, at least according to our forecasts.

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



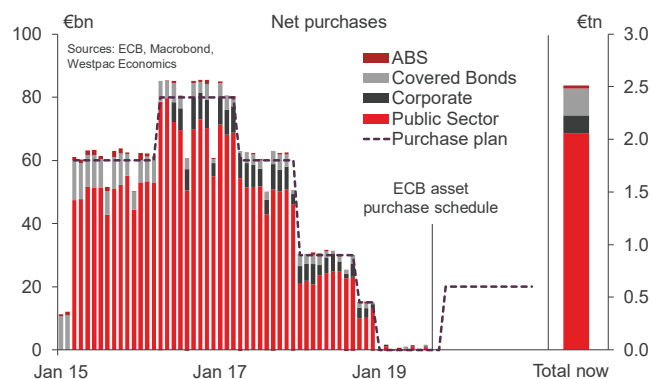
The week ahead.

Eur ECB policy decision

Oct 24, deposit rate, Last: -0.5%, WBC: -0.5%

- At the September meeting, the ECB cut the deposit rate 10bps to -0.5%, moved to a tiered reserve system (for each bank, a multiple of six times minimum reserves will be exempt from the deposit rate charge), restarted asset purchases (€20bn per month pace and will persist for as long as necessary), repriced TLTRO's (cheap bank loans incentive rate 10bps cheaper), and strengthened forward guidance.
- All up, the stimulus package broadly came in line with our own expectation. We did not anticipate the repricing of TLTRO-III but had expected a larger €40bn per month asset purchase program. We continue to believe the program will be lifted to that pace in 2020 and the deposit rate will be reduced to a low of -0.7%.
- Given September's moves and that the October meeting does not see new forecasts, policy is very likely to be unchanged this week. Draghi is likely to play a straight bat at his last press conference and reiterate the call for fiscal stimulus.

ECB asset purchase program - QE

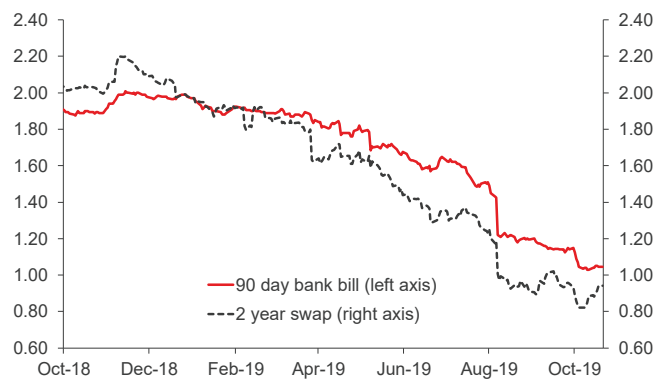


New Zealand forecasts.

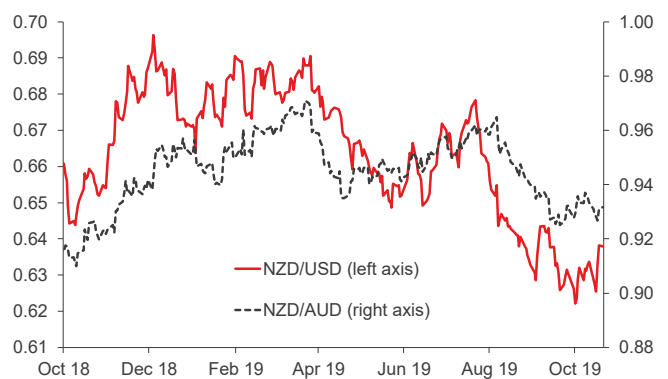
Economic forecasts	Quarterly				Annual			
	2019	2020			2018	2019f	2020f	2021f
% change	Jun (a)	Sep	Dec	Mar				
GDP (Production)	0.5	0.3	0.5	0.6	2.8	2.2	2.3	2.8
Employment	0.8	0.2	0.4	0.4	2.3	1.4	1.8	2.0
Unemployment Rate % s.a.	3.9	4.1	4.2	4.3	4.3	4.2	4.2	3.8
CPI	0.6	0.7	0.3	0.5	1.9	1.7	1.7	1.8
Current Account Balance % of GDP	-3.4	-3.4	-3.2	-3.2	-3.9	-3.2	-3.0	-2.8

Financial forecasts	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21
Cash	0.75	0.75	0.75	0.75	0.75	0.75
90 Day bill	0.90	0.90	0.90	0.90	0.90	0.90
2 Year Swap	0.80	0.80	0.80	0.85	0.90	0.95
5 Year Swap	0.95	1.00	1.05	1.10	1.20	1.25
10 Year Bond	1.00	1.05	1.15	1.20	1.25	1.35
NZD/USD	0.63	0.62	0.62	0.63	0.63	0.64
NZD/AUD	0.94	0.94	0.94	0.94	0.94	0.94
NZD/JPY	66.2	64.5	64.5	66.8	68.0	70.4
NZD/EUR	0.59	0.59	0.58	0.59	0.58	0.58
NZD/GBP	0.54	0.53	0.52	0.52	0.51	0.50
TWI	71.4	70.6	70.1	70.6	70.1	70.6

2 year swap and 90 day bank bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 21 October 2019

Interest rates	Current	Two weeks ago	One month ago
Cash	1.00%	1.00%	1.00%
30 Days	1.14%	1.19%	1.18%
60 Days	1.10%	1.12%	1.16%
90 Days	1.05%	1.05%	1.14%
2 Year Swap	0.94%	0.82%	0.95%
5 Year Swap	1.02%	0.83%	0.97%

NZ foreign currency mid-rates as at 21 October 2019

Exchange rates	Current	Two weeks ago	One month ago
NZD/USD	0.6379	0.6322	0.6260
NZD/EUR	0.5723	0.5756	0.5683
NZD/GBP	0.4938	0.5125	0.5019
NZD/JPY	69.22	67.56	67.44
NZD/AUD	0.9317	0.9363	0.9243
TWI	70.71	70.64	69.85

Data calendar.

		Last	Market median	Westpac forecast	Risk/Comment
Mon 21					
UK	Oct Rightmove house prices	-0.2%	-	-	Prices flat in annual terms.
Tue 22					
UK	BOE Haldane speaks	-	-	-	On diversity and pay in Frankfurt.
US	Oct Richmond Fed index	-9	-	-	Regional surveys very volatile.
	Sep existing home sales	1.3%	-0.5%	-	Supply and economic uncertainty are headwinds.
Wed 23					
NZ	Sep trade balance \$m	-1565	-	-1200	Seasonal low, but meat exports unusually strong.
Aus	RBA Assist. Gov Financial Markets	-	-	-	Chris Kent, panel at Swaps & Derivatives, Sydney 9.20am.
Eur	Oct consumer confidence	-6.5	-6.5	-	Still relatively upbeat due to lower unemployment.
US	Aug FHFA house prices	0.4%	-	-	House price growth has slowed below income growth.
Thu 24					
Eur	Oct Markit manuf. PMI flash	45.7	46.0	-	Manufacturing contraction is worsening...
	Oct Markit services PMI flash	51.6	52.0	-	... services have been resilient but now looking more shaky.
	ECB policy decision	-0.5%	-0.5%	-	President Draghi's last press conference.
US	Sep durable goods orders prel.	0.2%	-0.6%	-	Underlying investment trend to remain weak.
	Initial jobless claims	214k	-	-	Firing rates historically low.
	Oct Markit manuf. PMI flash	51.1	-	-	US manufacturers hit by global risks and USD...
	Oct Markit services PMI flash	50.9	-	-	... consumer a threat to services looking ahead.
	Sep new home sales	7.1%	-0.4%	-	Housing yet to show clear response to low rates.
	Oct Kansas City Fed index	-2	-	-	Regional surveys very volatile.
Fri 25					
Aus	2018/19 annual national accounts	2.0% (p)	-	-	Annual accounts can include revisions.
US	Oct Uni. of Mich. sentiment final	96.0	96.0	-	Sentiment under pressure, but still robust overall.

International forecasts.

Economic forecasts (Calendar years)	2016	2017	2018	2019f	2020f	2021f
Australia						
Real GDP % yr	2.8	2.4	2.7	1.8	2.4	2.7
CPI inflation % annual	1.5	1.9	1.8	1.7	1.9	2.0
Unemployment %	5.7	5.5	5.0	5.4	5.6	5.3
Current Account % GDP	-3.1	-2.6	-2.1	0.4	-0.7	-2.0
United States						
Real GDP %yr	1.6	2.2	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	3.6	3.6	3.8
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	0.7	0.3	0.4
Euro zone						
Real GDP %yr	2.0	2.4	1.8	1.2	1.1	1.2
United Kingdom						
Real GDP %yr	1.8	1.8	1.4	1.0	0.7	1.3
China						
Real GDP %yr	6.7	6.8	6.6	6.1	5.8	5.8
East Asia ex China						
Real GDP %yr	4.0	4.6	4.3	3.7	3.9	3.9
World						
Real GDP %yr	3.4	3.8	3.6	3.2	3.3	3.3

Forecasts finalised 4 October 2019

Interest rate forecasts	Latest	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Jun-21	Dec-21
Australia								
Cash	0.75	0.75	0.50	0.50	0.50	0.50	0.50	0.50
90 Day BBSW	0.89	0.85	0.70	0.70	0.70	0.70	0.75	0.75
10 Year Bond	1.10	0.95	1.00	1.15	1.20	1.25	1.40	1.50
International								
Fed Funds	1.875	1.375	1.125	0.875	0.875	0.875	0.875	0.875
US 10 Year Bond	1.74	1.45	1.40	1.45	1.50	1.55	1.70	1.80
ECB Deposit Rate	-0.50	-0.60	-0.70	-0.70	-0.70	-0.70	-0.70	-0.70

Exchange rate forecasts	Latest	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Jun-21	Dec-21
AUD/USD	0.6830	0.67	0.66	0.66	0.67	0.67	0.69	0.72
USD/JPY	108.58	105	104	104	106	108	111	112
EUR/USD	1.1123	1.07	1.05	1.06	1.07	1.09	1.11	1.14
GBP/USD	1.2847	1.17	1.18	1.20	1.22	1.24	1.31	1.35
USD/CNY	7.0774	7.30	7.30	7.20	7.10	6.90	6.75	6.60
AUD/NZD	1.0725	1.06	1.06	1.06	1.06	1.06	1.07	1.08

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