Weekly Commentary

18 February 2019

Larnach Castle, Dunedin

Flat as far as the eye can see

The RBNZ left the OCR unchanged at 1.75% in last week's *Monetary Policy Statement* and shifted to a more neutral outlook. While we think the OCR will be on hold for even longer than the RBNZ expects, last week's migration data and this week's announcement of the Tax Working Group recommendations underscore some of the key uncertainties in this outlook.

The RBNZ's February *Monetary Policy Statement* adopted a slightly more dovish tone than in November. As expected the interest rate projection was about 20 basis points lower and the Bank returned the comment the "next OCR move could be up or down" to the *Statement*.

Despite this, the details within the *Statement* were a little less dovish than the market had been braced for.

This may be because some of the analysis in the document was a little out of date. Notably, the RBNZ is forecasting 0.8% quarterly GDP growth in Q4. That seems implausibly high to us given the weak service sector activity implied by last week's soft Quarterly Employment Survey. As a comparison, we're forecasting 0.3% GDP growth in the December quarter.

Similarly, the RBNZ made no allowance in their forecasts for Stats NZ's new net migration estimates. These have loomed large in our own thinking because lower net migration estimates imply slower population growth, less need to build houses and therefore a weaker outlook for the construction sector than we had previously understood.

Presumably the RBNZ will look to include this data when making their next OCR decision, effectively slanting them in a dovish direction before any other developments are taken into account.

Another reason markets may have been prepared for a more dovish RBNZ statement than what was delivered, could have been international developments. Both the Federal Reserve and the Reserve Bank of Australia have adopted a decidedly more neutral outlook since the start of the year.

In the RBA's case, the shift toward a neutral setting has been driven by a downward revision to its growth forecasts and increased concern about the outlook for the household sector and the housing market. In particular, they sound much less sanguine about the potential for negative wealth effects from falling house prices in Sydney and Melbourne.

The downturn in house prices in Sydney and Melbourne have been for Australia-specific reasons. First, there has been a rise in bank funding costs and mortgage rates, independent of changes to the official policy rate. Second, regulatory pressure and the Royal Commission inquiry into the banking sector have prompted a tightening in lending standards. And finally, apartment building in recent years has led to an oversupply in the main centres.

Consequently, we think the main impact on New Zealand from the downturn in the Australian housing market is likely to come from softer consumer demand via the wealth effect. Australian households are likely to cut back on discretionary spending including on the likes of holidays to New Zealand. At the margin, we could also see reduced demand for building materials from New Zealand, as falling house prices weigh on building activity over the coming years.

Flat as far as the eye can see continued

As we detailed last week, before Wednesday's RBNZ decision we also changed our own outlook for the OCR over the longer run. Previously we were forecasting gradual OCR hikes from November 2020. We are now forecasting no change in the OCR over 2019, 2020, and 2021. This forecast means we think that the OCR outlook is evenly balanced over the foreseeable future, with risks on both sides.

An important catalyst for our change of call were the new migration estimates from Stats NZ, which imply lower construction activity (and therefore lower GDP growth) in the early 2020s. Combined with the unwinding Canterbury and Kaikoura rebuilds, that means the current construction boom will peak in 2019 and start slowly unwinding from 2020. However, last week's migration data underscored uncertainty around the extent of the slowdown in population growth. December estimates of net migration flows were much stronger than we had anticipated, with a suspiciously sharp spike in monthly arrivals. On an annual basis net migration has been trending lower since its 2016 peak, but this trend looks to have slowed over the last 6 months with this week's data showing annual net migration relatively stable at around 49,000 – 25% below its earlier peak. This moderates a little the degree to which slowing population growth will be a drag on demand, however, the broader story of slowing population growth remains in place.

The key risks to the interest rate outlook are developments in the housing market. Our forecast is for nationwide house price inflation of 3% this year which is a balance between low mortgage rates, a relaxation of the LVR lending restrictions and government policy changes aimed at reducing the attractiveness of housing to investors. But we're currently at a very uncertain juncture and there are some big opposing forces at play.

On the upside, low mortgage rates could lead to a bigger lift in house prices than we currently anticipate. In contrast, tax changes and the foreign buyer ban are the biggest headwinds. A capital gains tax would have a significant negative impact on house prices. While it's still unclear what form any capital gains tax will take, the fog should at least begin to clear on Thursday this week when the public gets its first look at the final recommendations from the Government's Tax Working Group. While the Government isn't due to respond to these recommendations until April, Thursday's announcement will at least give us a clearer idea of some of the options in the mix.

January REINZ data gives us a view on how these opposing forces are shaping up. House prices continued to broadly track sideways, with nationwide prices up 1% in the month and 3.1% in the year. Importantly, sales bounced back strongly after a particularly weak December. Taking a step back and looking at the big picture, there's been modest nationwide growth in house prices and sales over the last six months. Auckland and Canterbury continue to underperform relative to other regions, a trend that is likely to continue over the coming years.

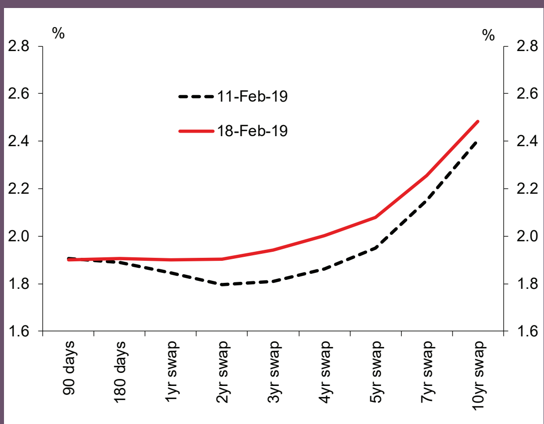
Fixed vs Floating for mortgages

The rise in wholesale interest rates following the Reserve Bank's February Monetary Policy Statement has reduced the downward pressure on retail mortgage rates. With cash rate hikes still a distinct prospect, we expect retail fixed mortgage rates to remain relatively steady in the near term.

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



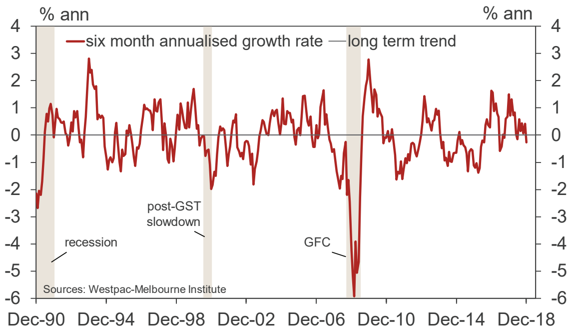
The week ahead

Aus Jan Westpac–MI Leading Index

Feb 20, Last: –0.27%

- 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, fell to –0.27% in Dec. The print extends a choppy performance in recent months but around a clear moderating trend.
- The Jan read will include a mixed bag of component updates. On the upside, the ASX200 rose 3.9% vs -0.4% last month; the Westpac-MI Consumer Expectations Index rebounded 5.4% vs -5.6% last month; commodity prices lifted 2.4%, and Westpac-MI Unemployment Expectations Index improved 2.9% vs a 2.2% deterioration last month. That goes against weaker updates on dwelling approvals, down -8.4% after a -9.8% fall last month; a further narrowing in the yield spread.

Westpac-MI Leading Index

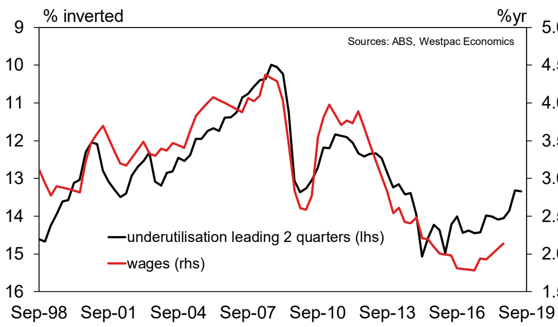


Aus Q4 Wage Price Index

Feb 20, Last: 0.6%, WBC f/c: 0.6%
Mkt f/c: 0.6%, Range: 0.5% to 0.7%

- Total hourly wages ex bonuses increased 0.6% in Q3, in line with market and Westpac expectations, lifting the annual rate to 2.3%yr from 2.1%yr. Private sector wages grew 0.5% holding the annual rate at 2.1%. Public sector wages grew 0.6% lifting the annual pace to 2.5%yr from 2.4%yr. Public sector wage inflation had been flat at 2.4%yr since Q1 2017.
- The labour market clearly tightened through 2018. Unemployment fell from a Q1 average of 5.5% to a Q4 average of 5.0%. This has led to a tightening of labour market conditions with firms reporting it is getting harder to find suitable labour. There has even been a trend improvement (decline) in underemployment.
- Along with the boost to the minimum wage it is clear that wage inflation has found a base and it is likely to lift modestly from here.

Underutilisation & private sector wages

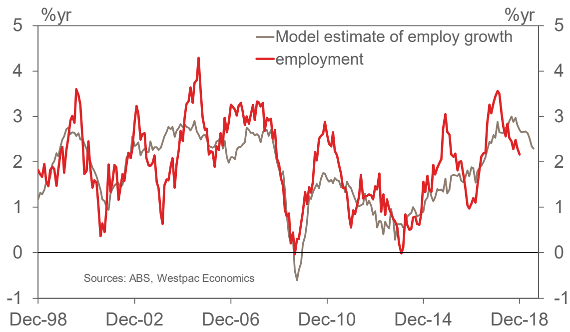


Aus Jan Labour Force Survey - employment '000

Feb 21, Last: 21.6k, WBC f/c: 15k
Mkt f/c: 15k, Range: 5k to 27k

- Total employment printed a solid 21.6k gain in December which was in line with market expectations for +20k. This has locked in a solid trend pace of growth with a three month average gain of 29.1k. In the year, employment grew 268.6k, or 2.2%, which matches the six month annualised pace of 2.2%yr.
- Our Jobs Index has moderated but is still pointing to a solid pace of employment growth. The annual pace of job ads recently turned negative just as some of the business surveys showed weaker employment conditions. But the low level of unemployment expectations suggests we are facing a moderation in employment, not a correction.

Jobs Index model of employment

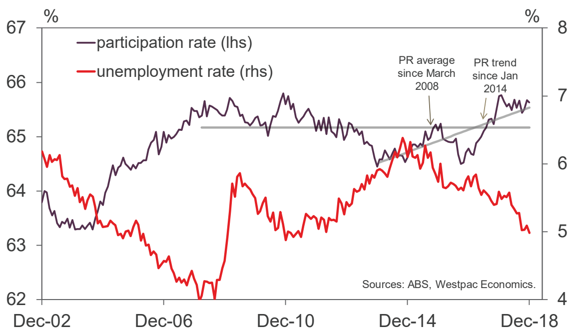


Aus Jan Labour Force Survey - unemployment %

Feb 21, Last: 21.6k, WBC f/c: 5.0%
Mkt f/c: 5.0%, Range: 4.9% to 5.1%

- Given the December gain in employment, it is not surprising that the unemployment rate eased back 0.1ppt to 5.0%. This fall was helped by a 0.1ppt moderation in the participation rate to 65.6% which limited the rise in the labour force to just 7.5k.
- Nationally, unemployment fell from 5.5% in Q1 to 5.0% in Q4. Victoria had the greatest improvement falling –1.1ppts to 4.4% while in NSW the unemployment fell –0.6ppts to 4.4%.In Qld the unemployment rate lifted 0.1ppt to 6.2% while it was flat in WA and SA at 6.2% and 5.6% respectively.
- For January, +15k on employment, holding the participation rate flat, is enough to hold unemployment at 5.0%.

Unemployment and participation rates

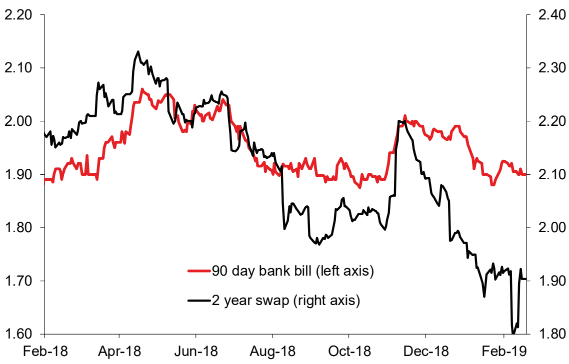


New Zealand forecasts

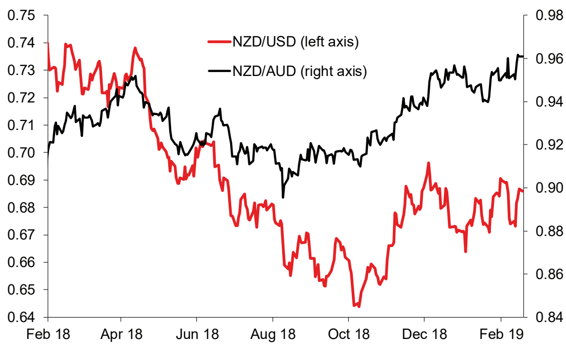
Economic Forecasts	Quarterly				Annual			
	2018		2019					
% change	Sep (a)	Dec	Mar	Jun	2017	2018f	2019f	2020f
GDP (Production)	0.3	0.3	0.7	0.9	3.1	2.7	2.6	3.1
Employment	1.0	0.1	0.2	0.3	3.7	2.3	1.1	1.7
Unemployment Rate % s.a.	4.0	4.3	4.4	4.3	4.5	4.3	4.2	4.0
CPI	0.9	0.1	0.3	0.5	1.6	1.9	2.0	2.1
Current 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	2.00	2.00	2.00	2.00	2.05
5 Year Swap	2.10	2.20	2.25	2.30	2.35	2.40
10 Year Bond	2.20	2.25	2.35	2.35	2.35	2.45
NZD/USD	0.67	0.66	0.64	0.64	0.65	0.66
NZD/AUD	0.94	0.94	0.94	0.93	0.93	0.93
NZD/JPY	73.7	73.3	72.3	71.7	72.2	72.6
NZD/EUR	0.59	0.59	0.58	0.58	0.59	0.58
NZD/GBP	0.53	0.52	0.49	0.48	0.49	0.49
TWI	73.4	73.0	71.3	70.7	71.0	71.3

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 18 February 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.85%	1.83%
60 Days	1.88%	1.89%	1.87%
90 Days	1.90%	1.93%	1.90%
2 Year Swap	1.90%	1.92%	1.92%
5 Year Swap	2.08%	2.09%	2.16%

NZ foreign currency mid-rates as at 18 February 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6860	0.6898	0.6753
NZD/EUR	0.6074	0.6017	0.5935
NZD/GBP	0.5308	0.5275	0.5252
NZD/JPY	75.77	75.53	74.14
NZD/AUD	0.9610	0.9517	0.9399
TWI	74.64	74.56	73.39

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 18					
NZ	Jan BusinessNZ PSI	53.0	–	–	Business confidence has picked up, but remains lows.
UK	Feb Rightmove house prices	0.4%	–	–	Economic uncertainty a significant drag.
Tue 19					
Aus	RBA minutes	–	–	–	Most detail revealed in Lowe's speech and SMP.
Eur	Feb ZEW survey of expectations	-20.9	–	–	Expectations have declined.
UK	Dec ILO unemployment rate	4.0%	4.0%	–	Unemployment still low, but Brexit concerns to weigh on hiring.
US	Feb NAHB housing market index	58	59	–	Builders remain positive on outlook.
	Fedspeak	–	–	–	Mester on the economy.
Wed 20					
NZ	GlobalDairyTrade auction	6.7%	–	–	Dry weather in NZ could push prices higher.
Aus	Jan Westpac-MI Leading Index	–0.27%	–	–	Choppy monthly reads around a clear weakening trend.
	Q4 wage price index	0.6%	0.6%	0.6%	A base has been found & wages are set to drift higher.
Eur	Feb consumer confidence flash	-7.9	–	–	Stabilised in Jan.
Thu 21					
NZ	Tax Working Group final report	–	–	–	Report to Government on possible changes to NZ tax system.
Aus	Jan employment '000	21.6	15	15	Employment growth has slowed & some leading indicators...
	Jan unemployment rate %	5.0%	5.0%	5.0%	... have eased but it is enough to hold unemployment flat.
Eur	Feb Markit manuf. PMI flash	50.5	50.5	–	... and regions as global trade stalls.
	Feb Markit services PMI	–	–	–	Services have held up a bit better.
	ECB minutes	–	–	–	Some clues for the March decision?
UK	Jan Public net borrowing, £bn	2.1	–	–	Borrowing requirements have remained modest.
US	Feb Phily Fed index	17.0	14.5	–	Regional surveys off highs, but still robust.
	Initial jobless claims	239k	–	–	Very low, and set to remain that way.
	Feb Markit manuf. PMI flash	54.9	55.0	–	PMI detail still consistent with...
	Feb Markt services PMI flash	54.2	–	–	... above-trend growth view.
	Jan leading index	-0.1%	0.2%	–	Leading index points to at or above trend through 2019.
	Jan existing home sales	-6.4%	0.2%	–	Supply and the higher rates of mid-2018 hit sales hard.
	Fedspeak	–	–	–	Bostic on the economy.
Fri 22					
Aus	RBA Governor Lowe	–	–	–	Parliamentary Testimony, Sydney, 9.30am.
Eur	Jan core CPI final %yr	1.1%	–	–	Flash showed 1.1%, top of narrow 0.9-1.1% recent range.
	ECB President Draghi speaks	–	–	–	In Bologna at an awards event.
US	Fedspeak	–	–	–	Williams discusses inflation.
	Fedspeak	–	–	–	Clarida on Fed review of policy, tools and communication.
	Fedspeak	–	–	–	Potter on quantitative models in macro research.
	Fedspeak	–	–	–	Bullard, Harker and Quarles on the balance sheet.
	Fedspeak	–	–	–	Williams gives closing remarks.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	2.9	2.2	2.6
CPI inflation % annual	1.7	1.5	1.9	1.8	1.8	1.9
Unemployment %	5.8	5.7	5.5	5.0	5.2	5.1
Current Account % GDP	-4.7	-3.1	-2.6	-2.4	-2.0	-2.8
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.5	2.1
Consumer Prices %yr	0.1	1.4	2.1	2.3	1.8	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	1.0	1.7	1.1	0.8	0.7
Euro zone						
Real GDP %yr	2.1	1.9	2.4	1.8	1.4	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	6.6	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	4.0	4.5	4.4	4.2	4.3
World						
Real GDP %yr	3.5	3.3	3.7	3.7	3.5	3.5
Forecasts finalised 8 February 2019						

Interest Rate Forecasts	Latest	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	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	1.97	2.05	2.05	2.00	2.00	1.95	1.95	1.90
10 Year Bond	2.11	2.30	2.40	2.60	2.60	2.50	2.50	2.50
International								
Fed Funds	2.375	2.375	2.625	2.875	2.875	2.875	2.875	2.875
US 10 Year Bond	2.65	2.85	3.00	3.10	3.00	2.90	2.80	2.75
ECB Deposit Rate	-0.40	–0.40	–0.40	–0.40	–0.30	–0.20	–0.10	0.00

Exchange Rate Forecasts	Latest	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Dec-20
AUD/USD	0.7091	0.71	0.70	0.68	0.69	0.70	0.71	0.72
USD/JPY	110.30	110	111	113	112	111	110	106
EUR/USD	1.1285	1.13	1.11	1.10	1.10	1.11	1.14	1.20
AUD/NZD	1.0388	1.06	1.06	1.06	1.08	1.08	1.08	1.08

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