

Weekly Commentary

20 May 2019



Hundertwasser Toilets, Kawakawa

It won't happen overnight

The housing market continued to cool in April. However, we expect to see it picking up again through the back half of this year. That's thanks to the very low level of interest rates and the cancellation of the capital gains tax, both of which will boost purchasers' appetites.

April was another very weak month for the housing market. Sales fell another 2.6% over the month, leaving them 11% lower than the same time last year. We also saw annual house price inflation slowing to 1.3%, its slowest pace since 2011.

Looking under the hood, a lot of the weakness in the housing market continues to be centred on Auckland, with prices down 4% over the past year and sales at their lowest level in eight years. However, April also saw a cooling in other regions, bucking the recent trend of rapid price increases.

This weakness in prices was expected – we have been saying for some time that the sharp decline in house sales over the first three months of 2019 signalled weakness in prices further ahead.

The big question is, of course, where is the housing market heading over the coming year? With weakness in sales continuing into April, we expect house prices to remain soft for a while yet.

However, there have been some big changes in the economic landscape in recent months, and we think these signal a change in direction for the housing market through the back half of this year.

The first of those changes was the announcement that the Government would not be proceeding with its plans to introduce a capital gains tax (CGT). For the past year or so, the prospect of a CGT was weighing on confidence in the housing market. The impact of this was particularly

pronounced in Auckland where investors traditionally make up a larger share of purchasers. There are still a number of other policy initiatives targeting property investors (such as restrictions on foreign buyers) that will weigh on house price growth. Nevertheless, the scrapping of CGT will help to buoy sentiment in the housing market.

The other big change has been the fall in mortgage rates in recent months. History has shown that low interest rates have a powerful impact on the housing market. And following the RBNZ's dovish lurch in March and the subsequent cut in the Official Cash Rate in May, we've seen some big drops in lending rates: two-year fixed mortgage rates are down 40 bps since March, and five-year mortgage rates have fallen to an all time low. That means that prospective buyers can now service much larger mortgages while making the same interest payments.

We expect these factors will drive a pickup in the housing market and a reacceleration in house price growth. If we are right, the first thing we will see is a lift in house sales over the coming few months (though we still expect Auckland to be weaker than the rest of the country).

These conditions will be a welcome development for the RBNZ. They've been trying to engineer a period of stronger domestic activity to boost inflation for some time. And with New Zealanders holding a large amount of our wealth in housing assets, we expect the pickup in the housing market to be associated with a firming in household spending.

It won't happen overnight

However, one potentially important consequence of a housing-led pickup in activity is a likely increase in household debt from what are already record levels. As a nation, New Zealand households currently hold financial liabilities that are equal to 164% of their disposable incomes. The earlier slowdown in the housing market had put the brakes on debt accumulation in recent years. However, we could see debt levels rising again as the housing market picks up.

Migration more modest than it initially seemed

Net migration has been one of the key factors shaping the economic cycle in recent years, adding to both demand and our supply capacity. However, Stats NZ recently changed how it measures migration. That's meant that there's been a fair bit of uncertainty about exactly how strong migration has been.

Recent estimates have revealed that there has been a second wind in net migration flows, which is consistent with the slowdown across the Tasman making New Zealand a relatively more attractive destination. However, we've been sceptical about just how large this pickup has been, and had discounted earlier estimates which implied that migration had unexpectedly picked up to the highest level in more than a decade.

The latest update on migration supports what we had suspected: although there has been some firming in recent months, the apparent pickup in net migration since late-2018 has been a lot more modest than it initially appeared.

Stats NZ now estimates that there was a net inflow of 56,000 people into the country over the past year. That's down 12% from its peak, and is more consistent with where we see broader economic conditions here in New Zealand and abroad.

Given the likelihood of further revisions over the coming months, we're still treating the latest migration figures with a fair bit of caution. We expect that migration flows will moderate over the next few years as some of the earlier strength in arrivals ease off and departures rise.

Trade tensions

Turning to developments offshore, we've seen trade tensions between the US and China continuing to simmer away. The two sides failed to reach a compromise in early May, which saw President Trump announcing that the existing 10% tariff on \$200bn of imports from China would rise to 25%. He also threatened to impose a tariff on the remaining \$325bn of imports from China. In response, China has signalled that it will introduce retaliatory measures.

As a protracted trade war is in neither side's best interest, we expect that the US and China will eventually reach a compromise. However, it may take some time for this to eventuate. And in the meantime, the resulting disruptions pose a downside risk for trade, investment and GDP growth, with potential spill-overs to other economies including New Zealand.

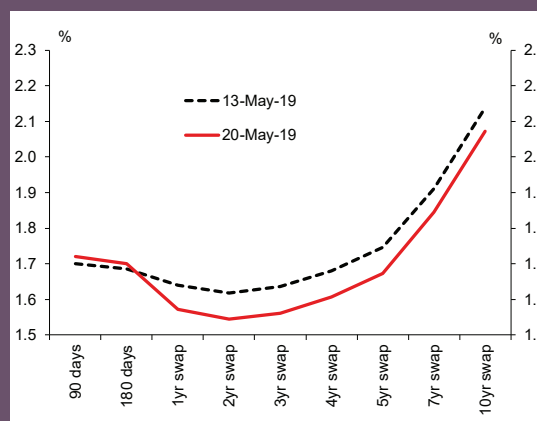
Fixed vs Floating for mortgages

We expect floating and one-year fixed mortgage rates to be fairly stable at current levels over the year ahead, then to gradually rise in subsequent years.

Based on that expectation, we regard today's three-year rates at the best value on offer. One- and two-year rates are also fairly good value, with neither particularly preferred to the other. Four- and five-year fixed rates are a little higher than where we expect shorter-term rates to go over the relevant timeframe, but they do offer the borrower certainty. Floating mortgage rates are expensive for borrowers, but they may be the preferred option for those who require flexibility in their repayments.

The big uncertainty is what the Reserve Bank does with the OCR. Our views are based on the Reserve Bank keeping the OCR at 1.5% for the foreseeable future. If they instead cut the OCR, floating and one-year fixed rates could fall.

NZ interest rates



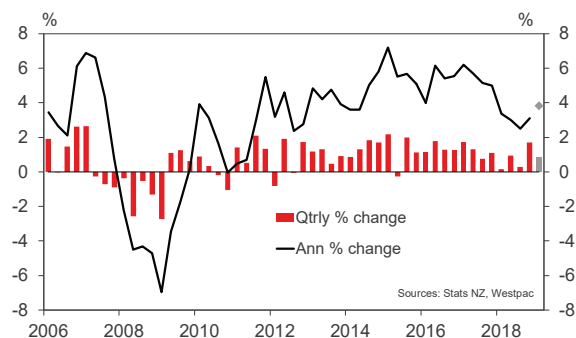
The week ahead

NZ Q1 real retail sales

May 22, Last: +1.7%, WBC f/c: +0.8%

- Retail spending was much stronger than expected in the December quarter, with the volume of goods sold rising by 1.7%. Spending was supported by falls in petrol prices and the boost to households' disposable incomes from the Government's Families Package.
- We're expecting a 0.8% rise in retail volumes in the March quarter, underpinned by a solid 1.2% rise in core (ex-fuel) categories. That would be consistent with the monthly gauges of spending which have held at firm levels despite increases in petrol prices.

NZ real retail sales



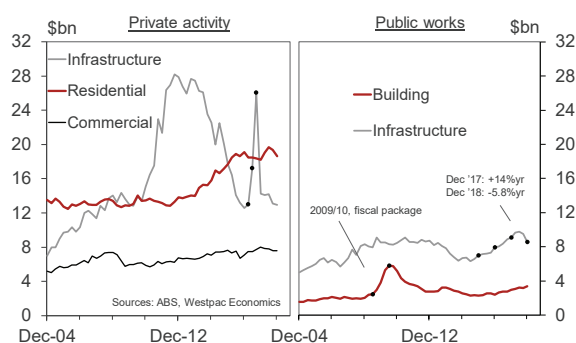
Aus Q1 construction work

May 22, Last: -3.1%, WBC f/c: 0.2%

Mkt f/c: flat, Range: -2.2% to 1.3%

- Construction work weakened over the second half of 2018, with home building falling sharply.
- For the March quarter, we expect a broad stabilisation, with work inching 0.2% higher.
- Home building activity still has further downside with dwelling approvals 27% below the levels prevailing over the second half of 2017.
- Public works is expected to resume its uptrend, after a drop of 6% in Q4, supported by a sizeable pipeline of work focused on transport projects.
- Private business construction is expected to be flat, with a modest rise in infrastructure (renewable energy and mining) offsetting a small decline in non-residential building.

Construction work: by segment

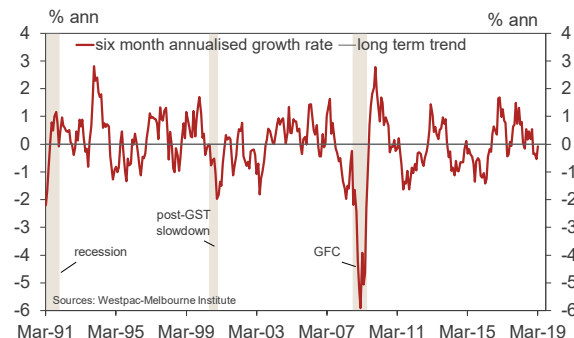


Aus Apr Westpac-MI Leading Index

May 22, Last: -0.09%

- 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 -0.54% in February to -0.09% in March.
- The March lift was entirely due to a 19% spike in one component - dwelling approvals. This spike unwind in April with approvals dropping 15.5%. That will in turn see the Index growth rate drop back to a pace more materially below trend. Looking across the other component updates this month: the ASX200 and the Westpac-MI Unemployment Expectations improved but the Westpac-MI Consumer Expectations Index, hours worked and US industrial production all softened a touch while commodity prices were flat in AUD terms.

Westpac-MI Leading Index

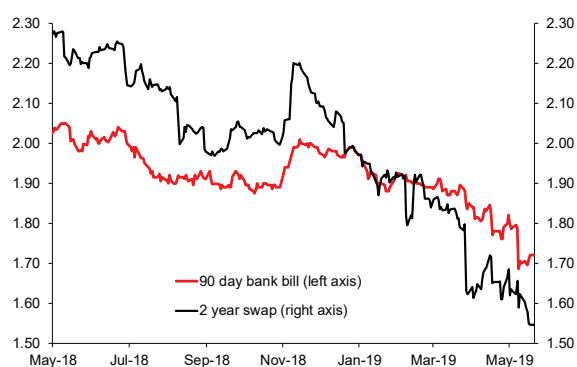


New Zealand forecasts

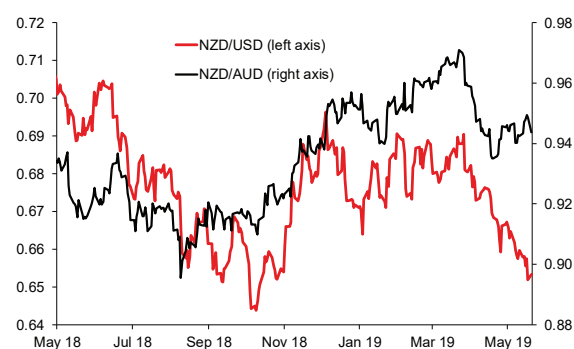
Economic Forecasts	Quarterly				Annual			
	2018	2019						
% change	Dec (a)	Mar	Jun	Sep	2018	2019f	2020f	2021f
GDP (Production)	0.6	0.5	0.8	0.8	2.8	2.5	2.8	2.0
Employment	0.0	-0.2	0.8	0.3	2.3	1.3	1.7	1.2
Unemployment Rate % s.a.	4.3	4.2	4.3	4.3	4.3	4.2	4.0	4.0
CPI	0.1	0.1	0.6	0.6	1.9	1.6	2.1	2.1
Current Account Balance % of GDP	-3.7	-3.4	-3.1	-3.0	-3.7	-2.9	-2.7	-2.7

Financial Forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
Cash	1.50	1.50	1.50	1.50	1.50	1.50
90 Day bill	1.70	1.65	1.65	1.65	1.65	1.65
2 Year Swap	1.55	1.60	1.65	1.70	1.75	1.75
5 Year Swap	1.70	1.75	1.80	1.85	1.90	1.95
10 Year Bond	1.80	1.85	1.90	1.90	1.95	2.00
NZD/USD	0.65	0.64	0.65	0.66	0.66	0.67
NZD/AUD	0.93	0.94	0.96	0.96	0.96	0.96
NZD/JPY	72.8	72.3	73.5	73.9	73.3	73.7
NZD/EUR	0.59	0.58	0.59	0.59	0.59	0.59
NZD/GBP	0.50	0.48	0.49	0.50	0.50	0.50
TWI	71.4	71.0	71.9	72.3	71.9	72.2

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 20 May 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.50%	1.75%	1.75%
30 Days	1.69%	1.81%	1.84%
60 Days	1.70%	1.79%	1.81%
90 Days	1.72%	1.79%	1.78%
2 Year Swap	1.55%	1.63%	1.65%
5 Year Swap	1.67%	1.78%	1.81%

NZ foreign currency mid-rates as at 20 May 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6534	0.6610	0.6675
NZD/EUR	0.5855	0.5919	0.5927
NZD/GBP	0.5128	0.5034	0.5141
NZD/JPY	72.02	73.14	74.71
NZD/AUD	0.9438	0.9487	0.9358
TWI	72.33	72.49	72.65

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 20					
NZ	Apr BusinessNZ PSI	52.9	-	-	Service sector activity has taken a step down in 2019.
UK	May Rightmove house prices	1.1%	-	-	House price growth remains sluggish, esp. in London.
US	Apr Chicago Fed activity index	-0.15	-	-	Pointing to growth around trend.
	Fedspeak	-	-	-	Harker on management science.
Tue 21					
Aus	RBA minutes	-	-	-	Further colour around the adoption of an easing bias.
	RBA Governor Lowe	-	-	-	'Economic Outlook and Monetary Policy', Brisbane 12:15 AEST.
Eur	May consumer confidence	-7.9	-7.6	-	Remains above average on improved labour market.
US	Apr existing home sales	-4.9%	2.6%	-	Housing market receiving benefit of lower rates.
	Fed Chair Powell speaks	-	-	-	Atlanta Fed Financial Markets Conference.
	Fedspeak	-	-	-	Evans and Rosengren at separate events.
Wed 22					
NZ	GlobalDairyTrade auction	0.4%	-	-	Seasonally low volumes, slowing pace of improvement in prices.
	Q1 real retail sales	1.7%	0.8%	0.8%	Monthly spending gauges have held up in early 2019.
Aus	Apr Westpac-MI Leading Index	-0.09%	-	-	To drop back into deeper negative on approvals spike unwind.
	Q1 construction work	-3.1%	flat	0.2%	To consolidate. Housing weakness offset by rebound in public.
Eur	ECB President Draghi	-	-	-	ECB colloquium in honour of departing Praet.
UK	Apr CPI	0.2%	0.7%	-	Sluggish economy to keep core inflation well contained.
	Apr public sector borrowing £bn	0.8	5.2	-	Restraint in spending has reduced borrowing needs.
US	Apr/May FOMC minutes	-	-	-	Views on risks of interest to market.
	Fedspeak	-	-	-	Bullard in HK, Williams press briefing, Bostic at Dallas Fed.
Thu 23					
Eur	May Markit manufacturing PMI	47.9	48.2	-	Subdued, weighed down by Germany...
	May Markit services PMI	52.8	53.0	-	... but so far services have offset weakness.
	European Parliament elections	-	-	-	To take place from 23-26 May.
UK	Apr retail sales	1.1%	-0.1%	-	Firmness in the labour market has boosted spending.
US	Initial jobless claims	212k	-	-	Very low.
	May Markit manufacturing PMI	52.6	53.0	-	Expected to stabilise after recent moderation.
	May Markit services PMI	53.0	-	-	Jobs and low rates positive for domestic demand.
	Apr new home sales	4.5%	-2.2%	-	Housing market receiving benefit of lower rates.
	May Kansas City Fed index	5	-	-	Has pointed to modest growth of late.
	Fedspeak	-	-	-	Kaplan, Daly, Bostic and Barkin on a panel.
Fri 24					
NZ	Apr trade balance \$m	922	300	300	Downside risk after surge in March exports.
US	Apr durable goods orders	2.6%	-2.0%	-	Underlying trend for investment soft.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018	2019f	2020f
Australia						
Real GDP % yr	2.5	2.8	2.4	2.8	1.8	2.2
CPI inflation % annual	1.7	1.5	1.9	1.8	1.8	1.6
Unemployment %	5.8	5.7	5.5	5.0	5.4	5.6
Current Account % GDP	-4.7	-3.1	-2.6	-2.1	-0.7	-2.0
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.4	2.1
Consumer Prices %yr	0.1	1.4	2.1	2.4	1.8	1.9
Unemployment Rate %	5.3	4.9	4.4	3.9	3.5	3.5
Current Account %GDP	-2.3	-2.3	-2.3	-2.6	-2.5	-2.4
Japan						
Real GDP %yr	1.2	0.6	1.9	0.8	0.7	0.6
Euro zone						
Real GDP %yr	2.1	2.0	2.4	1.8	1.2	1.4
United Kingdom						
Real GDP %yr	2.3	1.8	1.8	1.4	1.4	1.4
China						
Real GDP %yr	6.9	6.7	6.8	6.6	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	4.0	4.6	4.3	4.1	4.1
World						
Real GDP %yr	3.4	3.4	3.8	3.6	3.3	3.5

Forecasts finalised 10 May 2019

Interest Rate Forecasts	Latest	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Australia								
Cash	1.50	1.50	1.25	1.00	1.00	1.00	1.00	1.00
90 Day BBSW	1.55	1.60	1.55	1.40	1.40	1.40	1.40	1.40
10 Year Bond	1.64	1.70	1.80	1.80	1.80	1.80	1.85	1.90
International								
Fed Funds	2.375	2.375	2.375	2.375	2.375	2.375	2.375	2.375
US 10 Year Bond	2.38	2.50	2.65	2.70	2.65	2.60	2.55	2.55
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20	-0.10

Exchange Rate Forecasts	Latest	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/USD	0.6883	0.69	0.68	0.68	0.69	0.69	0.70	0.70
USD/JPY	109.65	112	113	113	112	111	110	110
EUR/USD	1.1177	1.11	1.10	1.10	1.11	1.12	1.14	1.15
GBP/USD	1.2792	1.31	1.32	1.33	1.33	1.33	1.34	1.34
AUD/NZD	1.0529	1.06	1.06	1.05	1.05	1.05	1.04	1.04

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