

# Weekly Commentary

23 October 2018



Glow Worm (*Arachnocampa Luminosa*)

## All gassed up

Consumer price inflation increased by more than expected in September, rising to an annual rate of 1.9%. That's much higher than the RBNZ was expecting, and it's likely that we'll see inflation push even higher over the next few quarters. Economic activity has also been firmer and the NZ dollar is lower. Against this backdrop, the chances of a near-term rate cut from the RBNZ have diminished. Nevertheless, interest rate hikes are still a long way off, with the Official Cash Rate set to remain on hold for some time yet.

Back in August there was a marked dovish lurch by the Reserve Bank. The RBNZ signalled that it expected to keep the Official Cash Rate at a low level for much longer than it had previously assumed. In addition, the accompanying policy statement and related media comments signalled that if activity and inflation did not firm as they expected, the OCR could be cut.

We took this signal from the RBNZ seriously, and based on economic conditions at the time we put the odds of a rate cut at one-in-three. However, we felt it was more likely that both inflation and economic activity would surprise to the upside of the RBNZ's downbeat near-term forecasts, and those conditions would prevent a cut. That is very much the way things have played out.

Looking first at inflation, the September quarter saw consumer prices rising by 0.9%, to be up 1.9% over the year. That was stronger than the 0.7% increase that we and other analysts were expecting. Importantly, it was well above the 0.4% rise that the RBNZ had factored into their August *Monetary Policy Statement* forecasts.

The biggest single contribution to September's rise in inflation was a 5.5% rise in petrol prices, reflecting a combination of higher international oil prices, a lower exchange rate, and the introduction of Auckland's regional fuel tax at the start of the quarter. We expect that fuel prices will remain elevated through the remainder of this year, and

that will push headline inflation above 2% over the next few quarters – two years sooner than the RBNZ was expecting.

From a monetary policy perspective, swings in inflation associated with gyrations in fuel prices are 'look through' events. Such price changes can reverse quickly and don't necessarily reflect underlying inflationary pressures. In addition, the related squeeze on households' disposable incomes can put a dampener on spending more generally.

What's more important for the Reserve Bank are changes in the economy's underlying inflation pulse and the broader strength of economic conditions. On the inflation front, we've previously highlighted some significant long-lasting factors that have been dampening prices in the retail sector, and those factors are continuing to limit the rise in overall inflation. However, with continued low interest rates and firm activity in recent years, we are now moving out of the very weak inflation environment that characterised the New Zealand economy for much of the past decade. Measures of underlying inflation have been trending higher over the past year (though most remain in the lower half of the RBNZ's 1 to 3% target range). In addition, the September quarter saw a stronger than expected increase in the more persistent non-tradables inflation components that are a key focus for monetary policy. This has left us with a picture of underlying inflation that, while still a bit below 2%, is gradually rising and is within the RBNZ's comfort zone.

# All gassed up continued

Looking at the economy more generally, the past few months have seen a number of stronger than expected developments. That includes a solid 1% rise in GDP in the June quarter, strong retail spending, and continuing firmness in dwelling consent numbers. And on top of those developments, the NZ dollar has taken a step down in recent months, which is helping to buffer export earnings and will support some lift in imported inflation.

To be fair, economic developments haven't all gone in one direction. Recent months have also seen falls in dairy prices, continued weakness in economic confidence, and increased volatility in the global backdrop. But on balance, the economic pulse has been firmer since the RBNZ last released its forecasts in August.

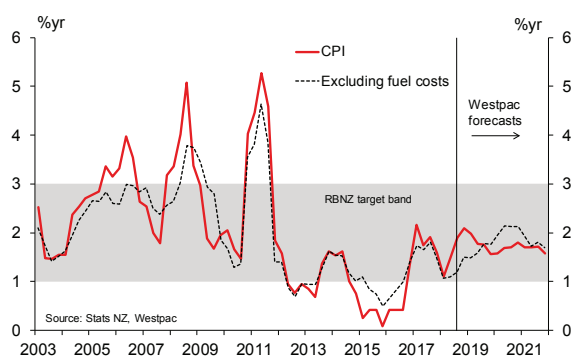
So what will the RBNZ make of all this? With inflation now close to target and some positive signs on the activity front, the chances of a rate cut over the coming year have fallen. Consistent with this, we expect that the upcoming November *Monetary Policy Statement* (due for release on 8 November) will be at least a bit less dovish than the August *Statement*. Financial markets have taken a similar view with the New Zealand dollar and swap rates rising after the CPI release.

We aren't completely dismissing the possibility of an OCR cut. As we've previously noted, the RBNZ's longer term GDP

forecasts look optimistic to us, and the new RBNZ Governor is likely to be highly attuned to downside surprises in growth and employment. Nevertheless, the odds of a cut are now much lower, especially in the near term.

With inflation now likely to push above 2% over the coming quarters, some might start questioning when the RBNZ will hike the OCR. We still think this is some way off, and expect that the RBNZ will remain on hold until May 2020. The RBNZ will want to be sure that we're not just looking at a temporary oil related rise, and that underlying inflation has come back to life.

## Inflation forecasts



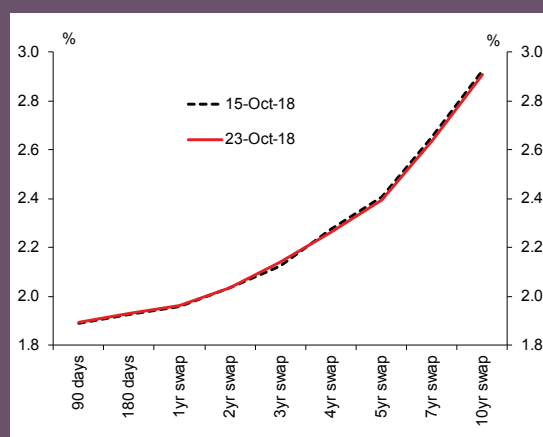
## Fixed vs Floating for mortgages

Fixed-term mortgage rates are currently falling, as the market adjusts to the Reserve Bank's softer stance. Looking further ahead, we expect floating and short-term fixed rates to rise gradually over the next few years, so taking a fixed rate may prove worthwhile once they have settled down.

One-year fixed rates are currently the lowest on offer, and appear to offer good value for borrowers. Longer-term fixed rates are high relative to where we think one-year fixed rates are going to go. 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



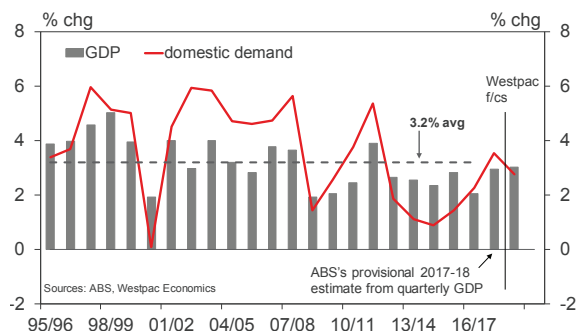
# The week ahead

## Aus 2017-18 national accounts

Oct 26, Current estimate: 2.9%

- Australia's economy expanded by 2.9% in 2017/18, as reported in the June quarter national accounts in full year on year growth terms with quarterly 'through the year' growth lifting to 3.4%.
- The annual national accounts provides new 'benchmark' estimates of income, expenditure, production and balance sheets with detailed sectoral and industry estimates. The accounts also include new estimates of the capital stock and of multi-factor productivity, which is likely to have seen weaker growth given the very strong gains in employment and hours worked in 2017.
- The annual accounts often see revisions. Last year GDP growth for 2016-17 was shaved back only marginally, from 2.1% to 2.0%. However, changes can be more material, also altering the composition of growth and its quarterly profile - the latter only becoming fully apparent with the Q3 GDP release (due Dec 3).

## Australia: annual economic performance

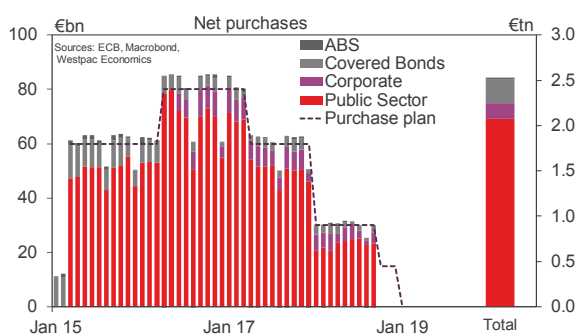


## Euro Area ECB policy decision

Oct 25, deposit rate: -0.4%, WBC f/c: -0.4%

- The September meeting contained an update to the ECB's macroeconomic projections which saw a slight downward revision in the growth outlook due to lower external demand. The growth forecasts for 2018 and 2019 were lowered by 0.1ppts, to 2.0% and 1.8%. This represents a quicker than anticipated return towards trend growth after 2017's outsized expansion. Core inflation was also lowered by 0.1ppt for 2019 and 2020, to 1.5% and 1.8%.
- At that time risks were seen as balanced with domestic economic strength a positive while US-China trade tariffs were seen as "a major source of uncertainty".
- Since that meeting, domestic fiscal uncertainty has been more apparent. A key focus of the press conference will be the ECB's view on the Italian budget as well as guidance on reinvestment after QE is scheduled to conclude come year-end.

## ECB asset purchase program - QE

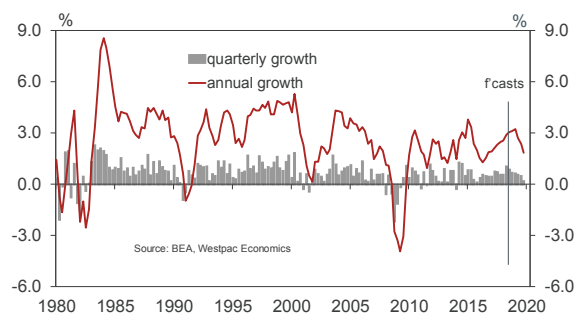


## US Q3 GDP

Oct 26, last: 4.2%, WBC f/c: 3.4%

- Q2 GDP for the US reset sentiment for the year, as the stellar 4.2% annualised gain made up for a weather-affected Q1. Taken together, growth has maintained a 3.2% annualised pace in 2018 to date, well above trend.
- This momentum is expected to persist in Q3, with the market expecting 3.2% growth, and Westpac 3.4%. In terms of the detail, the consumer trend remained robust through the quarter, though (at the margin) this momentum will be tempered by the turning down of residential construction. Regarding investment, the energy sector remains key, with this strength primarily showing up in structures investment. Equipment investment growth is likely to be more modest.
- Inventories and net exports consistently create significant volatility. In this instance however, we believe it will broadly be offsetting.

## US GDP to remain above trend into 2019



# Data calendar

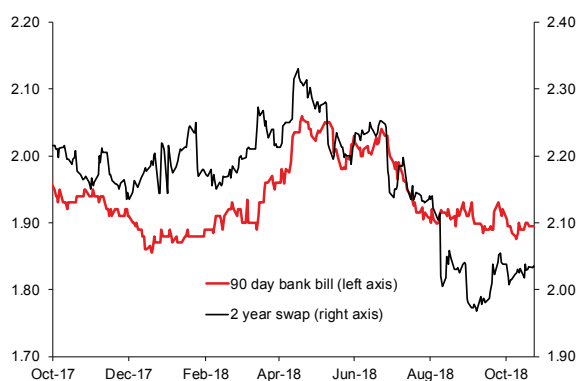
		Last	Market median	Westpac forecast	Risk/Comment
<b>Mon 22</b>					
<b>NZ</b>	Labour Day public holiday	-	-	-	Markets closed.
<b>Aus</b>	RBA Dep. Gov. Debelle speaks	-	-	-	Remarks at Walkley Bus. Journalism awards, Sydney 1:00 pm.
<b>US</b>	Sep Chicago Fed activity index	0.18	-	-	Above trend growth continuing.
<b>Tue 23</b>					
<b>Aus</b>	RBA Dep. Gov. Debelle speaks	-	-	-	ISDA Annual Australia Conference, Sydney 9:35 am.
	RBA Asst. Gov. Boulton speaks	-	-	-	On panel at Sibos conference, Sydney 12:30 pm.
	RBA Asst. Gov. Bullock speaks	-	-	-	On panel at Sibos conference, Sydney 2:00 pm.
	RBA Dep. Gov. Debelle speaks	-	-	-	On panel at Sibos conference, Sydney 3:30 pm.
<b>Eur</b>	Oct consumer confidence	-2.9	-	-	Receded from highs but still positive lower unemployment.
<b>US</b>	Oct Richmond Fed index	29	25	-	Regional surveys remain strong.
	Fedspeak	-	-	-	Kashkari at an education event.
<b>Wed 24</b>					
<b>Eur</b>	Oct Markit manufacturing PMI flash	53.2	-	-	Europe and other majors (ex US) slow...
	Oct Markit services PMI flash	54.7	-	-	... but note services PMI is holding up better in Europe.
	Sep M3 money supply %yr	3.5%	-	-	Credit data also released
<b>US</b>	Aug FHFA house prices	0.2%	0.3%	-	Momentum likely to soften given higher rates.
	Oct Markit manufacturing PMI flash	55.6	55.5	-	Not as strong as ISMs, but still robust.
	Oct Markit services PMI flash	53.5	54.0	-	Services benefitting from labour market strength.
	Sep new home sales	3.5%	-0.2%	-	Housing investment partials have clearly softened.
	Federal Reserve's Beige book	-	-	-	Conditions across the 12 districts.
	Fedspeak	-	-	-	George speaking on the US payments system in Sydney.
	Fedspeak	-	-	-	Bostic at energy summit in Baton Rouge.
	Fedspeak	-	-	-	Mester at Forecasters Club in NY.
<b>Thu 25</b>					
<b>NZ</b>	Sep trade balance, \$m	-1484	-1365	-1650	Seasonal low point, exacerbated by large plane imports.
<b>Eur</b>	ECB policy decision	-0.4%	-0.4%	-	On hold until after the Summer of 2019
<b>US</b>	Sep wholesale inventories	1.0%	-	-	Likely a material support in Q3.
	Sep durable goods orders	4.4%	-0.8%	-	Underlying trend robust, but a further acceleration uncertain.
	Initial jobless claims	-	-	-	Very low.
	Sep pending home sales	-1.8%	-0.5%	-	Supply of existing homes restricted.
	Oct Kansas City Fed index	13	-	-	Has fallen back in recent months.
	Fedspeak	-	-	-	Clarida on the economic outlook and monetary policy.
<b>Fri 26</b>					
<b>Aus</b>	2017-18 National Accounts	-	-	-	Annual accounts, additional information & potential revisions.
<b>US</b>	Q3 GDP	4.2%	3.2%	3.4%	Another strong outcome, with upside risk.
	Oct Uni. of Michigan sentiment	99.0	98.6	-	Households very happy.
	Fedspeak	-	-	-	Mester speaks to Money Marketeers in NY.
<b>Sat 27</b>					
<b>Chn</b>	Sep industrial profits %yr	9.2%	-	-	Chinese industry in a strong position.

# New Zealand forecasts

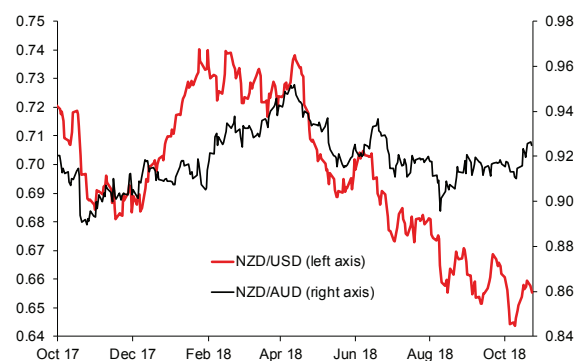
Economic Forecasts	Quarterly				Annual			
	2018			2019	2019			
% change	Jun (a)	Sep	Dec	Mar	2017	2018f	2019f	2020f
GDP (Production)	1.0	0.7	0.7	0.7	2.8	2.8	3.1	2.9
Employment	0.5	0.4	0.3	0.3	3.7	1.8	1.4	1.7
Unemployment Rate % s.a.	4.5	4.5	4.6	4.7	4.5	4.6	4.6	4.4
CPI	0.4	0.7	0.5	0.4	1.6	2.1	1.4	1.8
Current Account Balance % of GDP	-3.3	-3.5	-3.5	-3.2	-2.9	-3.5	-3.4	-2.9

Financial Forecasts	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20
Cash	1.75	1.75	1.75	1.75	1.75	1.75
90 Day bill	1.90	1.90	1.90	1.95	2.00	2.10
2 Year Swap	2.10	2.20	2.30	2.45	2.60	2.75
5 Year Swap	2.60	2.75	2.90	3.05	3.15	3.25
10 Year Bond	2.80	3.00	3.15	3.25	3.35	3.40
NZD/USD	0.66	0.65	0.64	0.64	0.65	0.65
NZD/AUD	0.92	0.92	0.91	0.91	0.90	0.90
NZD/JPY	75.2	74.1	72.3	71.7	72.8	72.2
NZD/EUR	0.57	0.57	0.57	0.56	0.56	0.55
NZD/GBP	0.52	0.53	0.52	0.52	0.53	0.53
TWI	72.4	71.6	70.6	70.4	70.8	70.8

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 23 October 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.82%	1.83%	1.83%
60 Days	1.86%	1.86%	1.86%
90 Days	1.90%	1.89%	1.92%
2 Year Swap	2.04%	2.02%	2.02%
5 Year Swap	2.40%	2.39%	2.40%

NZ foreign currency mid-rates as at 23 October 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6553	0.6444	0.6669
NZD/EUR	0.5712	0.5592	0.5676
NZD/GBP	0.5049	0.4908	0.5099
NZD/JPY	73.88	73.33	75.07
NZD/AUD	0.9250	0.9125	0.9184
TWI	72.13	70.77	72.44

# International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
<b>Australia</b>						
Real GDP % yr	2.5	2.6	2.2	3.3	2.7	2.8
CPI inflation % annual	1.7	1.5	1.9	1.7	1.8	1.6
Unemployment %	5.8	5.7	5.5	5.3	5.5	5.5
Current Account % GDP	-4.7	-3.1	-2.6	-2.5	-2.9	-3.8
<b>United States</b>						
Real GDP %yr	2.9	1.5	2.3	2.9	2.5	1.7
Consumer Prices %yr	0.1	1.4	2.1	2.5	2.0	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
<b>Japan</b>						
Real GDP %yr	1.4	0.9	1.7	1.1	0.8	0.7
<b>Euro zone</b>						
Real GDP %yr	2.1	1.8	2.5	2.0	1.5	1.5
<b>United Kingdom</b>						
Real GDP %yr	2.3	1.9	1.8	1.2	1.2	1.4
<b>China</b>						
Real GDP %yr	6.9	6.7	6.9	6.3	6.1	6.0
<b>East Asia ex China</b>						
Real GDP %yr	3.8	3.9	4.5	4.4	4.2	4.1
<b>World</b>						
Real GDP %yr	3.5	3.2	3.8	3.8	3.6	3.5

Forecasts finalised 5 October 2018

Interest Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
<b>Australia</b>								
Cash	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
90 Day BBSW	1.93	1.98	1.93	1.91	1.90	1.90	1.85	1.83
10 Year Bond	2.68	2.80	3.00	3.00	2.90	2.80	2.60	2.60
<b>International</b>								
Fed Funds	2.125	2.375	2.625	2.875	2.875	2.875	2.875	2.875
US 10 Year Bond	3.18	3.20	3.40	3.50	3.40	3.20	3.00	2.80
ECB Deposit Rate	-0.40	-0.40	-0.40	-0.40	-0.30	-0.20	0.00	0.20

Exchange Rate Forecasts	Latest	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Jun-20	Dec-20
AUD/USD	0.7109	0.72	0.71	0.70	0.70	0.72	0.74	0.75
USD/JPY	112.38	114	114	113	112	110	109	106
EUR/USD	1.1457	1.15	1.14	1.13	1.15	1.18	1.22	1.28
AUD/NZD	1.0832	1.09	1.09	1.09	1.09	1.11	1.12	1.10

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- (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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