Weekly Commentary

23 April 2019

Hundertwasser Toilets, Kawakawa

Should I stay or should I go?

With the Reserve Bank's May policy decision coming into sight, the next move in the Official Cash Rate remains a close call. We continue to expect a May rate cut. That's supported by the continued low level of inflation and softness in business sector indicators. However, the longer-term outlook for the economy is looking less worrying than it did a few months ago, especially given the recent news that there won't be a capital gains tax. That could have an important bearing on the RBNZ's thinking.

Inflation in New Zealand remains subdued. The March quarter Consumers Price Index revealed that inflation has slowed from 1.9% at the end of 2018 to 1.5% now. That was a little below our own and the RBNZ's forecast for a 1.6% result. Much of the decline in inflation was due to falls in petrol prices. But even smoothing through the normal quarter-to-quarter volatility, measures of the underlying trend in prices point to inflation of 1.5-1.7% – still short of the RBNZ's 2% medium-term target. In fact, inflation has essentially remained below 2% for the past seven years.

This ongoing softness in inflation is obviously of concern to the RBNZ. Even with the Official Cash Rate at a record low, domestic demand hasn't been strong enough to generate the pickup in inflation that they've been looking for. On top of that, some near-term indicators of business sector activity, including last week's Performance of Services Index and other recent surveys, are pointing to a cooling in growth through the first half of 2019.

Those concerns, along with nervousness around the global backdrop, saw the RBNZ shift its stance at the time of its March policy decision. In March, the RBNZ noted the next move in the cash rate was more likely to be down. That was a significant dovish lurch from its comments in previous months when it noted that the next move in the OCR could be up or down.

Given the lingering softness in inflation and signs of a cooling in near-term activity, we expect that the RBNZ will cut the cash rate by 25 basis points in May. That would take the OCR to a new record low of 1.50%. However, this is a close call. While the near-term picture is soft, the medium-term outlook is starting to look firmer than it did just a few weeks ago.

Looking first at the global front, much of the fear and loathing that rippled through financial markets earlier this year has now eased off. We still expect to see softness in some regions (particularly Australia). However, downward pressure on interest rates is helping to provide a floor under economic conditions in many economies. And in some of our major trading partners, like China, recent data actually points to a firming in activity.

While the global backdrop is looking a bit more positive to us, we're not so certain that the Reserve Bank will have come to the same conclusion. There's a natural conservativism among central bankers, including those at the RBNZ, meaning that they are more attuned to downside news on the global front than upside developments. The RBNZ is also mindful of the upside risks for the NZ dollar if overseas central banks remain on a more dovish track.

On the domestic front, it's true that a number of business sector indicators are pointing to a near-term cooling in

Should I stay or should I go?

growth. But bubbling below the surface, there are also signs that domestic demand is firming. As we've noted before, large increases in government spending are now being rolled out. We've also seen signs that the earlier downshift in net migration and population growth could be less stark than feared. In addition, construction sector indicators are signalling another step higher in building activity this year.

On top of those developments, we've also just seen a major change in the stance of fiscal policy. Last week the Government cancelled its plan to introduce a capital gains tax. This was a centrepiece policy for the Labour Party. However, this issue has been highly divisive for New Zealand voters, and Labour wasn't able to convince their coalition partners in the NZ First Party to support the policy.

The potential introduction of a capital gains tax has had an important dampening impact on economic confidence in recent months. In our own forecast, we had assumed its introduction would be a significant drag on nationwide house price growth over the next few years (and that was assuming that the policy would be watered down from what was initially proposed). Now, with this policy not proceeding, and with mortgage rates at very low levels, there is a chance of some reacceleration in the housing market over the coming months, along with an associated pickup in household spending.

What the cancellation of capital gains tax means for the RBNZ is a little less clear. Its usual practice is not to incorporate policy changes until they have been confirmed. However, potential policy changes can still affect confidence levels, and might still shade the RBNZ's thinking about the outlook.

Putting all this together, the RBNZ will be looking at a softer near-term outlook for growth and inflation, but the outlook for 2020 won't look as worrying as it did when it last reviewed the cash rate. Although we expect a cut, recent developments could see them standing pat in May.

The final piece of the puzzle will be the March quarter labour market data (due for release on 1 May). If that reveals a lift in the unemployment rate, the RBNZ is likely to feel more comfortable cutting in May. On that front, there has been a further pickup in the number of people on jobseeker benefits in the early part of 2019.

If the RBNZ doesn't cut rates in May, there's a chance that the door will be closed for the remainder of 2019. Through the second half of this year, we expect that the firming in the global economy will be more obvious. We also expect to see an improvement in the domestic data pulse, particularly in the household sector.

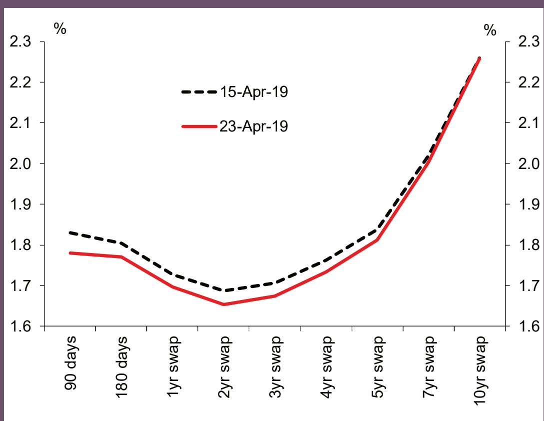
Fixed vs Floating for mortgages

Fixed mortgage rates have fallen recently, but they could fall even further in the near future. If the RBNZ cuts the OCR in May, fixed rates may drop again at that time.

We expect floating and one-year fixed mortgage rates to fall over the next year, but to gradually rise again in subsequent years. Based on that expectation, we regard three-year rates at the best on offer at present. One- and two-year rates are also fairly good value, with neither particularly preferred to the other.

Four- and five-year fixed rates have fallen sharply, but they still look high relative to where we expect shorter-term rates to go over those timeframes. Floating mortgage rates are expensive for borrowers, but they may be the preferred option for those who require flexibility in their repayments.

NZ interest rates



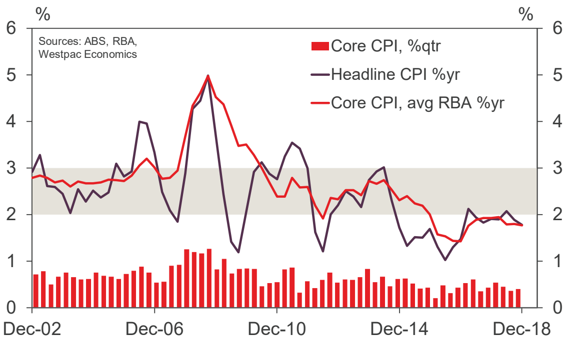
The week ahead

Aus Q1 Consumer Price Index

Apr 24, Last: 0.5%, WBC f/c: 0.1%
Mkt f/c: 0.2%, Range: 0.0% to 1.0%

- Consumer inflation undershot the RBA's 2-3% target band in 2018. Headline inflation was 1.8%, including a 0.6% rise in Q4. Core inflation for Q4 printed at 0.4%qtr, 1.8%yr.
- Key to this lack of price pressure are: weak wages growth; a housing downturn; sluggish consumer spending; and intense retail competition. While the AUD has weakened the pass through of higher import prices to consumers is limited.
- For the March quarter, we expect headline inflation of only 0.1%qtr 1.4%yr. Additional forces at work in the period are: retreating fuel prices, subtracting 0.2ppts (after adding 0.1ppt in Q4); and a seasonally soft quarter (-0.2ppts).
- Core inflation is expected to be soft, at 0.3%qtr, moderating to 1.6%yr. This follows a couple of quarters at 0.4%.

CPI inflation: below the target band

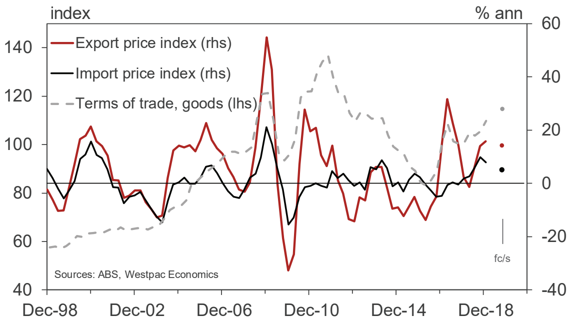


Aus Q1 import price index

Apr 26, Last: 0.5%, WBC f/c: -0.8%
Mkt f/c: 0.4%, Range: -1.0% to +0.8%

- Prices for imported goods rose by 7.8% in 2018, including a 0.5% lift in Q4. This increase in the cost of imports reflected the impact of the lower Australian dollar and higher global energy prices.
- For the March quarter, import prices are forecast to decline by 0.8% (with the risk of a more modest decline).
- Key to the expected fall for Q1 is the oil price - which corrected sharply lower after a strong run.
- The Australian dollar fell in the quarter - thereby placing upward pressure on the cost of imports. On a TWI basis, the Aussie fell by 2.2% in Q1, with a more modest decline against the US dollar, -0.8%.

Import & export goods prices

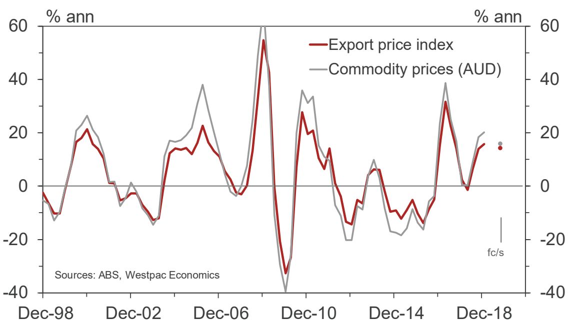


Aus Q1 export price index

Apr 26, Last: 4.4%, WBC f/c: 3.5%
Mkt f/c: 3.5%, Range: 3.1% to 4.0%

- Export prices increased jumped by 15.7% in 2018, including a 4.4% rise in Q4, moving higher on rising commodity prices and a lower Australian dollar.
- For Q1, the export price index is forecast to rise by 3.5%.
- In the opening quarter of 2019, commodity prices advanced further, up by 4.5% in AUD terms. In addition, the currency fell against the US dollar, placing upward pressure on prices.
- The terms of trade for goods, on these estimates, increased by around 4.3% in the March quarter, extending the positive run for Australian national income growth.
- As to prices for services, an update will be available with the release of the Balance of Payments on June 4.

Commodity prices & export price index

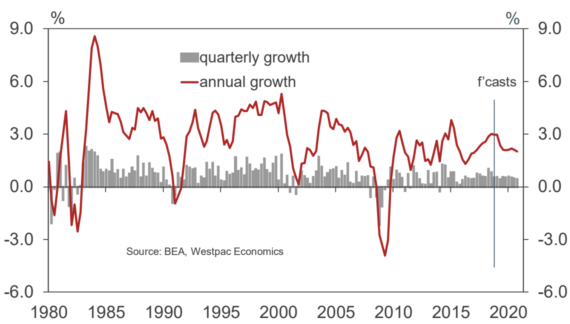


US Q1 GDP

Apr 26, Last 2.2%, WBC f/c: 2.2% annls'd

- US data at the turn of the year was disappointingly weak. However, as Q1 has rolled on, momentum has stabilised, and in some instances, begun to firm. As a result, we look for a gain in Q1 a touch above potential at 2.2% annualised
- Domestic final demand is likely to be a little weaker than the headline print, circa 2.0% annualised. Supporting this outcome will be subdued gains for the consumer and business investment, but strength in public demand.
- As the year rolls on, the consumer pulse is expected to hold around the current level, but business investment will slow further. The recent decline in residential construction should abate, but this will only partly offset the loss of support from the public sector come Q4.

US GDP to remain above trend into 2019

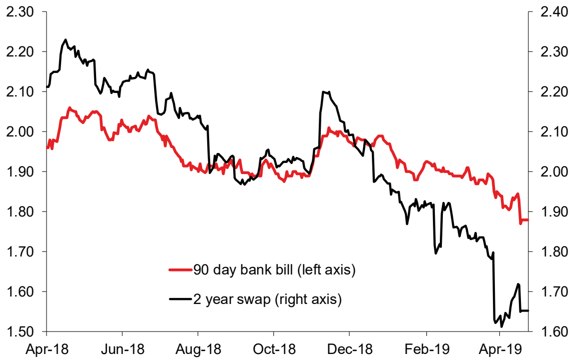


New Zealand forecasts

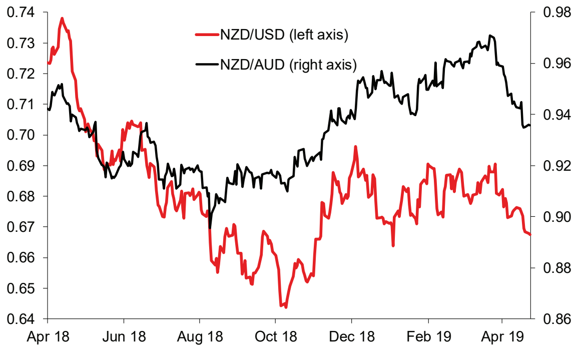
Economic Forecasts	Quarterly				Annual			
	2018	2019						
% change	Dec (a)	Mar	Jun	Sep	2018	2019f	2020f	2021f
GDP (Production)	0.6	0.5	0.8	0.8	2.8	2.5	2.8	2.0
Employment	0.1	0.2	0.3	0.4	2.3	1.2	1.6	1.3
Unemployment Rate % s.a.	4.3	4.4	4.4	4.2	4.3	4.2	4.0	4.0
CPI	0.1	0.1	0.4	0.7	1.9	1.5	2.1	2.1
Current Account Balance % of GDP	-3.7	-3.3	-3.1	-3.0	-3.7	-2.8	-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	1.25	1.25
90 Day bill	1.60	1.60	1.60	1.50	1.40	1.40
2 Year Swap	1.50	1.50	1.60	1.60	1.50	1.50
5 Year Swap	1.70	1.75	1.85	1.85	1.85	1.85
10 Year Bond	1.80	1.85	1.90	1.85	1.85	1.90
NZD/USD	0.65	0.65	0.66	0.66	0.65	0.65
NZD/AUD	0.93	0.96	0.97	0.96	0.94	0.93
NZD/JPY	72.8	73.5	74.6	73.9	72.2	71.5
NZD/EUR	0.59	0.59	0.60	0.59	0.58	0.57
NZD/GBP	0.50	0.49	0.50	0.50	0.49	0.49
TWI	71.4	72.1	73.0	72.3	70.8	70.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 23 April 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.84%	1.85%	1.86%
60 Days	1.81%	1.83%	1.88%
90 Days	1.78%	1.82%	1.90%
2 Year Swap	1.65%	1.65%	1.79%
5 Year Swap	1.81%	1.83%	1.88%

NZ foreign currency mid-rates as at 23 April 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6675	0.6733	0.6873
NZD/EUR	0.5927	0.6002	0.6085
NZD/GBP	0.5141	0.5163	0.5208
NZD/JPY	74.71	75.22	75.49
NZD/AUD	0.9358	0.9477	0.9703
TWI	72.65	73.28	74.70

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Tue 23					
Eur	Apr consumer confidence advance	–7.2	–6.9	–	Has steadied in recent months.
US	Feb FHFA house prices	0.6%	–	–	Price growth has slowed of late.
	Apr Richmond Fed index	10	10	–	Regional surveys positive albeit volatile.
	Mar new home sales	–2.6%	4.9%	–	Lower rates should aid construction in time.
Wed 24					
Aus	Q1 CPI	0.5%	0.2%	0.1%	A soft print, on: falling fuel prices; weakness in housing;
	Q1 CPI %yr	1.8%	1.5%	1.4%	a seasonally soft qtr; & retail competition. Annual headline
	Q1 core CPI (avg RBA measures)	0.4%	0.4%	0.3%	slows from 1.8% to 1.4%, while core slows from 1.8% to 1.6%.
UK	Mar public sector borrowing £bn	0.6	–	–	Borrowing requirements more moderate than expected.
Thu 25					
NZ/AU	ANZAC Day public holiday	–	–	–	Markets closed.
US	Initial jobless claims	–	–	–	Very low.
	Mar durable goods orders	–1.6%	0.5%	–	Underlying business trend soft.
	Apr Kansas City Fed index	10	–	–	Regional surveys positive albeit volatile.
Fri 26					
NZ	Apr ANZ consumer confidence	121.8	–	–	Households have been highlighting concerns about living costs.
	Mar trade balance $mn	12	131	400	Improving dairy export prices and volumes.
Aus	Q1 import price index	0.5%	0.4%	–0.8%	Mixed in Q1. Up on lower AUD, but offset by falling fuel prices.
	Q1 export price index	4.4%	3.5%	3.5%	Export prices up on higher commodity prices
	Q1 PPI	0.5%	–	–	Falling global energy costs to dent producer prices.
US	Q1 GDP	2.2%	1.8%	2.2%	A subdued start to 2019 anticipated.
	Apr Uni. of Michigan sentiment	–	–	–	Confidence remains robust.
Sat 27					
Chn	Mar industrial profits %yr	–	–	–	Income growth the basis for China development.

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	5.5	5.7
Current Account % GDP	-4.7	-3.1	-2.6	-2.1	-0.9	-2.2
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	0.8	0.7
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	1.2	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	4.5	4.4	4.2	4.3
World						
Real GDP %yr	3.4	3.4	3.8	3.6	3.5	3.5
Forecasts finalised 10 April 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	1.69	1.80	1.55	1.40	1.40	1.40	1.40	1.40
10 Year Bond	1.94	1.85	1.75	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	2.57	2.60	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	0.7180	0.70	0.68	0.68	0.69	0.69	0.70	0.70
USD/JPY	111.90	112	113	113	112	111	110	110
EUR/USD	1.1290	1.11	1.10	1.10	1.11	1.12	1.14	1.15
GBP/USD	1.3040	1.31	1.32	1.33	1.33	1.33	1.34	1.34
AUD/NZD	1.0690	1.06	1.05	1.03	1.05	1.06	1.08	1.08

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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