

Weekly Commentary

5 November 2018



Glow Worm (*Arachnocampa Luminosa*)

Much ado about little

Financial media in New Zealand has been abuzz with stories of falling equity prices in the US and falling house prices in parts of Australia. The implication is that New Zealand will be affected. We find that idea far too simplistic.

There will be very little direct impact on the New Zealand economy from either falling US share prices or falling Australian house prices. New Zealanders are not big owners of Australian property, international equities, or even New Zealand equities, so there won't be much in the way of a wealth effect. We've seen claims that New Zealand house prices tend to follow Australia's, but these are simply untrue – the two countries often experience distinct housing cycles. When we prepare our forecast of New Zealand GDP growth for our next quarterly *Economic Overview*, neither US equity prices nor Australian house prices will be major factors in our thinking.

That said, what is happening in the US and Australia does serve as a warning of sorts for New Zealand. It is probable that in the future New Zealand will suffer parallel situations for parallel reasons.

In the United States, the strong economy is generating fears of inflation, and consequent fears of higher interest rates. When interest rates rise, investors tend to find bonds more attractive. Consequently, they demand a higher rate of return before investing in equities – which can only be achieved by paying a lower price in the first place. Share prices in the US have been weaker this year mainly due to rising interest rates.

The parallel for New Zealand would be house and farm prices falling when local interest rates eventually rise.

The key reason that New Zealand house and farm prices have risen in recent years is record-low mortgage rates, which made it cheaper to borrow and made other forms of saving, such as term deposits, less attractive. Our analysis suggests that when New Zealand interest rates rise, house and farm prices will fall.

That would certainly be serious for the New Zealand economy. Kiwis have an extremely high proportion of their wealth tied up in houses and farms, and tend to consume less when the prices of those assets fall. A house and farm price downturn would also hit the economy via the banking system. A high proportion of bank loans in New Zealand are secured over property. When banks see their security buffers eroding, they tend to become less keen to lend to productive parts of the economy, which crimps growth.

But any likelihood of rising interest rates impacting New Zealand asset prices is years away, and is not a factor in the very near-term outlook. In fact, New Zealand recently experienced a *drop* in fixed mortgage rates which we expect will *boost* house prices in the immediate future.

Declining house prices in parts of Australia have been more to do with regulation. Bank lending standards have tightened at the regulator's behest. This has reduced households' access to credit, leaving them less able to pay for property. At the same time, changing rules are making it more difficult for foreign buyers to purchase property in

Much ado about little continued

Australia. Together, these two factors have been important drivers of Australia's housing market downturn.

New Zealand's housing market could well be affected by similar drivers in the future. New Zealand has recently introduced a foreign buyer ban. That probably is an imminent negative for New Zealand's housing market, and will suppress Auckland house prices in particular.

New Zealand could be affected by Australia's tighter banking regulations, because the biggest New Zealand banks are all wholly owned subsidiaries of Australian parents. But we are expecting the Reserve Bank of New Zealand to loosen its LVR mortgage lending restrictions when it delivers its next Financial Stability Report on 28 November. New Zealand banks could soon be *loosening* their lending standards, not *tightening* them. So credit conditions are more likely to boost the housing market in the near term, rather than constrain it.

A third factor affecting Australia's housing market has been a lift in mortgage rates independent of the Reserve Bank of Australia. This followed a lift in funding costs for Australia's banks. Again, New Zealand is currently experiencing falling mortgage rates, not rising. New Zealand has not experienced a lift in bank funding costs to anything like the same degree as Australia. So while this is something for New Zealand to watch, it is not a factor in the immediate outlook.

Weighing the near-term positives against the near-term negatives, we remain very comfortable with our view that New Zealand's housing market and economy will pick up a little in the very near term. However, further in the future we do expect an extended episode of falling house prices that will crimp consumer spending and therefore slow the economy. Rising mortgage rates and changing tax policy will eventually come to bear on house prices. But that expected downturn will be for local reasons and on New Zealand's own timetable, not simply because we are destined to follow other countries.

The coming week will be critical for financial markets. We expect the September quarter labour market surveys, released on Wednesday, to register another small rise in unemployment, from 4.5% to 4.6%. The labour market is cooling a little following the economic slowdown that occurred over 2017.

The following day, the Reserve Bank will release its November *Monetary Policy Statement*. We expect the Reserve Bank to acknowledge the recent run of strong economic and inflation data in the detail of the document, and by lifting the OCR forecast slightly. However, we expect the RBNZ to stick to the same broad outlook for monetary policy, including retaining the key line that the next move in the OCR could be "up or down." Such a slightly hawkish *Statement* would produce only a minor upward move in swap rates and the NZ dollar.

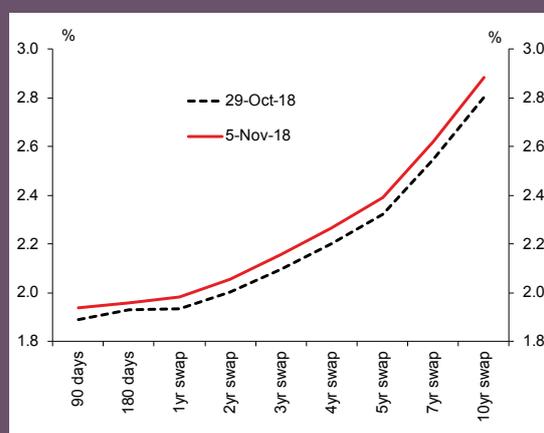
Fixed vs Floating for mortgages

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

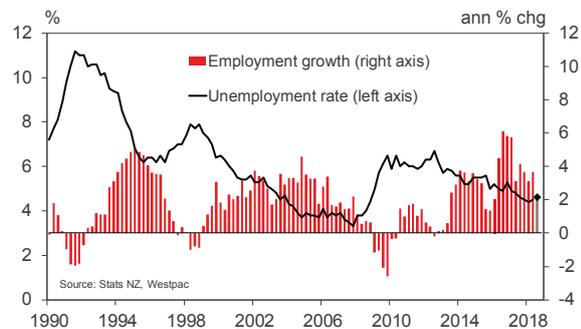
NZ Q3 Household Labour Force Survey

Nov 7, Employment change, Last: +0.5%, WBC f/c: 0.5%
Mkt f/c: 0.5%, Range: 0.3% to 0.7%

Unemployment rate, Last: 4.5%, WBC f/c: 4.6%
Mkt f/c: 4.5%, Range: 4.4% to 4.6%

- We expect the September quarter survey to show a small rise in the unemployment rate for the second quarter in a row. A modest 0.5% rise in employment would see annual growth slow to 2%.
- Recent indicators of labour demand have been mixed. Business confidence surveys have shown a sharp drop in hiring intentions, but job advertisements have continued to grow, albeit at a slower pace.
- A rise in the unemployment rate would be unwelcome for the Reserve Bank, given its recently-added focus on maximum sustainable employment. However, there will be little time to consider the results before the *Monetary Policy Statement*.

Household Labour Force Survey

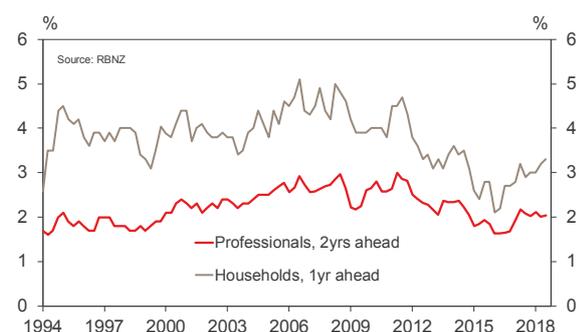


NZ Q3 RBNZ survey of inflation expectations

Nov 7, Two years ahead, last: 2.04%

- Since the last RBNZ survey of expectations, we've seen GDP growth surprising to the upside, a larger than expected increase in consumer price inflation and widespread public attention on petrol prices. More generally, businesses are highlighting upside pressure on prices and costs.
- The RBNZ's two year ahead inflation expectations measure (the most closely watched of the gauges the RBNZ puts out) tends to be more stable than other measures of expectations due to its longer-term focus. However, with signs of growing pressure on costs and other positive data in recent months, the risks are tilted towards at least some increase.

RBNZ survey of inflation expectations

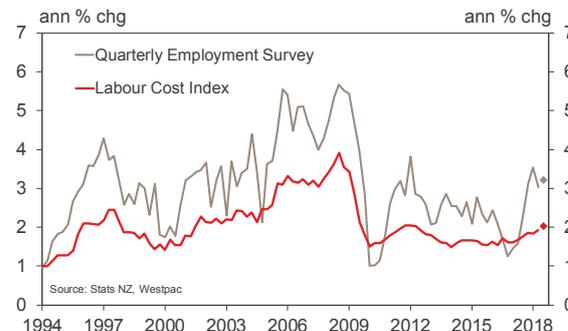


NZ Q3 Labour Cost Index

Nov 7, Private sector last: 0.6%, WBC f/c: 0.6%
Mkt f/c: 0.5%, Range: 0.4% to 0.7%

- We are expecting a 0.7% rise in the Labour Cost Index for all sectors, with private sector growth of 0.6%. In both cases this amounts to annual growth of 2%.
- Wage growth this quarter will be boosted by the first stage of the nurses' pay agreement, with a 6% increase that covers about 1% of the total workforce. We'll also see the second stage of the pay equity settlement for aged care workers, though the impact is much smaller than in the first stage a year ago.
- The June quarter survey showed early signs of a pickup in private sector wage growth. However, the LCI tends to evolve very slowly, which makes it difficult to judge whether there has been a genuine change in the trend.

LCI and QES salary and wages, all sectors



NZ RBNZ Official Cash Rate and Monetary Policy Statement

Nov 8, Last 1.75%, WBC f/c: 1.75%, Mkt: 1.75%

- We expect the RBNZ will leave the OCR on hold at 1.75% at its November meeting. However, as activity and inflation developments have been stronger than the RBNZ expected, the accompanying policy statement will be at least a little more hawkish than the August missive (though any change will be minor and will be confined to the details of the document).
- We expect the RBNZ to stick to the same broad monetary policy outlook, including restating the all-important phrase that the next move in the OCR could be "up or down" and that it "intends to keep the OCR at an expansionary level for a considerable period."
- The RBNZ's August OCR forecast was flat at 1.8%, before starting to rise in September 2020. That putative date for OCR rises could be brought forward by one or two quarters.

RBNZ Official Cash Rate



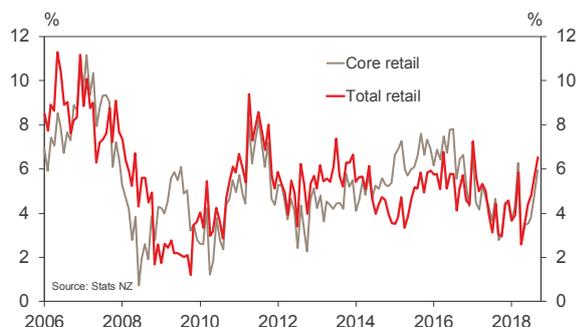
The week ahead

NZ Oct retail card spending

Nov 9, Last: +1.1%, WBC f/c: +0.5%

- Retail spending levels rose by a solid 1.1% in September, following a similar sized gain in August. Those gains were underpinned by increased spending on consumables (e.g. groceries), as well as firm spending on durables. Spending levels have been boosted by the Government's Families Package, which has added to the disposable incomes of many households.
- We expect more modest spending growth in October and are forecasting a 0.5% gain in the month. While the lift in disposable incomes has added to the level of spending, higher fuel prices are limiting increases in discretionary expenditure in core categories.

Card transactions, annual % change



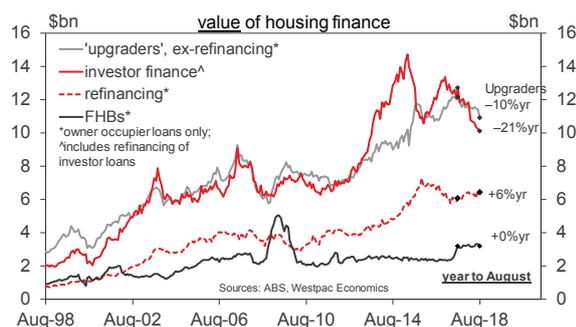
Aus Sep housing finance (no.)

Nov 9, Last: -2.1%, WBC f/c: -1.0%

Mkt f/c: -1.0%, Range: -2.2% to 0.5%

- Housing finance approvals continued to soften in August. The headline number of owner occupier loans fell 2.1% to be down -10.2%/yr. The value of investor loans was also lower, down 1.1% to be 20.5% lower over the year (an estimated -26% ex refi).
- The September update is likely to be another weak one. Housing markets continued to correct in the month, auction clearance rates again moving lower and prices slipping across all major cities. Industry data points to a 1% dip in the number of finance approvals with a more substantive fall in the value of approvals suggesting a significant reduction in average loan size, in turn reflecting a reduction in assessments of borrowing capacity. The value of investor loans will again be of interest.

Value of finance approvals by segment



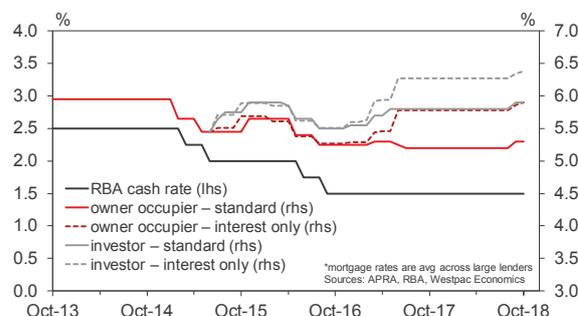
Aus Nov RBA policy decision

Nov 6, Last: 1.50%, WBC f/c: 1.50%

Mkt f/c: 1.50%, Range: 1.50% to 1.50%

- The RBA will again hold rates unchanged at their November meeting, as they have since they last cut rates in August 2016. The Governor's decision statement will repeat the line that: "further progress in reducing unemployment and having inflation return to target is expected, although this progress is likely to be gradual". We expect the RBA cash rate to remain unchanged at 1.50% throughout 2018, 2019, and during 2020.
- This month's decision will be followed by the release of updated commentary and forecasts with the RBA's Statement on Monetary Policy on Nov 9. We expect the Bank to retain its upbeat 3.25% growth forecasts for both 2018 and 2019 with no change to its trajectory for inflation. But a lower starting point is likely to lower the forecast profile for the unemployment rate.

RBA cash rate and mortgage interest rates

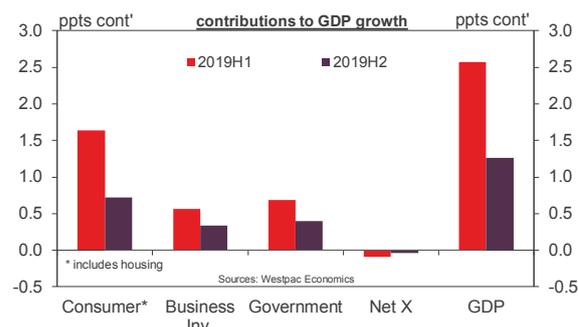


US November FOMC meeting

Nov 7-8, last 2.125%, WBC 2.125%

- The FOMC has persistently focused on the US' own real economy in 2018. As a result, their belief in a continued 'gradual normalisation' of monetary policy has remained resolute.
- Come the November meeting, there is no reason to expect a material change in view, though rates will not be raised. Employment growth has remained strong, so too GDP.
- The nascent evidence of interest rate sensitive sectors coming under pressure is unlikely to concern the Committee at this stage with policy still seen as accommodative. This is also true of recent market declines as equities remain at elevated levels.
- For the FOMC, next week's mid-terms have little to no immediate significance. Fiscal policy will become an issue from mid-to-late 2019, as support for growth fades.

US' current momentum to persist into H1 2019

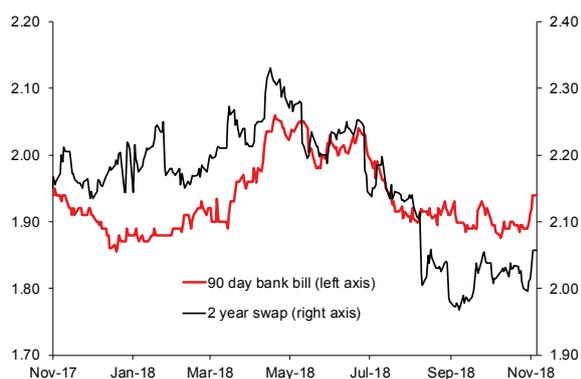


New Zealand forecasts

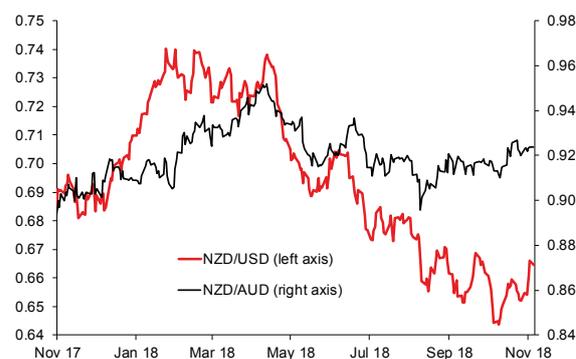
Economic Forecasts	Quarterly				Annual			
	2018			2019				
% change	Jun (a)	Sep	Dec	Mar	2017	2018f	2019f	2020f
GDP (Production)	1.0	0.7	0.7	0.7	2.8	2.8	3.1	2.9
Employment	0.5	0.4	0.3	0.3	3.7	1.8	1.4	1.7
Unemployment Rate % s.a.	4.5	4.5	4.6	4.7	4.5	4.6	4.6	4.4
CPI	0.4	0.7	0.5	0.4	1.6	2.1	1.4	1.8
Current 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	2.50	2.70	2.90	3.05	3.15	3.25
10 Year Bond	2.70	2.90	3.10	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 5 November 2018

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.75%	1.75%	1.75%
30 Days	1.85%	1.82%	1.83%
60 Days	1.90%	1.86%	1.86%
90 Days	1.94%	1.90%	1.89%
2 Year Swap	2.06%	2.04%	2.02%
5 Year Swap	2.39%	2.40%	2.39%

NZ foreign currency mid-rates as at 5 November 2018

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6645	0.6553	0.6444
NZD/EUR	0.5827	0.5712	0.5592
NZD/GBP	0.5094	0.5049	0.4908
NZD/JPY	75.19	73.88	73.33
NZD/AUD	0.9238	0.9250	0.9125
TWI	72.71	72.13	70.77

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 05					
NZ	Oct ANZ commodity price index	-1.8%	-	-	Weaker NZD offsetting softer world prices.
Aus	Oct AiG PSI	52.5	-	-	Services expanding, led by business segments.
	Oct MI inflation gauge	2.1%	-	-	Held around 2% over 2018.
	Oct ANZ job ads	-0.8%	-	-	Have been weaker than other leading indicators.
Chn	Oct Caixin China PMI services	53.1	52.8	-	NBS variant showed weakness in employment a risk.
	Q3 current account balance \$bn	5.3	-	-	Detail on financial flows.
Eur	Nov Sentix investor confidence	11.4	8.8	-	Cooled back towards trend.
	ECB VP Guindos speaks	-	-	-	In Brussels at event on managing financial crises.
UK	Oct Markit services PMI	53.9	53.4	-	Continues to point to moderate growth.
US	Oct Markit services PMI final	54.7	54.7	-	Manufacturing measures...
	Oct ISM non-manufacturing	61.6	59.4	-	... have cooled somewhat, will services follow.
Tue 06					
Aus	RBA policy decision	1.5%	1.5%	1.5%	On hold – see page 2 for discussion.
Eur	Oct Markit services PMI final	53.3	53.3	-	Flash eased. Level still positive.
	ECB Praet speaks	-	-	-	In Brussels at event on managing financial crises
US	Sep JOLTS job openings	7136	-	-	Hires; fires; quits; and job openings.
	Mid-term elections	-	-	-	Democrats expected to take back the House.
Wed 07					
NZ	GlobalDairyTrade auction	-0.3%	-	-	Little change expected.
	Q3 unemployment rate	4.5%	4.5%	4.6%	Jobseeker benefit numbers have picked up...
	Q3 employment	0.5%	0.5%	0.5%	... indicators of labour demand point to modest jobs growth.
	Q3 LCI wages inflation prv. sector	0.6%	0.5%	0.6%	Signs private sector wage growth is firming.
	RBNZ 2 year ahead inflation exps.	2.04%	-	-	Inflation has firmed, businesses reporting rising cost.
Chn	Oct foreign reserves \$bn	3087.03	-	-	Have been fairly stable of late.
UK	Oct Halifax house prices	-1.4%	-	-	Economic uncertainty weighing on prices, esp. in London.
Thu 08					
NZ	RBNZ Official Cash Rate	1.75%	1.75%	1.75%	Statement to be a little more hawkish after recent firmer data.
Chn	Oct trade balance \$bn	31.7	-	-	US/ China balance the focus.
	Oct foreign direct investment %oyr	8.0%	-	-	Not closely watched.
UK	Oct RICS house price balance	-2%	-	-	Weakness centred on London.
US	Sep consumer credit	20.1	16.0	-	Auto loans in focus.
	Initial jobless claims	214k	-	-	Very low.
	FOMC policy decision, midpoint	2.125%	2.125%	-	Positive tone expected despite uncertainties.
Fri 09					
NZ	Oct retail card spending	1.1%	-	0.5%	Rising fuel prices restraining broader spending growth.
Aus	RBA Statement on Monetary Policy	-	-	-	Updated forecasts key focus – see page 2 for a discussion.
	Sep housing finance	-2.1%	-1.0%	-1.0%	Headline is # of owner occupier loans. Other detail weaker.
Chn	Oct PPI %oyr	3.6%	-	-	Commodities driving upstream price pressures...
	Oct CPI %oyr	2.5%	-	-	... but these are not feeding through to the consumer.
UK	Q3 GDP	0.4%	0.5%	0.7%	While activity indicators have flattened off...
	Sep trade balance, £b	-1274	-1468	-	...the Sept quarter as a whole is set to post solid growth...
	Sep industrial production	0.2%	0.1%	-	...following firm gains in the summer months...
	Sep construction output	0.3%	-	-	...including strength in services.
US	Oct PPI	0.2%	0.2%	-	Tariffs yet to have a meaningful effect.
	Nov Uni. of Mich. sentiment prel.	98.6	97.9	-	Strong.
	Sep wholesale inventories	0.8%	-	-	Volatile.
	Fedspeak	-	-	-	Quarles discusses financial regulation in Washington.

International forecasts

Economic Forecasts (Calendar Years)	2015	2016	2017	2018f	2019f	2020f
Australia						
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
United States						
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
Japan						
Real GDP %yr	1.4	0.9	1.7	1.1	0.8	0.7
Euro zone						
Real GDP %yr	2.1	1.8	2.5	2.0	1.5	1.5
United Kingdom						
Real GDP %yr	2.3	1.9	1.8	1.2	1.2	1.4
China						
Real GDP %yr	6.9	6.7	6.9	6.3	6.1	6.0
East Asia ex China						
Real GDP %yr	3.8	3.9	4.5	4.4	4.2	4.1
World						
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
Australia								
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	2.66	2.65	2.80	2.90	2.90	2.80	2.60	2.60
International								
Fed Funds	2.125	2.375	2.625	2.875	2.875	2.875	2.875	2.875
US 10 Year Bond	3.14	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	0.7198	0.72	0.71	0.70	0.70	0.72	0.74	0.75
USD/JPY	112.67	114	114	113	112	110	109	106
EUR/USD	1.1402	1.15	1.14	1.13	1.15	1.18	1.22	1.28
AUD/NZD	1.0812	1.09	1.09	1.09	1.09	1.11	1.12	1.10

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