

Weekly Commentary

12 August 2019



Cardboard Cathedral, Christchurch

A week to remember

Last week was a massive one for New Zealand economic news. The US-China trade war entered a troubling new phase, the local jobs market defied expectations of a slowdown, and the Reserve Bank delivered a surprisingly large interest rate cut.

The week kicked off with China retaliating to the latest US tariff move in a range of ways, including a devaluation of its currency. It is becoming clearer that the trade wars are going to impact Chinese demand for New Zealand products. We were not surprised, then, to see a decline in dairy prices in last week's GlobalDairyTrade auction. We have now reduced our forecast of this season's farmgate milk price payment to \$6.70/kg milk solids, on the expectation that Chinese demand for milk will falter. At the start of the year our forecast was \$7.20/kg, so we've gone from expecting a strong dairy season to an average one. The other key area of fallout is going to be export log prices, which already fell 25% in June. We anticipate further price decline given what is happening in China.

The second key development was a surprise drop in the unemployment rate to an eleven-year low of 3.9%. That's tight, but not extreme by New Zealand standards – unemployment got into the low 3s in the mid-2000s. This was no data aberration – Stats NZ's suite of labour market indicators was strong almost across the board. Employment growth was a healthy 0.8% according to the Household Labour Force Survey, and the Quarterly Employment Survey (QES) was similarly robust.

Wage growth clearly accelerated on all measures, with the Labour Cost Index registering 0.7% quarterly and 2.1% annual growth, the fastest since the GFC. Much of that was a product of the 7.3% increase in the minimum wage, but

not all. We are finally seeing signs that wage inflation more generally is warming, albeit gradually.

The labour market may have gotten quite tight, but it is a lagging indicator. Forward-looking data such as job ads tells us that the labour market will soon weaken – we expect the unemployment rate to rise over the remainder of this year, although it won't get particularly high.

The final shock of the week was the biggest – the Reserve Bank lowered the OCR by 50 basis points to 1.0%. In the history of the OCR, the only meetings at which the OCR has been cut by more than 25 basis points have been after the 9/11 terrorist attack, during the most alarming days of the Global Financial Crisis, and immediately after the Christchurch earthquake. It was strange to cut 50 basis points in today's non-emergency environment, especially given the on-hold decision that was made just six weeks previously. We think two 25 basis point moves would have been better – cutting by 50 points had an unnecessary whiff of panic to it.

The RBNZ's thinking is to get ahead of the curve, delivering all of the monetary easing that it deems necessary at once. There was no explicit signal of another imminent cut. On that basis, we doubt that the RBNZ will cut the OCR in September.

But we have learned just how reactive the new Monetary Policy Committee is to downside economic developments.

A week to remember

And we expect that there will be further downside news in the months ahead. The recent escalation of the trade war could cause New Zealand export commodity prices to fall, there is a good chance that GDP will undershoot the RBNZ's optimistic near-term forecasts of 0.6% and 0.7% over the final two quarters of this year, and there is always the chance of another alarming Presidential tweet. We have concluded that the RBNZ is quite likely to reduce the OCR again at the November *Monetary Policy Statement*, to a new low of 0.75%.

The detail of the Monetary Policy Statement was mostly unsurprising – the RBNZ is worried about the global outlook, and cognisant that the domestic economy has slowed. But there were a couple of details that stuck out.

First, the decline in the RBNZ's own survey of inflation expectations seems to have played a surprisingly strong role in the decision. Two-year ahead inflation expectations fell from 2.01% to 1.86%, although longer-term expectations were stable. This puts inflation expectations data firmly on the radar going forward, although the release timetable is unhelpful. The RBNZ will get the inflation expectations data early, but will release it publically only one day before the November 13 *Monetary Policy Statement*.

Second, the RBNZ has abandoned its previous forecast that house price inflation will accelerate to 5% due to

the cancellation of capital gains tax and the drop in mortgage rates. Nationwide house prices declined in the second quarter of this year. The RBNZ has concluded that government policies, slowing population growth, and ample construction activity are suppressing house prices, and will continue to do so.

We disagree with the RBNZ's conclusions on house price inflation. True, there are negative forces acting on the market at present, but our analysis suggests that the stimulus from falling mortgage rates will dominate. We were previously forecasting 7% house price inflation for next year, but the latest OCR cut is likely to lead to further mortgage rate declines, so the risk to our house price forecast is to the upside.

There have already been a number of straws in the wind suggesting we are on the right track. House sales data for June was very strong, and realestate.co.nz data revealed that the stock of unsold homes fell further in July. Last week Barfoot and Thompson, Auckland's largest real estate agency, reported a 10.4% seasonally adjusted lift in house sales for July, and a further sharp drop in unsold inventory. This week we get the July nationwide housing market data. At this stage all we expect to see is market turnover trending higher, although the data can be very volatile month to month so it will pay to interpret the results with caution.

Fixed vs Floating for mortgages

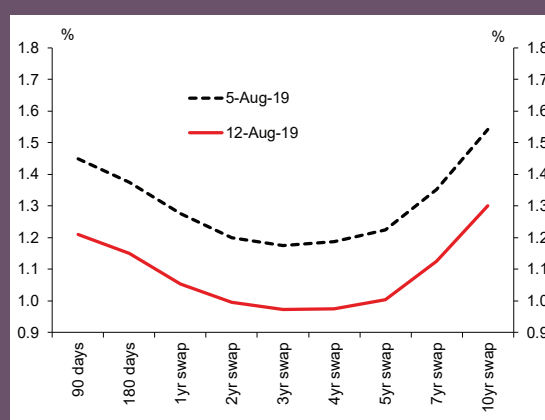
We expect the Reserve Bank to lower the OCR once more in November. If that is correct, both floating and fixed mortgage rates may fall further over the coming months. However, mortgage rates could rise again in the early 2020s.

Based on our OCR forecasts, three-year fixed mortgage rates seem the best value on offer today. However, opportunities to fix at an even lower rate might emerge over the coming month or two. Today's one- and two year rates are also fairly good value, with neither strongly preferred to the other.

Four- and five-year fixed rates are higher than where we expect shorter-term rates to go over the relevant timeframe, but longer-term fixed rates do offer insurance against the risk of future interest rate increases.

Floating mortgage rates are normally expensive for borrowers, but they may be the preferred option for those who require flexibility in their repayments.

NZ interest rates



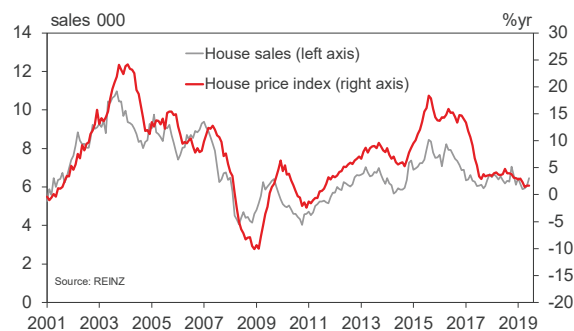
The week ahead

NZ Jul REINZ House Price Index

Aug 12 -16, Last: +0.3%

- With mortgage rates pushing downwards, there is a substantial amount of stimulus in the pipeline for the housing market. That's been reinforced by the cancellation of the proposed capital gains tax.
- Early signs that those factors are having the expected effect were seen in June, with house sales rising by just under 7% in seasonally adjusted terms. The number of sales is still down on a year ago, but is now clearly off its lows. Meanwhile, house prices remained fairly subdued, with another small decline in Auckland and continued modest gains in the rest of the country.
- We expect a continued firming in sales in July. Consistent with this, there has already been a drop in the number of unsold homes. A pickup in house price inflation should be more evident by year-end.

REINZ house prices and sales

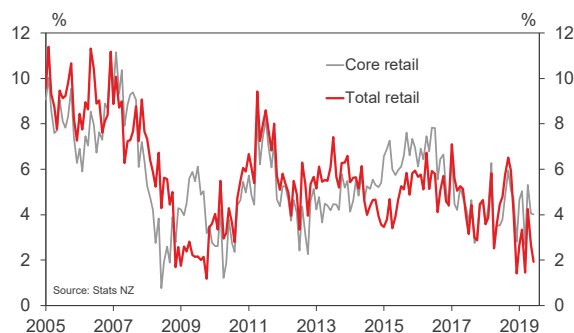


NZ Jul retail card spending

Aug 12, Last: Flat, WBC f/c: +0.6%

- Retail spending was flat in June. In part, that soft result was due to a fall in petrol prices over the month that capped nominal spending levels. However, for many households the fall in petrol prices would have freed up funds for spending in other areas. In fact, core (ex-fuel) spending posted a moderate 0.4% rise over the month.
- We expect a 0.6% gain in spending over July. In part, that's due to a rise in petrol prices. We also expect modest gains in core categories. Lingering softness in the housing market remains a drag on spending appetites.

Card transactions, annual % change

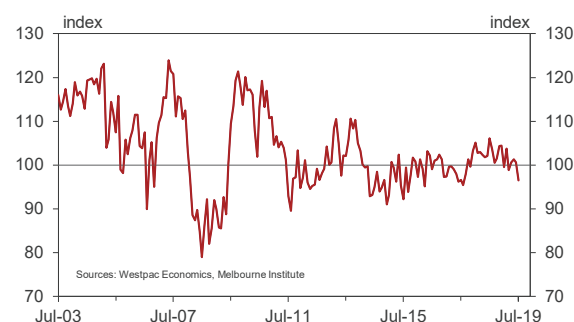


Aus Aug Westpac-MI Consumer Sentiment

Aug 14 Last: 96.5

- The Westpac Melbourne Institute Index fell 4.1% to 96.5 in July from 100.7 in June, a troubling decline given what should have been a supportive backdrop in the month – the RBA cut interest rates by a further 25bps, the Federal government's tax package passed through Parliament, and the Sydney and Melbourne housing markets showed clear signs of stabilising.
- The August survey is in the field over the week to August 10 – a turbulent week for the global economy, financial markets roiled by escalating trade tensions between the US and China. Locally, the RBA left rates on hold at its August meeting but retaining a clear easing bias; housing markets continue to stabilise; and the Federal government's tax relief may be starting to see cash flow to some households. However, that may not be enough to offset the effects of recent financial markets turmoil.

Consumer Sentiment Index



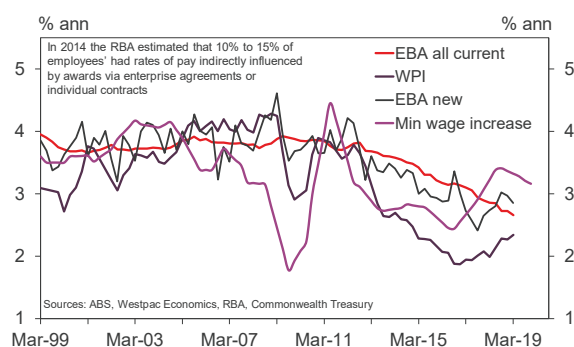
Aus Q2 Wage Price Index (WPI)

Aug 14, Last: 0.5%, WBC f/c: 0.5%

Mkt f/c: 0.5%, Range: 0.5% to 0.6%

- In the March quarter, total hourly wages ex bonuses rose 0.5% compared to a market median (and Westpac) expectation for 0.6%.
- Wage inflation has lifted off its record low of 1.9%yr in June 2017 but running at 2.3%yr in March 2019 it can hardly be described as a breakneck pace. We expect wage inflation to drift higher from here. Our forecasts have it peaking around 2.75% in late 2020. But given how well contained wage inflation is across the nation, and between sectors, even this modest increase looks optimistic with the risks meaningfully skewed to the downside.
- For Q2, there is little to suggest there has been a meaningful acceleration in wages. Our 0.5% forecast holds the annual pace flat at 2.3%yr.

WPI slowly slowly drifting higher



The week ahead

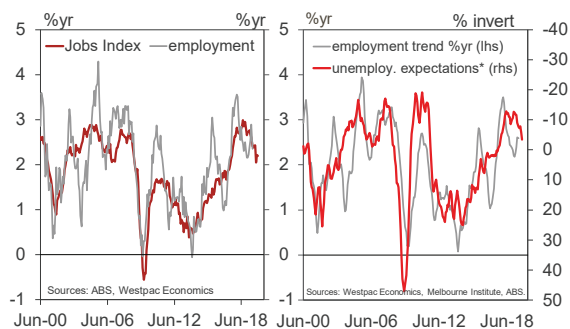
Aus Jul Labour Force Survey - employment '000

Aug 15, Last: 0.5k, WBC f/c: 5k

Mkt f/c: 14k, Range: -10k to 37k

- The June Labour Force Survey reported a marginal 500 gain in employment. Employment has been robust so far this year; the three month average gain was +29.2k in June a modest decline from +35.8k in May but up on +24.45k in April.
- In the year to June, employment has grown 296k or 2.4%. The pace of employment growth eased back from 2.9%yr in May but it is still stronger than the 2.2%yr pace at the end of 2018. Our Jobs Index suggests employment should be growing around 2.4%yr currently before slowing to 2.1%yr through Q4. The fact unemployment expectations deteriorated through the last few months suggest household are started to experience a softer labour market.
- Our forecasts for a 5k gain in employment will hold the annual pace of growth flat at 2.4%yr.

Westpac employment indicators



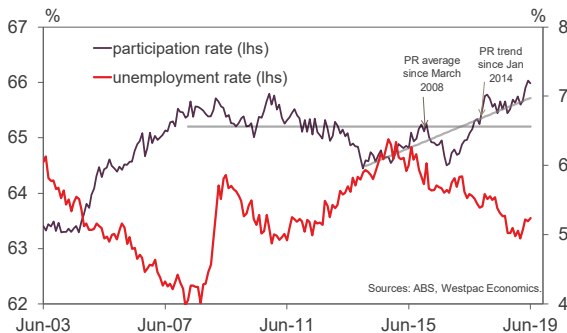
Aus Jul Labour Force Survey - unemployment %

Aug 15, Last: 5.2%, WBC f/c: 5.3%

Mkt f/c: 5.3%, Range: 5.1% to 5.3%

- At one decimal place the unemployment rate was flat at 5.2% in June. However, at two decimal places it lifted from 5.19% to 5.24%, only a whisker away from rounding up to 5.3% highlighting a relative underperformance of the labour market.
- Given that the participation rate is near a record high, we are forecasting a modest decline in July to match our forecasting for a small 5k rise in employment. Holding growth in working age population steady, unemployment is forecast to rise to 5.3%.

Unemployment and participation rates

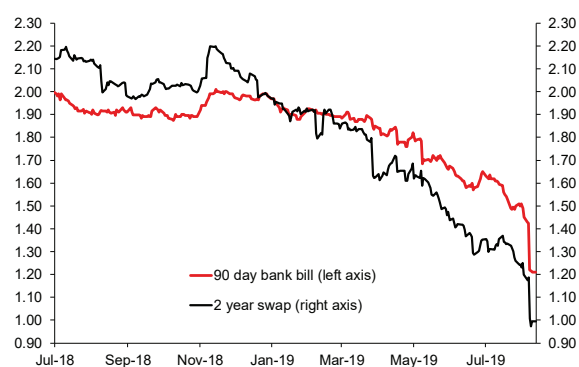


New Zealand forecasts

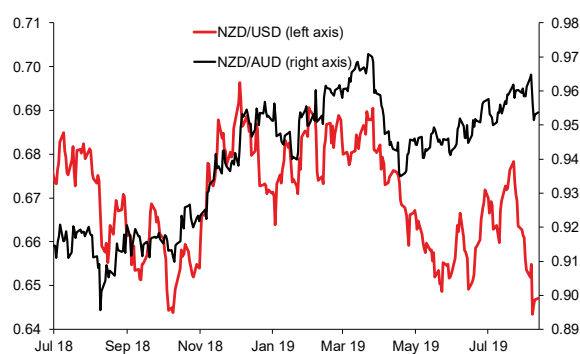
Economic Forecasts	Quarterly				Annual			
	2019				2018	2019f	2020f	2021f
% change	Mar (a)	Jun	Sep	Dec				
GDP (Production)	0.6	0.4	0.6	0.8	2.9	2.3	3.0	2.4
Employment	-0.2	0.8	0.3	0.3	2.3	1.3	2.0	1.8
Unemployment Rate % s.a.	4.2	3.9	4.3	4.2	4.3	4.2	3.9	3.7
CPI	0.1	0.6	0.7	0.3	1.9	1.7	1.9	2.1
Current Account Balance % of GDP	-3.6	-3.4	-3.4	-3.4	-3.8	-3.4	-3.4	-3.6

Financial Forecasts	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Cash	1.00	0.75	0.75	0.75	0.75	0.75
90 Day bill	1.00	0.90	0.90	0.90	0.90	0.90
2 Year Swap	0.90	0.80	0.80	0.80	0.85	0.90
5 Year Swap	1.10	1.00	1.00	1.05	1.10	1.15
10 Year Bond	1.15	1.00	1.05	1.10	1.15	1.20
NZD/USD	0.64	0.64	0.63	0.63	0.64	0.64
NZD/AUD	0.94	0.94	0.95	0.95	0.96	0.96
NZD/JPY	67.8	67.8	67.4	68.0	70.4	71.0
NZD/EUR	0.59	0.59	0.58	0.58	0.59	0.58
NZD/GBP	0.54	0.54	0.52	0.52	0.52	0.51
TWI	71.1	71.0	70.1	69.9	70.5	70.0

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 12 August 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.00%	1.50%	1.50%
30 Days	1.12%	1.51%	1.62%
60 Days	1.17%	1.50%	1.60%
90 Days	1.21%	1.50%	1.60%
2 Year Swap	1.00%	1.26%	1.36%
5 Year Swap	1.01%	1.33%	1.47%

NZ foreign currency mid-rates as at 12 August 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6471	0.6635	0.6688
NZD/EUR	0.5777	0.5961	0.5934
NZD/GBP	0.5370	0.5359	0.5323
NZD/JPY	68.33	72.10	72.21
NZD/AUD	0.9537	0.9598	0.9532
TWI	72.09	73.12	73.30

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 12					
NZ	Jul REINZ house sales	6.8%	-	-	Due this week. While price growth remains soft...
	Jul REINZ house prices, %yr	1.7%	-	-	...early signs of a firming in the market are appearing.
	Jul card spending	0.0%	-	0.6%	Moderate gains in core categories expected.
US	Jul monthly budget statement	-8.5	-123.0	-	Deficit trend one way.
Tue 13					
NZ	Jul food price index	-0.7%	-	0.9%	Seasonal rise in produce prices.
Aus	RBA Assistant Governor speaks	-	-	-	Kent (Financial Markets), Syd, 8:00 am.
	Jul NAB business survey	3	-	-	Conditions index below trend, risk softened further in July.
Eur	Aug ZEW survey of expectations	-20.3	-	-	Sentiment remains negative.
UK	Jun ILO unemployment rate	3.8%	3.8%	-	The labour market remains resilient despite headwinds.
US	Jul NFIB small business optimism	103.3	-	-	Still positive, but becoming a little concerned.
	Jul CPI	0.1%	0.3%	0.3%	Energy supportive, core prices also robust circa 0.2%.
	Q2 NY Fed h'hold credit report	-	-	-	Detail on household borrowings.
Wed 14					
Aus	Aug WBC-MI Consumer Sentiment	96.5	-	-	In the field over the week to August 10 - a turbulent week.
	Q2 wage price index	0.5%	0.5%	0.5%	Wages have lagged behind and little change expected.
	RBA Deputy Governor speaks	-	-	-	Debelle at Redefining Conduct in FX markets, Syd 5:30 pm.
Chn	Jul fixed asset investment ytd %yr	5.8%	5.9%	6.0%	Investment growth grinding higher...
	Jul industrial production ytd %yr	6.0%	6.0%	6.0%	... downside risks to grow as new tariff uncertainty hits...
	Jul retail sales ytd %yr	8.4%	8.4%	8.3%	... weakening jobs trend also puts consumption at risk.
Eur	Q2 employment %yr	1.3%	-	-	Employment growth has been strong but signs of slowing.
	Q2 GDP 2nd estimate	0.4%	0.2%	0.2%	Flash at 0.2%, a modest result weighed down by...
	Jun industrial production	0.9%	-1.0%	-	... an ailing manufacturing sector...
UK	Jul CPI	0.0%	-0.1%	-	Annual inflation close to 2%, lower GBP limiting downside.
US	Jul import price index	-0.9%	0.0%	-	Dollar offsetting tariff impact.
Thu 15					
Aus	RBA Deputy Governor speaks	-	-	-	Debelle on "Risks to the Outlook", Sydney 9:00 am.
	Aug MI inflation expectations	3.2%	-	-	A broad lack of inflationary pressure in the economy.
	Jul employment	0.5k	14k	5k	Employment growth to slow but moderating participation...
	Jul unemployment rate	5.2%	5.3%	5.3%	...from near record highs to limit rise in unemployment.
UK	Jul retail sales	1.0%	-0.3%	-	The firm labour market is supporting spending.
US	Aug Fed Empire state index	4.3	2.0	-	Regional surveys have been volatile.
	Q2 productivity	3.4%	1.4%	-	Momentum looks to be subsiding.
	Aug Philly Fed index	21.8	10.0	-	Regional surveys have been volatile.
	Jul retail sales	0.4%	0.2%	0.3%	Softening job/wage trend to dampen spending pulse.
	Initial jobless claims	209k	-	-	Very, very low.
	Jul industrial production	0.0%	0.3%	-	US manufacturers being hit by tariffs and US dollar.
	Aug NAHB housing market index	65	66	-	Low rates and unemployment a lasting positive.
	Jun business inventories	0.3%	0.1%	-	Inventory accrual likely to slow.
	Jun total net TIC flows	32.9	-	-	Demand for Treasuries remains robust, even at lower rates.
Fri 16					
NZ	Jul Business NZ manuf PMI	51.3	-	-	Businesses are reporting weak trading conditions.
Eur	Jun trade balance €bn	20.2	-	-	Surplus has narrowed but is still large.
US	Jul housing starts	-0.9%	0.6%	-	Low rates yet to drive acceleration in activity....
	Jul building permits	-5.2%	3.1%	-	... uncertainties over growth outlook could weigh further.
	Aug Uni. of Michigan sentiment	98.4	97.1	-	Remains at a robust level.

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	2.4
CPI inflation % annual	1.7	1.5	1.9	1.8	1.7	1.9
Unemployment %	5.8	5.7	5.5	5.0	5.4	5.6
Current Account % GDP	-4.7	-3.1	-2.6	-2.1	-0.2	-1.5
United States						
Real GDP %yr	2.9	1.6	2.2	2.9	2.3	1.7
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	3.6	3.6
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	0.3
Euro zone						
Real GDP %yr	2.1	2.0	2.4	1.8	1.1	1.2
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	5.8
East Asia ex China						
Real GDP %yr	3.8	4.0	4.6	4.3	3.8	4.0
World						
Real GDP %yr	3.4	3.4	3.8	3.6	3.2	3.3

Forecasts finalised 9 August 2019

Interest Rate Forecasts	Latest	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
Australia							
Cash	1.00	1.00	0.75	0.50	0.50	0.50	0.50
90 Day BBSW	0.97	0.95	0.85	0.70	0.70	0.70	0.70
10 Year Bond	0.94	1.00	1.00	1.05	1.05	1.10	1.10
International							
Fed Funds	2.125	1.875	1.375	1.375	1.375	1.375	1.375
US 10 Year Bond	1.70	1.75	1.55	1.60	1.60	1.65	1.70
ECB Deposit Rate	-0.40	-0.50	-0.60	-0.60	-0.60	-0.60	-0.60

Exchange Rate Forecasts	Latest	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
AUD/USD	0.6811	0.68	0.68	0.66	0.66	0.67	0.67
USD/JPY	105.93	106	106	107	108	110	111
EUR/USD	1.1197	1.09	1.08	1.08	1.08	1.09	1.11
GBP/USD	1.2142	1.18	1.19	1.20	1.22	1.24	1.26
AUD/NZD	1.0487	1.06	1.06	1.05	1.05	1.05	1.05

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