Weekly Commentary

26 August 2019

Cardboard Cathedral, Christchurch

Around we go again

Our latest quarterly *Economic Overview* details some substantial changes to our economic forecasts. Storm clouds have gathered over the global economy, and New Zealand is getting caught in the downdraught. Monetary policy is riding to the rescue, and we expect that rising asset prices will help to shore up GDP growth. But propping up growth in this manner now will deepen the long-term risks in the economy.

The New Zealand economy has continued to soften this year. After expanding at rates of over 3% through 2018, annual GDP growth has slowed to 2.7% in the early part of this year. Adjusting for population changes, annual growth has now fallen to just 1.1%, its slowest pace in eight years.

The slowdown in growth was foreseeable in many respects. We've previously highlighted that the Canterbury rebuild would gradually wind down, net migration would slow, and the cooling housing market would dampen household spending. All of that has come to pass, and the resulting weakness in demand has been a significant drag on GDP growth over the past year.

However, we had expected to see the economy regain some momentum in mid-2019, due to low interest rates and increases in government spending. Instead, activity has remained subdued, with recent indicators pointing to quarterly GDP growth of only around 0.5% through the second half of 2019.

Part of the reason for our more cautious near-term outlook is the state of the global economy. The US-China trade war has intensified, and aside from the direct impact of tariffs, the uncertainty generated by the conflict is proving to be toxic for business confidence and investment decisions. The effects are being felt in some of our key export industries: overseas visitor numbers are down 3%, and export prices for wool, logs and dairy have fallen. Last week we lowered our farmgate milk price forecast for this season by 20c to $6.50/kg.

This weakening in the external environment has reinforced the sense of nervousness already present in many corners of the domestic economy. Business confidence has been low since the 2017 election, and it has fallen even further in recent months. Businesses are reporting tough trading conditions, including strong competition, rising costs and sluggish growth in demand. That has seen margins squeezed and plans for investment spending wound back.

To date, the labour market has been resilient to the downturn in the business sector, with the unemployment rate falling to an 11-year low of 3.9% in June. However, there are signs that hiring is slowing, with employment intentions and the number of job advertisements falling in recent months. We expect that unemployment will push back up to 4.2% by the end of this year.

With the economy losing momentum, the Reserve Bank has cut the OCR to a new record low and has clearly shown a willingness to do more if required. The RBNZ's 'lower for longer' stance has weighed on the currency, providing a welcome relief for exporters. Last week the NZD/USD exchange rate dropped below 64c, a target that we have maintained since February last year.

But we think that the major impact of lower interest rates will be via asset markets. New Zealand has already entered

Around we go again

a 'search for yield' environment, with investors shunning bank deposits in favour of assets that have the potential for higher returns or capital gains. We think it's only a matter of time before New Zealanders turn their eyes back to the housing market.

We expect house price inflation will accelerate from around 1% now to around 7% per annum for the next two years. Relative to previous housing market upswings, that's still a fairly modest lift, with policy changes such as the foreign buyer ban and the introduction of ring-fencing for investment properties likely to limit price gains to some extent. However, even a lift of this magnitude will be very important for economic conditions more generally. New Zealanders hold the bulk of their wealth in housing assets, and rising house price growth is likely to support a related lift in household confidence and spending.

We're also expecting a continued spend-up from the Government over the coming years. With the 2020 election coming into sight, we are forecasting that the Government will introduce plans for around $1bn per annum of additional spending at each Budget – a level of spending that we think can be achieved while still running small surpluses, ensuring that it is politically palatable.

Overall, we are expecting a more delayed pick-up in the domestic economy. Previously we were forecasting GDP growth to accelerate to 3.1% in 2020, but we've now slashed that back to 2.3%. However, we expect growth to reach a peak of 2.8% in 2021, as the cocktail of monetary and fiscal stimulus has its greatest impact.

Our forecasts imply that New Zealand is going to experience another iteration of a very familiar cycle. The economy has gone through repeated episodes of falling interest rates that spark rising asset prices, which in turn boost economic growth. The facilitator is ever-increasing debt. This cycle cannot last forever. When asset prices and debt levels eventually stabilise or fall, things could turn ugly. The difficulty is pinpointing when that might happen.

One possibility is that the current headwinds from offshore and low confidence domestically might create an economic downdraught that is too strong for interest rates to counter, sending us into a tailspin of falling asset prices. But such a scenario could only really play out if monetary policy was not sufficiently powerful, and we don't believe that is the case.

Things are more likely to come to a head when interest rates rise. There are a range of possible catalysts for that, including a credit crunch, but historically inflation has been the spoiler. We don't see any signs of rising inflation rising in the near term, and hence we think interest rates will stay low for a long time. That is why we are forecasting another turn of the merry-go-round, with growth underpinned by rising asset prices and rising debt. But we do think that interest rates will eventually rise, which is why during the mid-2020s we are forecasting a period of falling house prices and a downturn in economic growth.

Fixed vs Floating for mortgages

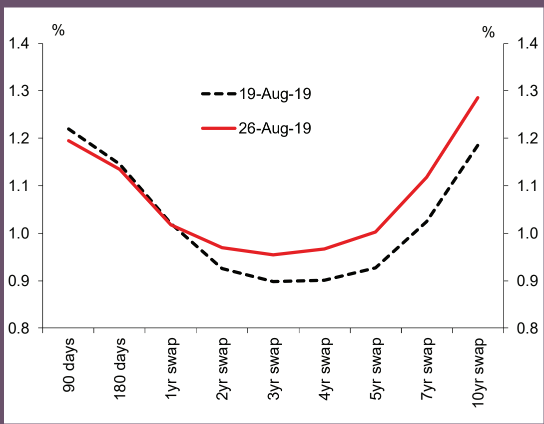
Mortgage rates are falling, and with the Reserve Bank expected to cut the OCR once more, we think they will keep falling. This means there is no hurry to fix.

Among the fixed rates on offer, we think the best value at present is the one-year rate. It is lower than the floating or six-month rates, yet it may still allow borrowers to roll onto lower rates at the end of the fixed term. Fixing for a longer term may mean that borrowers miss out on re-fixing at the lowest rates, at least according to our forecasts.

That said, fixing for longer terms does offer security against future interest rate increases, and therefore may be preferred by those with low risk tolerance.

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 Aug ANZ Business confidence

Aug 29, Last –44.3

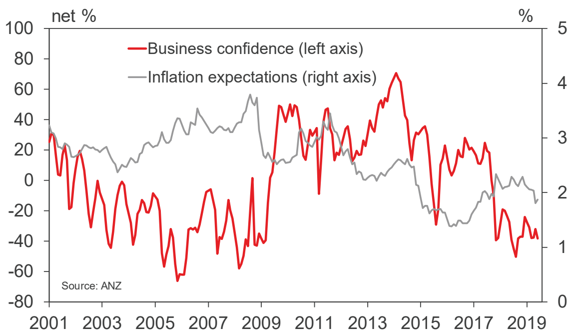
- Business confidence continued to deteriorate in July, with businesses also reporting very weak trading activity. This weakness in business conditions is weighing on investment and hiring intentions. Pressure on margins remains a key concern.
- We expect that business sentiment will remain weak in August. The past few weeks have seen a further softening in the global backdrop, and that does appear to be spilling over into local conditions. The recent reduction in the Official Cash Rate will provide some relief, but it will take some time before its impact on business conditions will be evident.

NZ Jul dwelling consents

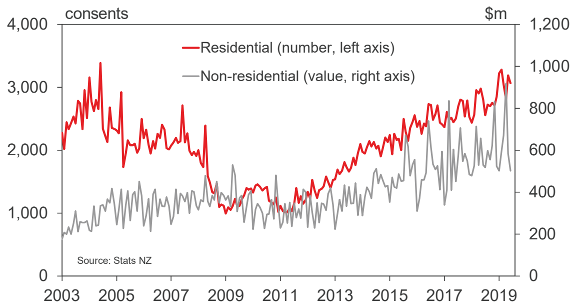
Aug 30, Last: –3.9%, WBC f/c: Flat

- Residential dwelling consent issuance fell 3.9% in June. That was a relatively modest decline given that consent numbers rose a whopping 13.5% in May. With strong issuance over the past year, dwelling consent numbers are running at a multi-decade high. There has been a particularly large number of consents issued in Auckland.
- We expect that consent numbers will remain steady at a high level in July. Consent numbers for stand-alone homes have remained strong. There have recently been sizeable swings in the various medium density categories, which account for a growing share of consent issuance and which can be 'lumpy' on a month-to-month basis. But those sorts of swings are still expected to leave us with a solid picture for overall consent issuance in July.

NZ business confidence and inflation expectations



NZ building consents



Aus Q2 construction work

Aug 28, Last: –1.9%, WBC f/c: –1.3%
Mkt f/c: –1.0%, Range: –2.5% to 1.3%

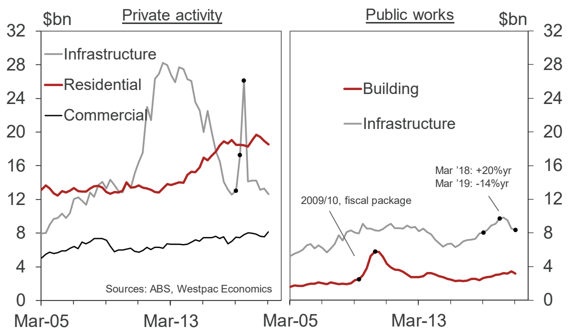
- Construction work has trended lower since mid-2018, declining by $4.0bn, –7.4%. Falls are spread across three segments, namely: public works, –$1.5bn; private infrastructure, –$1.6bn; and housing, –$1.2bn.
- In the June quarter, work most likely fell further, down a forecast 1.3%.
- The home building downturn continued in Q2 and has further to run with dwelling approvals sharply down from their highs.
- Public works, while at a high level, have moderated of late reflecting a gap in the investment project pipeline.
- Elsewhere, activity was likely mixed in Q2. The mining investment wind-down is largely behind us, with prospects for an emerging uptrend over coming quarters.

Aus Q2 private business capex

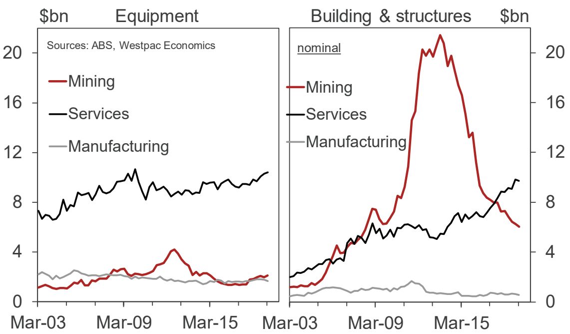
Aug 29, Last: –1.7%, WBC f/c: –0.3%
Mkt f/c: 0.4%, Range: –1.7% to 3.0%

- In the March quarter, capex printed –1.7%qtr, –1.9%yr. For June, we anticipate a small decline, –0.3%.
- Building & structures are expected to be broadly flat – across both mining infrastructure and commercial building (although this level of detail is not published in this survey).
- Equipment spend is forecast to decline by around 0.8%, building upon the 0.5% drop in Q1. This soft spot coincides with the additional uncertainty leading into the May Federal election, as well as the slowdown in the domestic economy.

Construction work: by segment



CAPEX: by industry by asset



The week ahead

Aus 2019/20 capex plans

Aug 29, Last: Est 6 2018/19: $122bn, +3.8% vs Est 6 a yr ago
Aug 29, Last: Est 2 2019/20: $99bn, +12.8% vs Est 3 a yr ago

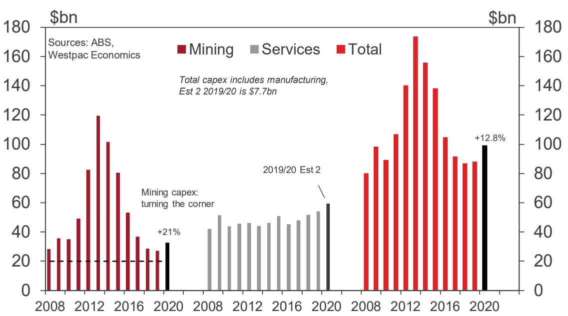
- This survey, conducted in July and August, includes the outcome for capex spending in 2018/19 and the 3rd estimate for 2019/20 plans.
- Est 2 for 2019/20 is $99bn, 12.8% above Est 2 a year ago.
- If Est 3 is to be 12.8% above Est 3 a year ago, then plans will need to be upgraded to $116bn.
- We see the risk of a less positive update. We anticipate an Est 3 printing around $113bn, +10% vs Est 3 a year ago (led higher by mining and the building side of services). The key, a greater recognition of the challenging economic backdrop, both globally and domestically, particularly around the consumer.

Aus Jul dwelling approvals

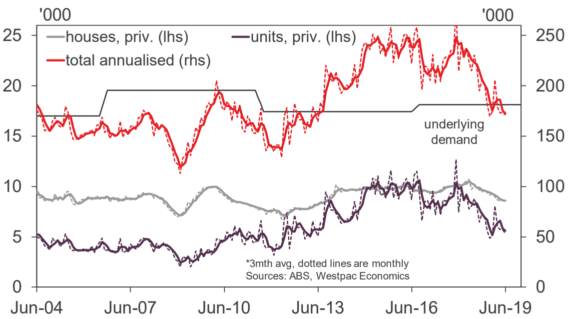
Aug 30, Last: –1.2%, WBC f/c: 1.0%
Mkt f/c: 0.0%, Range: –2.0% to 1.0%

- Dwelling approvals declined 1.2% in June following a slight 0.3% rise in May. High rise approvals are starting to find a base, albeit with choppy reads month to month, and non-high rise have firmed a touch.
- Australia's housing markets have shown a clear improvement in recent months with prices stabilising in Sydney and Melbourne and the RBA's rate cuts in June and July giving clear support. That said, any boost to construction will be slower to appear, with other factors likely to continue weighing on the high rise segment. On balance, we expect approvals to be up 1% in the month.

Capex plans, by industry: Estimate 2



Dwelling approvals

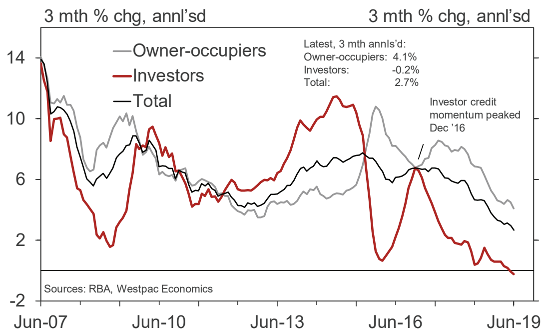


Aus Jul private credit

Aug 30, Last: 0.1%, WBC f/c: 0.1%
Mkt f/c: 0.2%, Range: –0.2% to 0.3%

- NOTE: The RBA will publish the financial aggregates from August 2019 using an improved conceptual framework and a new data collection. The changes are likely to result in revisions, some of which may be significant.
- Ahead of any boost from the recent RBA rate cuts, private sector credit growth slowed to an anaemic pace. Credit grew by only 0.1% in April, May and June, with the prospect of a repeat for July.
- In June, housing credit grew by 0.16%, 3.5%yr. We anticipate another soft read in July.
- Business credit has hit a flat spot due to election uncertainty and a slowing economy.

Housing credit weak ahead of RBA rate cut

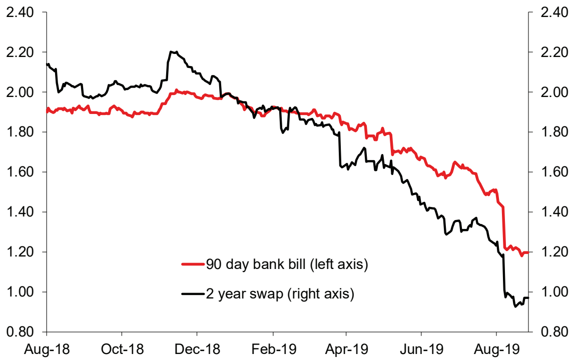


New Zealand forecasts

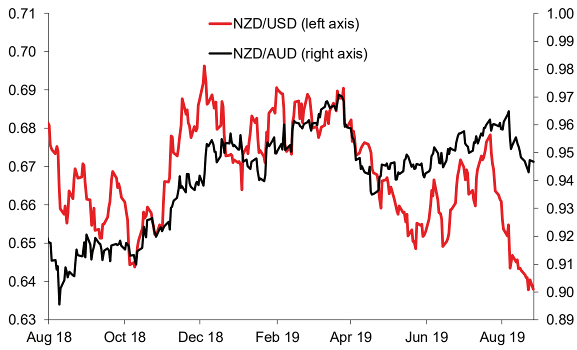
Economic Forecasts	Quarterly				Annual			
	2019							
% change	Mar (a)	Jun	Sep	Dec	2018	2019f	2020f	2021f
GDP (Production)	0.6	0.5	0.4	0.5	2.9	2.1	2.3	2.8
Employment	-0.1	0.8	0.2	0.4	2.3	1.3	1.8	2.0
Unemployment Rate % s.a.	4.2	3.9	4.1	4.2	4.3	4.2	4.2	3.8
CPI	0.1	0.6	0.6	0.3	1.9	1.6	1.7	1.8
Current Account Balance % of GDP	-3.6	-3.4	-3.3	-3.2	-3.8	-3.2	-2.9	-2.7

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	1.00	1.00	1.00	1.05	1.10	1.15
10 Year Bond	1.05	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	0.96	0.96	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	0.53	0.52	0.52	0.51
TWI	71.9	72.2	71.4	71.0	71.6	71.1

2 Year Swap and 90 Day Bank Bills



NZD/USD and NZD/AUD



NZ interest rates as at market open on 26 August 2019

Interest Rates	Current	Two weeks ago	One month ago
Cash	1.00%	1.00%	1.50%
30 Days	1.17%	1.12%	1.51%
60 Days	1.17%	1.17%	1.50%
90 Days	1.20%	1.21%	1.50%
2 Year Swap	0.97%	1.00%	1.26%
5 Year Swap	1.00%	1.01%	1.33%

NZ foreign currency mid-rates as at 26 August 2019

Exchange Rates	Current	Two weeks ago	One month ago
NZD/USD	0.6380	0.6471	0.6635
NZD/EUR	0.5719	0.5777	0.5961
NZD/GBP	0.5204	0.5370	0.5359
NZD/JPY	67.01	68.33	72.10
NZD/AUD	0.9468	0.9537	0.9598
TWI	71.33	72.09	73.12

Data calendar

		Last	Market median	Westpac forecast	Risk/Comment
Mon 26					
NZ	Jul trade balance $m	365	–254	–800	Higher imports expected after an unusually low June.
US	Jul Chicago Fed activity index	–0.02	–	–	Points to growth around trend.
	Jul durable goods orders	1.9%	1.3%	–	Investment trend remains weak.
	Aug Dallas Fed index	–6.3	–1.0	–	Manufacturers coming under pressure from tariffs & USD.
	Fedspeak	–	–	–	Bullard gives welcoming remarks.
Tue 27					
Aus	RBA Dep. Gov. Debelle speaks	–	–	–	'A Balance of Payments', Canberra at 12pm.
Chn	Jul industrial profits %yr	–3.1%	–	–	Profitability under pressure given global tensions.
Eur	ECB speak	–	–	–	de Guindos and BOE Tenreyro speak on policy.
US	Jun FHFA house prices	0.1%	–	–	House price growth has moderated….
	Jun S&P/CS home price index	0.14%	0.20%	–	… but gains are likely to persist given jobs and rates.
	Aug Richmond Fed index	–12	–	–	Manufacturers coming under pressure from tariffs & USD.
	Aug consumer confidence index	135.7	130.0	–	Confidence has been strong, but is it now at risk?
Wed 28					
Aus	Q2 construction work done	–1.9%	–1.0%	–1.3%	A further fall, led by housing and public works.
Eur	Jul M3 money supply %yr	4.5%	–	–	Lending data of high importance.
UK	Aug Nationwide house prices	0.3%	–	–	Brexit uncertainty continuing to dampen price growth.
US	Fedspeak	–	–	–	Barkin to Virginia Chamber of Commerce.
Thu 29					
NZ	Aug ANZ business confidence	–44.3	–	–	Firms continue to highlight weak trading conditions.
Aus	Q2 private new capital expend	–1.7%	0.4%	–0.3%	Equipment spend, a soft spot around the Federal election.
	2019/20 capex plans, AUDbn	99	–	–	Est 2 on 2, +12.8%. Risk Est 3 is softer – economic slowdown.
Eur	Aug economic confidence	102.7	102.5	–	Has been softening…
	Aug business climate indicator	–0.12	–	–	… with business climate indicator going sub-zero in Jul.
US	Q2 GDP 2nd estimate % ann	2.1%	2.0%	2.0%	Second estimate; little chance of a material revision.
	Jul wholesale inventories	0.0%	–	–	Softening end demand points to less inventory accrual.
	Initial jobless claims	209k	–	–	Remain historically low.
	Jul pending home sales	2.8%	0.0%	–	Lead on existing home sales; supply the main headwind.
	Fedspeak	–	–	–	Daly at RBNZ/IMF conference (7:30 am AEST).
Fri 30					
NZ	Aug ANZ consumer confidence	–5.1%	–	–	Consumer sentiment remains downbeat.
	Jul building permits	–3.9%	–	0.0%	Annual issuance to remain at very high levels.
Aus	Jul dwelling approvals	–1.2%	0.0%	1.0%	House prices stabilising but construction less so.
	Jul private sector credit	0.1%	0.2%	0.1%	Anaemic growth: housing downturn & business flat spot.
Eur	Jul unemployment rate	7.5%	7.5%	–	Declining; so far resilient to manufacturing weakness.
	Aug core CPI %yr	0.9%	1.0%	–	Remains sticky around 1%.
UK	GFK consumer confidence	–11	–10	–	Economic uncertainty has increased in recent weeks.
	Jul net mortgage lending £bn	3.7	–	–	The housing market and credit growth remains soft.
US	Jul personal income	0.4%	0.3%	0.4%	Wages growth still best characterised as modest.
	Jul personal spending	0.3%	0.5%	0.6%	Spending growth robust for now, but likely to slow.
	Jul PCE inflation %yr	1.4%	1.4%	1.4%	Core measure to remain at 1.6%yr.
	Aug MNI Chicago PMI	44.4	48.0	–	Manufacturers coming under pressure from tariffs & USD.

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	0.99	0.95	0.85	0.70	0.70	0.70	0.70
10 Year Bond	0.98	0.90	0.90	1.00	1.00	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	1.64	1.60	1.55	1.60	1.60	1.65	1.65
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	0.6755	0.67	0.67	0.66	0.66	0.67	0.67
USD/JPY	106.59	106	106	107	108	110	111
EUR/USD	1.1070	1.09	1.08	1.08	1.08	1.09	1.11
GBP/USD	1.2230	1.18	1.19	1.20	1.22	1.24	1.26
AUD/NZD	1.0575	1.05	1.05	1.05	1.05	1.05	1.05

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