ASB

Economic Note

Q2 GDP Review

20 September 2018

Cracker Q2 performance

- Q2 GDP grew 1.0% qoq, slightly stronger than our own forecast of 0.9% and market expectations of 0.8%, and well above the RBNZ August MPS forecast of 0.5%.
- Q2 growth was reasonably broad-based and would have been even stronger if not for a large decline in gas production due to an unplanned outage.
- Focus will now shift to how fast the economy grew over Q3, with concerns that weak business sentiment points to a slowdown in the underlying trend pace of economic growth over the second half of 2018.

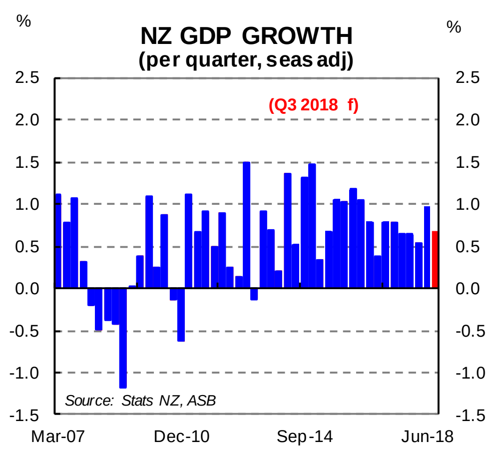
GDP - June 2018	Previous	Actual	ASB	RBNZ	Market
quarterly % growth	0.5	**1.0**	0.9	0.5	0.8
annual % growth	2.6	**2.8**	2.7	2.3	2.6
annual average % growth	2.7	**2.7**	2.7		

Summary & implications

Q2 GDP lifted 1.0% qoq, slightly stronger than ASB's forecast of 0.9% growth and market expectations of 0.8% growth and **well above the RBNZ's August Monetary Policy Statement (MPS) forecast of 0.5% growth**. **Growth over the quarter was reasonably broad-based**, and would have been stronger if not for some temporary disruption to activity in the gas industry. **The RBNZ faces a considerable upside surprise to its near-term GDP growth outlook** ahead of next week's OCR review, but the impact of this surprise could be partially tempered if the RBNZ revises its H2 2018 GDP growth forecasts lower. **Focus will now shift to how fast the economy grew over Q3, with concerns that weak business sentiment points to a slowdown in the underlying trend pace of economic growth over the second half of 2018.** We expect the RBNZ to wait until February 2020 before lifting the OCR, and the risk of a rate cut over the next year remains on the radar.

Economy (almost) firing on all cylinders over Q2

Growth over the June quarter of 2018 was strong and would have been phenomenal if not for a near 20% decline in mining production due to an unplanned shut down in gas production. As we expected, GDP growth was led by strong growth in electricity generation, a large broad-based lift in agricultural production, a strong performance in retail and wholesale trade (as foreshadowed by earlier data), and strong growth in arts, recreational and cultural services. We also saw stronger than expected growth in other parts of services, including a strong 1.8% lift in transport, postal and warehousing, and 1.1% lift in information media



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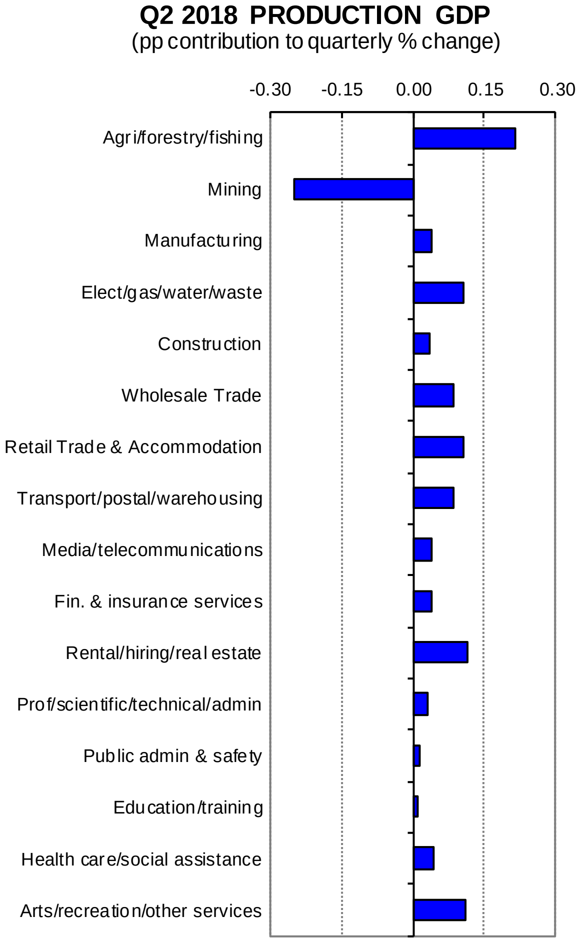
and telecommunications. And there was surprisingly decent growth in areas exposed to the housing cycle, including financial & insurance services and rental, hiring and real estate services.

It is evident in Q2 that all parts of the economy were performing well, as the strength was remarkably broad-based. This sits with our view that the economy is currently benefiting from a number of supports, including high Terms of Trade, low interest rates and high population growth. Indeed, a 1% growth outcome is impressive given there was considerable drag to economic activity from temporary disruption in oil and gas related industries. StatsNZ reports that a leaking pipeline led to an unplanned shut down in NZ's largest natural gas field. This led to downstream impacts on manufacturing production, which added to some drag from the planned shut down at the Marsden Point oil refinery.



Exports razzle and dazzle

Economic growth was also strong from an expenditure basis. As expected, **household spending grew at a robust pace**. **Investment was surprisingly soft**, with non-residential investment remaining broadly flat despite continued growth in non-residential building activity. Transport investment was also weaker than expected (given import figures). **Plant and machinery declined in line with our expectations** (down 1.3%). This decline is fairly mild in context of the strong growth seen over the previous 18 months. Nonetheless, it is an area at risk of further declines given the drop in business investment intentions over the past few months.

Net exports contributed positively, supported by **strong growth in both goods and much stronger than expected services exports.** The strength in goods exports was broad based, with strong lift in meat, dairy, horticulture, forestry and manufactured goods. With NZ's key trading partners performing well and demand for NZ commodities remaining strong, NZ's export prices are consequently at very high levels. The recent fall in the NZD has also (anecdotally) further boosted exporter confidence on the year ahead.

Risks to Q3 growth as business sentiment fizzles

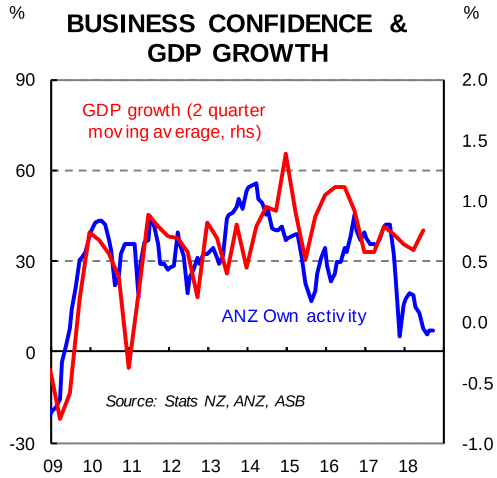
Alas, looking ahead, **growth may have lost some momentum over Q3. Negative business sentiment poses a threat to economic growth sustaining at current rates over the coming year.** Ahead of today's release, we had just 0.6% growth for Q3 pencilled in, although we will take some time to reassess this figure in light of some of today's outcome. Furthermore, t**aking recent business confidence readings at face value, in particular business investment and employment intentions, suggest growth could be much weaker than we are forecasting over the second half of the year.** While we prefer to wait for some hard data (given the strong fundamentals supporting the economy), we are mindful of the risks presented to our relatively upbeat growth forecasts over the coming year.

Revisions

Q1 production GDP growth was unrevised at 0.5%, although the **expenditure growth profile was revised slightly.** Revisions to quarterly GDP figures are normal as StatsNZ incorporates additional and more accurate data that are only on a less frequent basis (i.e. annual rather than quarterly). The **Production Accounts are the 'official' measure of GDP in NZ**, and most of the **annual benchmarking for the production figures takes place when the Q3 GDP figure is reported – which will be in late December this year.** Sometimes these revisions are minor and sometimes these revisions can have large impacts (as was the case last year, when economic growth over the previous two years was revised significantly higher). **The next quarter's revisions will be closely watched as any significant change to the past year's economic performance could have implications for whether the RBNZ leaves rates on hold, or cuts rates next year.**

RBNZ implications – perceptions vs. reality matters

The Q2 outcome is a significant positive surprise for the RBNZ. However, we are unsure how the RBNZ will respond to this surprise given the continued slide in business confidence. At face value, the recent fall in business confidence suggest material downside risk to the RBNZ's H2 2018 growth forecasts (0.8% in Q3 and 0.7% in Q4). **It's possible that, as the RBNZ considers its near-term GDP forecasts for the upcoming OCR Review, the stronger Q2 outcome will be partially offset by downward revisions to the RBNZ forecasts for second half of 2018.**



Given the ongoing slide in business confidence we see a non-negligible chance of a rate cut over the next year, but the threshold of such a move remains fairly high. **Q2 GDP reinforces that the momentum in the economy was relatively robust over the first half of the year despite some of the negative headlines and weak business confidence outcomes generated since late 2017. The gap between perceptions and reality suggests the RBNZ should be cautious in jumping to conclusions on the back of sentiment data alone**, and wait to gather clearer evidence about the economy's growth performance for the second half of the year. The RBNZ may also want to be sure that core inflation measures are stable (and signalling the economy could do with a further boost), rather than lifting in line with its current expectations.

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