Economic Weekly

7 August 2017

Economy's strength in question ahead of RBNZ announcement

- Employment unexpectedly fell in the June quarter, adding to a weaker run of economic data.
- The RBNZ is widely expected to leave the OCR unchanged but push out the timing of rate hikes.
- We now expect the RBNZ to first lift the OCR in early 2019 (previously late 2018).

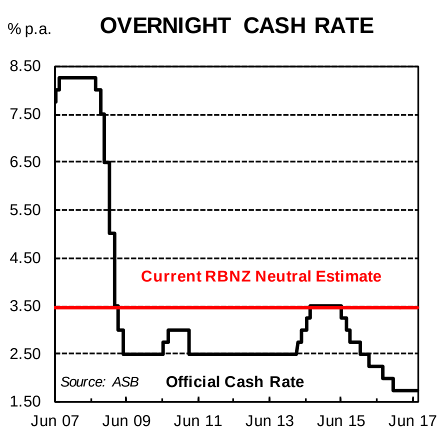
Last week's labour market data added to the run of soft economic developments ahead of the Reserve Bank of New Zealand's (RBNZ) Official Cash Rate (OCR) announcement and Monetary Policy Statement (MPS) this week. **The market reacted to headline employment unexpectedly falling over the June quarter**, in contrast to expectations of a modest increase. Furthermore, the **fall in employment follows two consecutive quarters of weak GDP growth**, soft inflation pressures and a significant softening in the Auckland housing market. The weak GDP growth figures did prompt some navel gazing around the state of the economy, although we concluded that the outlook remains promising.

The labour market report was stronger than the headline implied. The Household Labour Force Survey, while the official source of data for NZ's unemployment rate and is the 'broadest' measure of employment, is notorious for its volatility quarter to quarter. Rather, the Quarterly Employment Survey, whilst has its own limitations, can be a better guide to the underlying trends in the labour market. And here, the results were all strong in Q2. Filled jobs lifted 1% in the quarter and paid hours were up 0.9%. Also, wage inflation is showing some sign of gradually lifting with public sector wage growth recovering after a long period of restraint compared to the private sector. Public sector wage growth is now the strongest since 2010.

The RBNZ is likely to see some positives in Q2's employment report and won't be rushing to panic stations and cutting the OCR this week. However, the **RBNZ does face a weaker inflation outlook**. **Weak GDP outcomes** reinforce capacity pressures are less than previously thought. As a result, **domestic inflation pressures** are not lifting as fast as expected and the **high NZD** is an additional headwind to headline inflation. The RBNZ recently **lowered its estimate of the neutral OCR** (see chart of the week below). But it's also not all inflation-negative news. Fonterra's 'conservative' forecast for this season's milk price is a robust $6.75 per kg milk solids, which will **boost farmers' confidence**. **NZ's Terms of Trade are close to historic highs**, thanks to strong global demand for NZ's commodity exports and a butter boom. **The RBNZ can be confident incomes and growth will improve;** cutting the OCR now because of a quarter or two of slower growth will just result in excessive volatility in the economy. This slow spot is likely just a **delay in the inevitable** recovery and we have **subsequently pushed back our expectation for the first rate hike from late 2018 to early 2019.** Likewise, **we expect the RBNZ will cautiously push back its own forecast** for rate hikes a quarter or two, back to 2020. However, the market's expectations ahead of the RBNZ's announcement have moved quite far in the past week, with interest rates falling. If the RBNZ does not remove OCR hikes entirely from its OCR forecast, financial market participants could be 'disappointed' on Thursday, resulting in a rebound in interest rates and the NZD.

Foreign Exchange	• NZD/USD fell last week after NZ employment growth was weaker than expected.
Interest Rates	• NZ interest rates fell last week as the RBNZ is expected to lower its OCR track.
Week Ahead	• The RBNZ's Q3 Survey of Expectations, OCR and MPS; electronic card transactions.
Week in Review	• Business confidence edged down, dairy prices dipped, Q2 employment fell last week.
Global Calendars	• Australian housing finance, US industrial production and CPI are key this week.

Chart of the Week: What is neutral OCR and why does it matter?



The RBNZ indicated it has revised down its average estimate of the neutral OCR to 3.5% and will incorporate this in the upcoming August MPS. This compares to the RBNZ's previously published estimate of 3.6%-3.7%. Over a period of time, the RBNZ's estimate of neutral interest rates has fallen steadily, having been above 4% as recently as a couple of years ago.

The neutral OCR is the 'goldilocks' level where interest rates are considered not too high and not too low. The implication of a lower neutral OCR is that the current settings are **less stimulatory than previously thought**. This means the RBNZ either needs to cut the OCR or hold the OCR at current levels for longer to achieve its previously forecast lift in growth and inflation. Given the revision is less than 25 basis points, we believe the RBNZ will opt for the latter approach.

Foreign Exchange Market

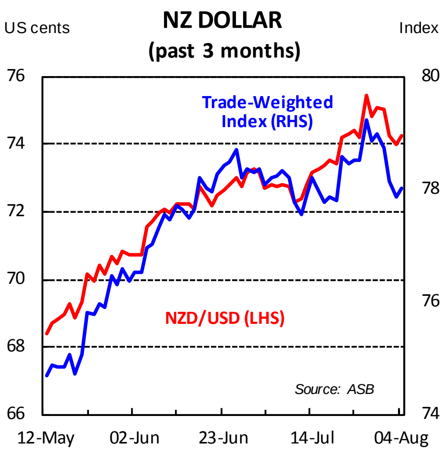
FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7401	0.7509	0.7282	0.7275	0.7195	UP	0.7300	0.7550
NZD/AUD	0.9345	0.9403	0.9598	0.9506	0.9394	FLAT	0.9200	0.9500
NZD/JPY	81.93	82.97	82.74	82.26	72.76	FLAT/UP	80.80	83.20
NZD/EUR	0.6286	0.6397	0.6379	0.6764	0.6460	FLAT/DOWN	0.6200	0.6390
NZD/GBP	0.5676	0.5719	0.5614	0.5808	0.5478	FLAT/UP	0.5600	0.5770
TWI	78.2	79.0	78.3	79.1	76.3	FLAT/UP	77.00	80.00

^Weekly support and resistance levels * Current is as at 9.30 am Monday; week ago as at Monday 5pm.

US weakness continues to be the dominant theme in currency markets and any reaction to economic data and events at the moment tends to be short-lived. For example, the NZD/USD dropped half a cent following the unexpected fall in NZ Q2 employment growth, hitting a one-week low. However, shortly afterwards the NZD/USD found a support level of about 0.7400 with continued US weakness limiting any additional downside in the NZD/USD. Throughout the week, the NZD/GBP lifted about half a cent following dovish comments from the Bank of England during its rate announcement.

Underlying USD weakness has seen the NZD/USD lift roughly 3 cents since the RBNZ's May Official Cash Rate (OCR) and Monetary Policy Statement (MPS). The NZ Trade Weighted Index is also about 2% higher than in May. As a result, it is likely that the strength of the NZD influences the RBNZ's inflation outlook during Thursday's OCR and MPS. Market expectations are for the RBNZ to push out the timing of the first OCR hike, which could weigh on the NZD/USD. However, ongoing USD strength will likely limit any NZD weakness.

Short-term outlook:



Key data	Date	Time (NZT)	Market
RBNZ inflation expectations, Q3, 2-year, %	7/08	3:00 pm	-
RBNZ OCR and MPS	10/08	9:00 am	1.75
NZ electronic cards, July, total, %	10/08	10:45 am	0.3
US CPI, July, core, %yoy	12/08	12:30 am	1.7

Key events: NZD: Q3 two-year inflation expectations (today), RBNZ meeting & Monetary policy Statement (Thu). **USD:** Jun wholesale inventories (Thu). **AUD:** Jul business confidence (Tue), Aug consumer sentiment & Jun housing finance (Wed). **JPY:** Jun current account (Tue). **CNY:** Jul trade balance (Tue), Jul CPI (Wed).

Speakers: Fed: non-voter Bullard (Tue), voter Kashkari (Tue), voter Dudley (Thu); voters Kaplan & Kashkari (Fri). **RBA:** Kent (Wed), Lowe (Fri).

Medium-term outlook:

Last Quarterly Economic Forecasts

Our FX forecasts were fine-tuned in mid-July following a period of low volatility in currency markets. Despite the fine-tuning, we have left our USD forecasts unchanged. Uncertainties around the timing of US fiscal stimulus remain, especially given the ongoing difficulties in getting other reforms through Congress, and will continue to weigh on the USD. **As a result, we continue to expect the NZD/USD to average 0.7200 over the second half of 2017. Over 2018, we expect the NZD to outperform the USD.** NZ's persistently high Terms of Trade (ToT) will continue to provide the NZD with significant support. The high ToT will lift real GDP and will keep the RBNZ on track to raise interest rates by the end of 2018. **We expect the USD to stabilise once the fiscal policies are signed into effect, however, this may now not occur until 2019.**

On top of the persistently high ToT, the NZD remains supported by relatively high interest rates, increased offshore investor demand and a structural improvement in the current account deficit. As a result, we expect the NZD/AUD to remain firm. Further, the **risk that the RBNZ raises interest rates before the Reserve Bank of Australia will further support the NZD/AUD**. Over 2017, we expect the NZD/AUD to average 0.9500 then lifting above 0.9600 towards the end of 2018.

We have revised our GBP forecast higher again, following our upward revision in May. High UK CPI is likely to see the BoE raise interest rates in November. Further, the fact that the European Court of Justice will now have a role in UK law making post-Brexit means the UK economy is likely to hold up better than expected over the forecast horizon. We expect the NZD/GBP to largely remain with a range of 0.54-0.57 until the end of 2019.

In the near term we expect to see NZD/JPY hold above 80. The recent narrowing of the Japanese current account surplus has removed some of the JPY strength. Further out, the prospect for more BOJ easing and RBNZ tightening should further strengthen the NZD against the JPY, holding the NZD/JPY above 84 over 2018.

Interest Rate Market

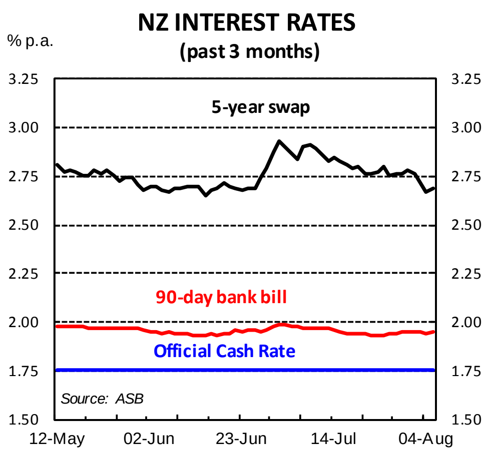
Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	1.75	1.75	1.75	1.75	2.25	FLAT
90-day bank bill	1.95	1.95	1.97	2.01	2.25	FLAT/DOWN
2-year swap	2.19	2.22	2.32	2.41	2.00	DOWN
5-year swap	2.69	2.76	2.90	3.07	2.09	DOWN
5-year benchmark gov't stock	2.49	2.57	2.68	2.70	1.81	DOWN
NZSX 50	7746	7694	7616	7094	7308	DOWN

^Weekly support and resistance levels * Current is as at 9.30am Monday; week ago as at Monday 5pm.

NZ interest rates fell last week on a combination of offshore events and growing expectations for a softer inflation outlook from the RBNZ this week. On Tuesday the RBA left rates on hold, as expected, but the more cautious tone (including comments around the strength of the AUD) reinforced expectations that the RBA will be on hold for a long time yet. US interest rates also fell over the week on the back of softer than expected data. However, Friday night's stronger than expected Non-farm Payrolls release saw US interest rates recover some of their losses from earlier in the week.

While NZ interest rates tend to be pushed around by offshore moves (notably those in the US and Australia), **growing expectations for the RBNZ to lower its inflation outlook also weighed on interest rates last week.** Many economic commentators (including ourselves) released previews last week detailing expectations for the RBNZ to delay the timing of the first OCR hike. The combination of weak GDP growth, the weaker than expected Q2 CPI, the high NZD and ongoing softness in wage growth are all key factors in commentators expecting the RBNZ to lower the OCR track.

Short-term outlook:



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Comment: This week, the **key release will be Thursday's RBNZ OCR and MPS.** The **risk is that the RBNZ does not change the OCR track and by keeping the status quo, disappoints market expectations.** If the RBNZ leaves the outlook unchanged, yields would likely lift sharply. However, if the RBNZ lowers its outlook, we would expect to see NZ interest rates dip further.

Attention will also be paid to **this afternoon's RBNZ 2-year inflation expectation result.** Given the softer than expected Q2 CPI result, the risk is that inflation expectations dip back towards 2%. However, the RBNZ is unlikely to be too concerned as long as expectations remain around the 2% level.

Medium-term outlook:

Last Quarterly Economic Forecasts

The RBNZ continued to hold the OCR at its record-low of 1.75% at its June OCR Review. In May, the RBNZ surprised markets by retaining its neutral policy stance, despite the stronger than expected Q1 CPI result and Q2 RBNZ inflation expectations data.

At the June OCR review, the RBNZ acknowledged the major developments since the May Monetary Policy Statement. **GDP growth proved weaker than expected**, the **TWI has appreciated** and **energy prices have declined**. However, providing some offset, the **higher Terms of Trade and Budget 2017** are all positive for medium-term growth prospects. While the **RBNZ's assessment of events was broadly in line with our expectations, some market participants were surprised that the RBNZ did not use firmer language on the NZD**. The RBNZ 'merely' noted the higher NZD was partly due to export prices.

At the May MPS, a key point of difference between our view and the **RBNZ's was our medium-term milk price assumption**. We see scope for the RBNZ to revise this up in light of **Fonterra's confident opening season milk price forecast**. However, we will have to wait for the August MPS to confirm if this is the case.

The **RBNZ's view of the inflation outlook remained unchanged from the May MPS**. The RBNZ reiterated that the Q1 strength was largely due to temporary rises in petrol and food prices and that inflation was likely to be volatile over the next few quarters. However, we think the RBNZ's inflation outlook will have softened, given recent events. **Notably, Q2 inflation moderated more than the RBNZ expected** (with annual inflation falling back to 1.7% compared to the RBNZ's May expectation of 2.1%) and Q2 wages growth remained subdued.

As a result, we now think that the RBNZ will leave the OCR on hold until February 2019, previously November 2018.

Key international data for the week ahead

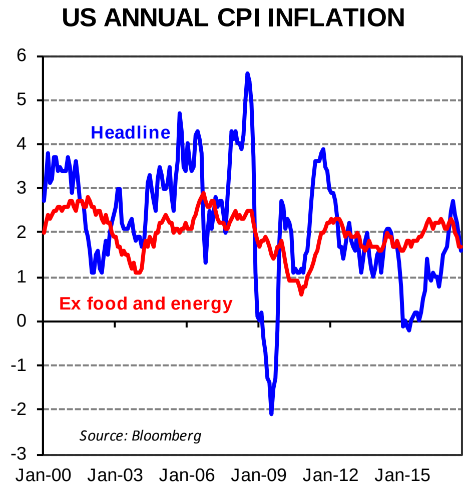
Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Australia Housing Finance, Value of Loans, June, %mom	09/08	1:30 pm	2.9	-	1.0
Australia MI-Consumer Sentiment, August, Index	09/08	12:30 pm	96.6	-	-
Reserve Bank of Australia Gov Lowe to Testify in Parliament	11/08	-	-	-	-
US CPI, Headline, July, %yoy	12/08	12:30 am	1.6	-	1.7

We expect **Australian loans to owner-occupiers to rise slightly in June**, indicating some switching away from investor lending is underway. Total lending is expected to show a modest rise. The overall trend in lending is lower, though, with APRA changes slated to limit lending growth. Higher interest rates to investors are also likely to be crimping demand.

The **Australian MI-Consumer Sentiment Survey** edged 0.4% higher in July to 96.6 but was still below the critical 100 mark which separates consumer optimism (>100) and consumer pessimism (<100). It will be interesting to see whether improving jobs data (and particularly full-time jobs) in recent months will percolate through to enhanced consumer confidence in August.

The **Reserve Bank of Australia's Governor Lowe** is likely to repeat the script outlined in last Friday's Statement of Monetary Policy and recent Board minutes where the central bank sounded more upbeat on the domestic economy. However, it also warned about the negative impact sustained strength in the AUD would have on the growth outlook.

US inflation pressures have eased recently. A slow-down in wage growth and low inflation expectations are bearing down on inflation, despite the low unemployment rate.



NZ Data Preview: a look at the week ahead

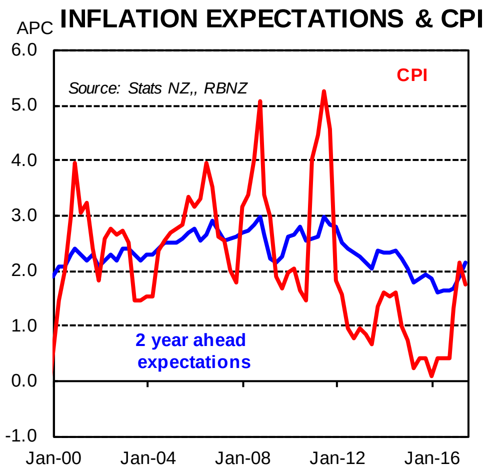
Data	Date	Time (NZT)	Previous	Market expects	ASB expects
RBNZ Survey of Inflation Expectations, Q3, 2-year ahead, %	07/08	3:00 pm	2.17	-	2.0
RBNZ OCR & MPS	10/08	9.00 am	1.75	1.75	1.75
Electronic Card Transactions, July, Total, %mom	10/08	10:45 am	0.0	0.3	0.2

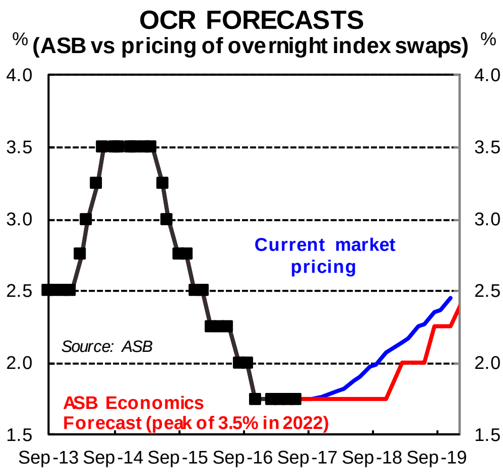
2-year-ahead inflation expectations lifted back above 2% in Q2 for the first time since December 2013. This followed two quarters when inflation lifted sharply. However, inflation has since softened again, and as a result we expect 2-year-ahead inflation expectations will have also dipped back towards 2%. We expect one-year-ahead inflation expectations will also dip slightly to 1.8%. From the RBNZ's perspective, a slight softening will reinforce the view that it will be appropriate to leave the OCR on hold for a sustained period of time.

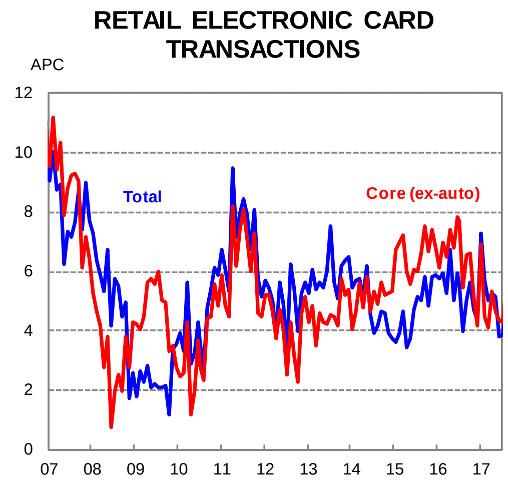
We expect the RBNZ to sound a more cautionary tone in the August Monetary Policy Statement. The balance of events since the June OCR decision points to less inflation pressure. The NZ dollar is higher; the Q2 CPI was weaker than the RBNZ expected; the RBNZ's estimate of the neutral interest rate has edged down further. In addition, Q1 GDP was weaker than expected, now for a second quarter in a row.

As a result, the RBNZ's OCR forecast track is likely to show rate increases will occur in early 2020, 3-6 months later than in its May MPS forecasts. We also don't completely rule out the RBNZ lowering its 2017/18 OCR forecasts slightly if it wanted to signal that there is a higher risk that it cuts the OCR over the next year. Reflecting the shift in risks, **we have also nudged out our own view of when the RBNZ will first lift the OCR, to February 2019** (previously November 2018).

Electronic Card Spending was softer than expected over June, as the Lions tour didn't generate as much spending as expected and as fuel prices fell. **For July, we expect low total spending growth again for the month.** In particular, fuel prices dipped over 4% during the month, so we expect this to drive the overall softness in spending. Meanwhile, hospitality spending is still likely to be strong on the back of the tail end of the Lions tour. **All up, we expect total card spending to rise 0.2% over the month, with core spending slightly higher at 0.4%.**







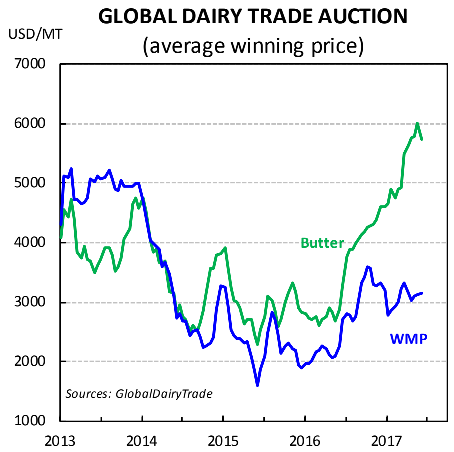
Data Recap: weekly recap

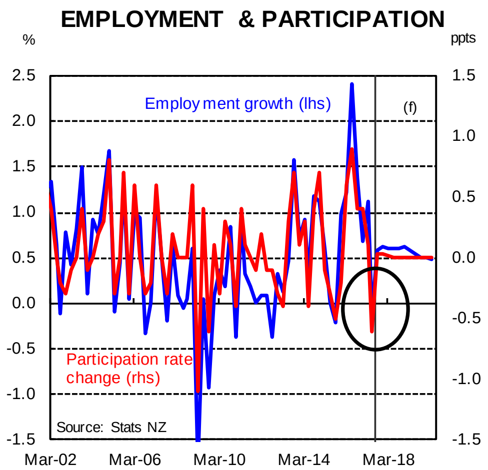
Data	Date	Actual	Market forecast	ASB Forecast
ANZ Business Outlook, headline confidence, July	31/07	19.0	-	-
GlobalDairyTrade auction, whole milk powder, % change	01/08	+1.3	-	+4 to +6
HLFS Unemployment Rate	02/08	+4.8	+4.8	+4.8
HLFS Employment growth, qoq	02/08	-0.2	+0.7	+0.7
LCI Wage Growth, qoq	02/08	+0.4	+0.4	+0.4
Household Lending, sa, % change	05/08	0.4	-	-

ANZ monthly business confidence edged slightly lower in July, reflecting the usual winter decline. On a seasonally-adjusted basis, own activity and general business confidence held onto recent gains. It is encouraging that, so close to an election, firms remain upbeat about the year-ahead prospects for their own businesses' activity and the broader economic outlook. **One area of surprise was an unexpected fall in construction intentions, particularly given the strong pipeline of construction** demand that remains. The RBNZ will be encouraged to see inflation indicators pointing in the right direction, but will wait to see firm evidence of higher core inflation pressures before contemplating OCR increases.

Overall dairy auction prices dipped 1.6% at last week's auction. Milk fat prices led the fall, with butter and anhydrous milk fat (AMF) both falling 4.9%. However, whole milk powder prices (up 1.3%) rose against the grain; although this lift was less than expected. It's not altogether surprising that milk fat prices took a breather, given the price explosion over recent months. Butter prices, for example, have surged over 35% this year, while AMF prices have lifted a more modest, but still robust, 18%. **However, we suspect that the slowdown in milk fat prices may be temporary.** Demand continues to surge and inventories are now very tight. Indeed as supply struggles to keep up, we expect that any further lift in milk fat prices will lift dairy prices more generally.

Employment fell by 0.2% over Q2, weaker than the 0.7% lift in employment forecast by both ourselves and the market. But despite employment falling over the quarter, the **unemployment rate hit a recent low in Q2, falling to 4.8%.** The dip in the unemployment rate reflects the fact that the **labour force participation rate fell to 70.0% in Q2**, from a record high of 70.6% in Q1. The falling participation rate was seen across both male and female workers, as well as across most age groups. However, the lift in those taking themselves out of the labour force in Q2 was mainly women. By region, **Auckland continues to contribute the most to employment growth,** followed by Waikato and Wellington. **Wage growth over the quarter was largely in line with expectations** with the Labour Cost Index showing another quarter of muted wage growth. With no signs of wage growth accelerating over the quarter, we now think the RBNZ will leave the OCR on hold until February 2019.





Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast Market	Forecast ASB
Mon 7 Aug	~	AU	Bank Holiday (NSW, ACT)					
	~	CH	BoP current account balance	Q2 P	CNY bn	$18.4b	~	~
	11:30	AU	Ai Group PCI	Jul	Index	56.0	~	~
	13:30	AU	ANZ job advertisements	Jul	m%ch	2.7	~	~
	15.00	NZ	RBNZ Survey of Inflation Exp, 2-yr ahead	Q3	y%ch	2.17	~	2.0
	17:00	JN	Leading index CI	Jun P	Index	104.6	~	~
Tue 8 Aug	~	CH	Trade balance	Jul	CNY bn	42.8	$45.7	~
	10:18	CH	Foreign direct investment	Jul	y%ch	2.3	~	~
	11:30	AU	ANZ Roy Morgan Weekly Confidence Index	Aug	Index	118.4	~	~
	11:50	JN	BoP current account	Jun	¥bn	1,400.9	1,379.7	~
	13:30	AU	NAB business conditions	Jul	Index	15.0	~	~
	13:30	AU	NAB business confidence	Jul	Index	9.0	~	~
Wed 9 Aug	10:00	AU	RBA's Kent gives Bloomberg address in Sydney					
	12:30	AU	WBC consumer conference index	Aug	Index	96.6	~	~
	13:30	CH	CPI	Jul	y%ch	1.5	1.5	~
	13:30	CH	PPI	Jul	y%ch	5.5	5.6	~
	13:30	AU	No. of own-occupiers	Jun	m%ch	1.0	~	3.0
	13:30	AU	Investment Lending	Jun	%	-1.4	~	~
	18:00	JN	Machine tool orders	Jul P	y%ch	31.1	~	~
Thu 10	09:00	NZ	RBNZ official cash rate	Aug	%	1.75	1.75	1.75
	10:14	NZ	REINZ house sales	Jul	y%ch	-24.7	~	~
	10:45	NZ	Card spending retail	Jul	m%ch	0.0	~	~
	11:50	JN	Machine orders	Jun	m%ch	-3.6	3.1	~
	11:50	JN	PPI	Jul	m%ch	0.0	~	~
	11:50	JN	Housing loans	Q2	y%ch	3.3	~	~
	13:00	AU	Consumer inflation expectation	Aug	%	4.4	~	~
Fri 11 Aug	10:30	NZ	Business NZ manufacturing PMI	Jul	Index	56.2	~	~
	10:45	NZ	Food prices	Jul	m%ch	0.2	~	~
	11:30	AU	RBA's Lowe before House Economics Committee in Melbourne					

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Last	Forecast Market	Forecast ASB
Mon 7 Aug	08:30	UK	Halifax house price 3 months/year	Jul	%	2.6	~	~
	16:45	US	Fed's Bullard speaks on U.S. Economy in Nashville, TN					
	18:25	US	Fed's Kashkari speaks in Bloomington, MN					
	20:00	US	Consumer credit	Jun	£bn	18.4	16.0	~
Wed 9 Aug	13:30	US	Nonfarm productivity	Q2 P	%	0.0	0.6	~
	13:30	US	Unit labor costs	Q2 P	%	2.2	1.0	~
	15:00	US	Wholesale trade sales	Jun	m%ch	-0.5	~	~
	15:00	US	Wholesale inventories	Jun F	m%ch	0.6	0.6	~
Thu 10 Aug	09:30	UK	Industrial production	Jun	m%ch	-0.1	~	~
	09:30	UK	Manufacturing production	Jun	m%ch	-0.2	~	~
	09:30	UK	Construction output	Jun	m%ch	-1.2	~	~
	09:30	UK	Visible trade balance	Jun	£mn	-11,863	~	~
	13:30	US	Initial Jobless and continuing Claims	Aug	~	~	~	~
	13:30	US	PPI ex food and energy	Jul	m%ch	0.1	0.2	~
	15:00	US	Fed's Dudley to Hold Press Briefing					
Fri 11 Aug	13:30	US	CPI	Jul	m%ch	0.0	0.1	~
	13:30	US	Real average weekly earnings	Jul	y%ch	1.1	~	~
	14:40	US	Fed's Kaplan speaks in Arlington, Texas					
	16:30	US	Fed's Kashkari speaks to Independent Community Bankers of Minn					

Economics & Research			Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853	
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778	
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915	
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661	
Publication and Data Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660	

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@ASBMarkets

ASB Economics
ASB North Wharf, 12 Jellicoe Street, Auckland