

Economic Weekly

02 March 2020

Cool heads

What a difference a week makes. Financial markets have abruptly shifted from pricing coronavirus as a short, sharp, largely China-centric shock to something that more closely resembling a global recession. The impact on stocks, currencies, commodity prices, and interest rates has been marked. On Page 2 we provide our own take. Suffice to say, our initial estimates of the likely economic impact on NZ now look too light. We expect some form of co-ordinated fiscal and monetary stimulus to be rolled out in time, but we caution that uncertainty is rife and it's not the time to panic. The RBNZ has thus far sounded (rightly) reluctant to use the OCR to tackle a problem that, to date, has had very uneven impacts on the economy. As the risk that this evolves into a broader macro slowdown rises, an interest rate cut is looking increasingly odds on, potentially as soon as March. However, the degree of uncertainty is such that we are reluctant to formally call for a cut just yet. We'll continue to assess things on a day by day basis, as will the Bank. Cool heads are required. Keep an eye on our Weeklies and Economic Notes for updates.

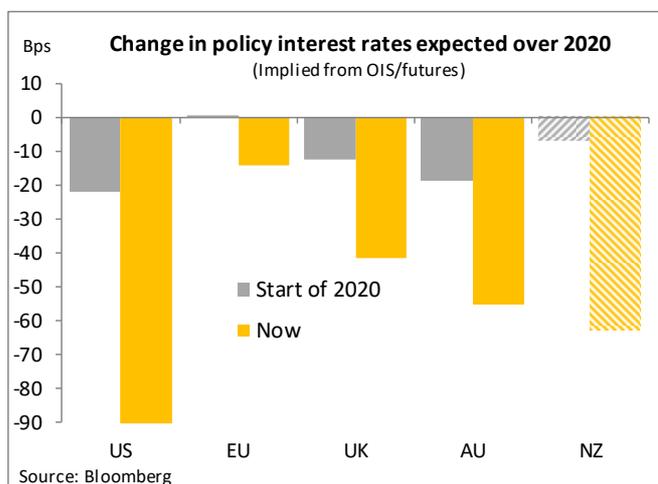
Key events and views

Key Insight	COVID-19 watch
Foreign exchange	NZD drops as COVID-19 outbreak spreads
Interest rates	Fresh lows for NZ yields, our OCR forecast is under review.
Domestic events	GDT auction, Q4 construction
International events	US ISM manufacturing & services, non-farm payrolls, AU GDP & RBA rate decision.

Chart of the Week: A high stakes game of chicken

The rapid escalation in fears about the global spread of COVID-19 have prompted a sharp about-face in interest rate expectations. Nowhere has this been more marked than in the US where a full 90bps of cuts are now demanded for this year.

The People's Bank of China has already doled out support, and central banks across broader Asia are sure to follow. But policy-makers in the G10 to date have struck a notably reticent tone, suggesting it's either too soon to contemplate lower interest rates, or calling for targeted support measures. Which group will be right? For now, we're siding with the central bankers, at least in NZ's case. But the risks are quickly moving in favour of markets' view – tomorrow's RBA meeting will be an important test case; markets are 120% priced for a 25bps cut.



COVID-19 watch: Calm heads are needed

- The COVID-19 outbreak has now reached NZ and could potentially impose significant disruptions on the NZ and global economy over 2020. However, the scale and persistence of its impact remains unknown.
- Households, businesses and policymakers should stay calm. It would be prudent to recognise the new landscape in which we are in and to have a plan B.
- Odds of an OCR cut/cuts have grown and our OCR forecasts are under review. Both the RBNZ and the Government are well placed to provide support if the outbreak has prolonged impacts.

The current situation

The outbreak of the COVID-19 coronavirus has turned what was looking to be a strong economic outlook for 2020 on its head. The spread of the virus has been swift despite efforts to contain it by authorities. Close to 90,000 persons are confirmed to have COVID-19 in close to 60 countries, and worryingly, the first case of COVID-19 in NZ was confirmed last week. Numbers of new COVID-19 cases reported outside of China are now higher than those in the Chinese mainland. South Korea, Japan, Iran and Italy remain new hubs and the outbreak has spread to most corners of the world.

The mortality rate of the COVID-19 coronavirus looks to be low (around 3000 deaths reported so far). More than 40,000 people have recovered so far, but the widespread nature of the outbreak, and its long incubation period make containment difficult.

Already this is causing significant disruption to the movement of people, goods and services. The slump in the Chinese Purchasing Managers Indexes in the weekend to fresh record lows point to a significant hit on Chinese GDP. Global supply chains are clogged and the movement of goods and services significantly impacted. Global tourism flows have been particularly hard hit. To date, the World Health Organisation has yet to announce a global pandemic, which would trigger off more widespread global disruptions.

Financial markets and commodity markets have reacted swiftly, and point to a sizeable hit to the global economy:

- Global equity markets have slid into correction territory (more than 10% falls over last week) and equity market volatility has spiked higher.
- NZ and global yields have plummeted, with US 10 and 30-year Treasury yields at record lows and with NZ 10-year bond yields approaching October 2019 lows, down to 60bps since the start of the year. Odds of central bank rate cuts have grown.
- The NZD is playing its role as shock absorber. The NZD is below 62 US cents, with the NZ trade-weighted index at close to 5-year lows.
- Commodity prices are lower than they would otherwise be. Oil prices (Dubai grade) are down roughly 30% since early January.

The coronavirus will remain the major driver of financial markets in coming weeks, and continued volatility is to be expected.

It's important to be prepared

What can people do? As we discussed in our Quarterly Economic [Forecasts](#), calm heads are needed. We tend to be overly cautious around new and misunderstood risks, which is what this virus is. Panic does no one any good. However, the situation is evolving quickly. **It is prudent for firms, households and policymakers to be prepared. This means having a plan B or even a plan C ready if need be.**

The disruption from the virus will eventually settle. That will be an opportune time to review or develop contingency planning for a range of business risks, and consider the benefit and costs of diversifying export markets and suppliers.

Potential NZ Economic impacts

The economic impacts of COVID will largely depend on disruptions to economic activity caused by efforts to contain the outbreak. Our economic [Forecasts](#), assume that COVID-19 has a short-lived impact on the NZ economy, but we

acknowledged the risks of a more drawn out and significant hit. In short, we assumed that the NZ economy would contract in Q1 of 2020, but subsequently rebound over the remainder of the year as normal service resumed. However, in our [note](#) on COVID-19 we warned that an escalation in the outbreak and its potential spread to NZ could potentially deliver a longer-lasting and more significant hit to the NZ economy.

The situation remains volatile and it is difficult to see how things will pan out. Nevertheless, it would be prudent to consider a range of potential outcomes. A useful framework for analysis is a [speech](#) by NZ Finance Minister Robertson in which he said the Government was looking at various scenarios for NZ and global economy, including:

- 1) A temporary global demand shock impacting the NZ economy across the first half of 2020, before growth rebounds in the second half as export activity return to normal.
- 2) A longer lasting shock to the NZ domestic economy, as the global impact feeds through to the economy for a period of time, and where there are cases of COVID-19 in NZ.
- 3) COVID-19 turns into a global pandemic with widespread and long-lasting impacts, both globally and domestically.

Using a similar framework, we will be soon be publishing updated research that sketches out the potential impacts to the NZ economy under each of these scenarios. **The spread of the outbreak to NZ and the spread of COVID-19 globally highlight the risk of a more widespread impact to NZ economic activity, as firms and households hunker down.** At present, we look to be somewhere between scenarios (1) and (2).

Policy implications

What are the policy implications? **With such an event, wider government policy should be the first cab off the rank.** Government has a vital role to play in co-ordinating the nationwide response and providing targeted support to impacted sectors.

Monetary policy can still help, and it is becoming increasingly likely the OCR will move lower if the impact of demand looks to be long lasting. Our OCR forecasts are under review. Importantly, the Fed and RBA interest rate decisions are due before the RBNZ. An OCR cut as soon as March is a distinct possibility if the outbreak spreads and if other global central banks trim their policy rates. It is imperative that the RBNZ (and other central banks) remains measured, given that they have an important role to maintain confidence.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6210	0.6322	0.6477	0.6809	DOWN	0.6050	0.6300	UP
NZD/AUD	0.9592	0.9561	0.9646	0.9594	FLAT/UP	0.9450	0.9750	FLAT
NZD/JPY	66.56	70.52	70.63	76.03	DOWN	64.00	69.00	FLAT
NZD/EUR	0.5629	0.5841	0.5875	0.5988	DOWN	0.5500	0.5750	UP
NZD/GBP	0.4854	0.4886	0.4946	0.5135	DOWN	0.4750	0.4950	UP
TWI	69.8	70.9	71.6	73.71	DOWN	N/A	N/A	UP

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

NZD Recap

As the COVID-19 outbreak went global over the past week (with the number infected in South Korea, Iran and Italy rising sharply over the week), global investors went on the defensive and market participants started to price in a larger economic impact from the likely disruption as authorities attempted to limit or slow the outbreak's spread. In this "risk off" environment, equities fell and safe-haven investment demand lifted, seeing the NZD drop against the USD, JPY and EUR while remaining steady against the AUD and GBP.

On Monday morning, one of NZ's major banks have called for a 50 basis point Official Cash Rate cut in March, which has further weighed on the NZD. While we believe the RBNZ is increasingly likely to act, it remains early days (no need to panic yet!) and targeted fiscal response is the most appropriate first-line of defence for the economy. Furthermore, the RBNZ will remain wary of large policy moves that may, themselves, increase the level of unnecessary panic.

Near-term outlook

We now expect the Federal Reserve to cut the Fed Funds rate later in March (Thursday 19th, 7am NZ time), with Fed Chairman Powell issuing a short statement on Saturday morning (NZT) acknowledging the risks that COVID-19 presents to the US economy. History shows that the NZD/USD and AUD/USD both fall substantially during a US rate cut cycle, and we see further downside risk to the NZD in the near term.

The Reserve Bank of Australia (RBA) meets on Tuesday and while we don't expect the RBA to cut at this meeting, we acknowledge the risks that it does. A rate cut from the RBA would put further upward pressure on the NZD/AUD. If both the RBA and the Federal Reserve cut rates in March, it would increase the likelihood of the RBNZ also cutting the OCR in late March in order to ensure the NZD continues to provide support to exporters during this highly uncertain and volatile period.

Medium-term outlook

We expect the NZD to resume a gradual uptrend in of 2020, although the USD is expected to cap the extent of NZD/USD strength. In saying that, the coronavirus outbreak is a huge source of volatility and uncertainty for our forecasts. We also expect the NZD/AUD to continue rising over 2020, as the NZ economy continues to outperform that of Australia. In NZ we now expect the RBNZ to leave the OCR on hold, while in Australia we expect two more RBA cuts.

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ASB foreign exchange forecasts

(end of quarter)	Sep-19	Dec-19	Mar-20	Jun-20	Mar-21	Mar-22	Mar-23
	<< actual		forecast >>				
NZD/USD	0.63	0.67	0.67	0.66	0.64	0.66	0.68
NZD/AUD	0.93	0.96	0.99	0.99	0.96	0.96	0.96
NZD/JPY	68	73	69	69	67	67	71
NZD/EUR	0.57	0.60	0.61	0.59	0.57	0.58	0.58
NZD/GBP	0.51	0.51	0.50	0.49	0.49	0.50	0.52
NZD TWI	70.2	73.8	72.7	71.8	69.4	70.2	71.9

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	1.00	1.00	1.75	UNCH	UP
90-day bank bill	1.05	1.14	1.26	1.89	UNCH	UP
2-year swap	0.78	1.00	1.12	1.86	UNCH	UP
5-year swap	0.84	1.07	1.17	2.04	UNCH	UP
10-year swap	1.11	1.32	1.43	2.49	UNCH	UP
10-year govt bond yield	1.06	1.22	1.31	2.18	UNCH	UP
Curve Slope (2s10s swaps)	0.33	0.32	0.31	0.63	UNCH	DOWN

* Current as at 9.30am today; week ago as at Monday 5pm. Key UNCH = Broadly unchanged

Market Recap

Concerns over the spread COVID-2019 coronavirus outbreak have continued to weigh on NZ and global yields. Last week, the first case of COVID-19 was confirmed in NZ. The outbreak has now spread to more than 60 countries and the number of new cases being reported outside of China has overtaken those on the Chinese mainland. The slump in Chinese PMIs to record lows over the weekend added to the risk-off tone to markets as did sharp falls in global equity indices over the week. **Moves in global interest rates have been sizeable.** US Treasury yields touched fresh record lows for the 10 to 30-year tenors. NZ 10-year government bond yields are around record lows (0.91%), with NZ swap yields are 25-30bps lower than a week ago. Market pricing for RBNZ interest rate cuts have firmed, with a 25bp cut in March more than fully priced in, and with more than 60bps of OCR cuts now priced in by the end of 2020 (from just 15bp of 2020 cuts a fortnight ago). Federal Open Market Committee (FOMC) chair Powell noted that the US economy remained strong but signalled the Fed was open to a rate cut if necessary. More than 75bps of Fed cuts are now priced in for 2020 and we have bought forward our FOMC interest rate cut view (see below).

Near-term NZD interest rate outlook

We expect interest rate markets to remain volatile over the next few months. The near-term direction of NZ and global yields will continue to depend on developments relating to the (highly uncertain) impact of the COVID-19 coronavirus. **Market pricing has already moved a long way and we have moved to a neutral bias for the NZ interest rate outlook from our previous lower NZ rates view.** Markets now expect a 25bp RBA interest rate cut tomorrow, but our CBA colleagues (and most market analysis) expect the RBA to hold the cash rate at 0.75%, and to acknowledge COVID-19 risks. Markets are about 80% priced for a 25bp cut by the Bank of Canada this week. **Our focus on the next few months will be the impact of COVID-19 on global and NZ growth.** Forward looking gauges – both domestic and global – are starting to show signs of a pending COVID-19 hit to economic activity. This week's US manufacturing ISM will be looked at for signs of COVID-19 disruption to global supply chains. Other published data this week – Australian Q4 GDP (mkt: 0.4% qoq) and US non-farm payrolls - are mostly backward looking and should have a limited impact on NZ yields.

Medium-term outlook

Our OCR forecasts are under review, with the risk being the RBNZ cuts the OCR. The RBA is expected to cut the 0.75% cash rate by 50bps in 2020 (April, Aug). The 1.50%-1.75% Federal Funds rate is expected to be cut by 50bps in 2020 (Mar, Apr), with the risk of further cuts over 2020. Additional policy support could be unveiled over the coming months as Chinese authorities seek to offset the impacts of COVID-19. Low inflation, moderate global growth and negative risks should cap NZ and global long-term interest rates at low levels. Risks to the local NZ interest rate outlook remain skewed to the downside. mark.smith4@asb.co.nz

ASB interest rate forecasts

	Sep-19	Dec-19	Mar-20	Jun-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.00	1.00	1.00	1.00	1.00	1.25	1.75
NZ 90-day bank bill	1.15	1.29	1.15	1.20	1.25	1.50	2.00
NZ 2-year swap rate	0.94	1.26	1.05	1.10	1.20	1.55	1.95
NZ 5-year swap rate	0.94	1.45	1.10	1.20	1.40	1.80	2.15
NZ 10-year swap rate	1.21	1.78	1.35	1.50	1.70	1.95	2.30
NZ 10-year Bond	1.10	1.65	1.25	1.35	1.50	1.75	2.00

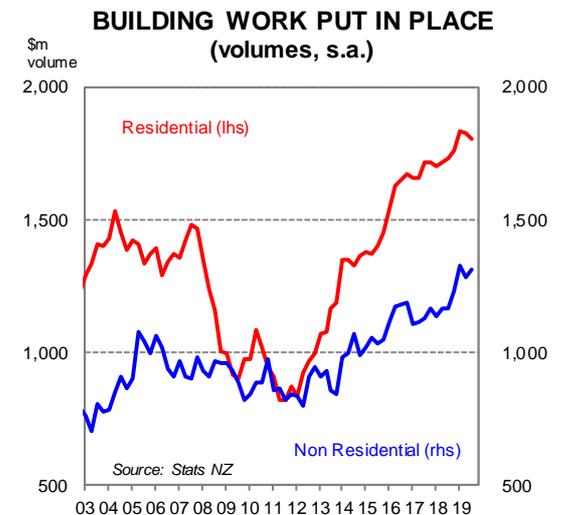
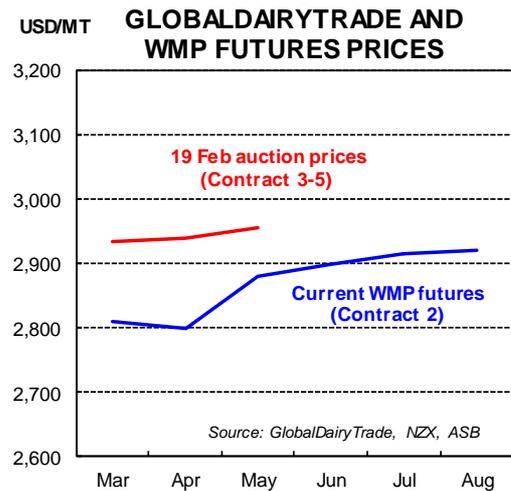
Domestic events

Data	Date	Time (NZT)	Market	ASB
GlobalDairyTrade auction, whole milk powder, % change	03/03	Overnight	-	-3.0
NZ Building Consents, Residential, Dec, %mom	04/03	10:45am	-	-
Building work put in place, volume, Q3, %	06/03	10:45 am	-	0.3

We expect whole milk powder (WMP) prices to fall 3.0% at the GlobalDairyTrade auction overnight Tuesday. The market remains concerned about the impact of the coronavirus on short-term global dairy demand, given the outbreak has spread beyond China's borders. Over February, WMP prices slid over 8% on the back of the coronavirus concerns.

Residential dwelling consents have lifted strongly over the past few years and on an annual basis nationwide consent numbers are at their highest since the mid-1970s. The recent interest-rate induced pick-up in housing demand and house price growth is likely to keep residential construction demand at high levels over 2020.

We expect the volume of building work put in place to remain unchanged over Q4 (+0.0% qoq), following the previous quarter's 0.4% qoq increase. We expect the lift in building activity to be led by a 0.6% increase in residential building, while we expect non-residential building to ease 0.8%. The overall level of construction demand remains at very high levels, but construction growth has slowed over the past year. The fall in interest rates over 2019 has stimulated property demand and is likely to keep construction demand high, despite slowing population growth and economic headwinds as a result of the COVID-19 outbreak.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
US ISM Manufacturing, February, points	02/03	4:00 am	50.5	51.5
Australia Balance of Payments, Q4, \$Abn	03/03	1:30 pm	2.3	0.97
RBA Interest Rate Announcement, %	03/03	4:30 pm	0.75	0.75
Eurozone CPI, February, %yoy	03/03	11:00 pm	1.2	
Australia GDP, Q4 %qoq	04/03	1:30 pm	0.4	0.3
Eurozone Retail Sales, January, %mom	04/03	11:00 pm	0.6	
Australia Retail Trade, December, %mom	06/03	1:30 pm	0.0	0.4
US Non-farm Payrolls, February, 000s	07/03	2:30 am	175	190

*Originally published by CBA Global Markets Research on Friday 28th February at 12:53 pm

We expect **Australia** to have a third consecutive **current account surplus** for Q4 2019 of \$A0.97bn (or 0.2% of GDP). Rising export volumes and solid commodity prices have resulted in a healthy trade surplus. On our calculations, net exports will make a 0.2% contribution to growth over the quarter.

We expect the Reserve Bank of Australia (RBA) to hold the official cash rate steady at 0.75% in March but we have pencilled in a rate cut in April. In recent communication, the RBA reasoned that further easing would be necessary “if the unemployment rate were to be moving materially higher and there was no further progress being made towards the inflation rate”. Since then we saw the unemployment rate rise to 5.3% from 5.1% and the leading indicators of the labour market have softened.

We are expecting a soft 0.3% outcome for **Australian Q4 2019 GDP**. This would see the annual rate of growth tick up to 1.8%, a fair way below our estimates of trend growth (around 2.75%). We will refine our numbers as the rest of the partial data is released over the next few days. GDP is likely to soften further in Q1 2020 with both the bushfires and the coronavirus impacting on the tourism sector. The education sector will also be impacted by the virus.

We expect **retail trade in Australia** to lift by 0.4% in January after falling 0.5% in December. The current ban on Chinese tourists and students because of the coronavirus will mean less spending in the retail sector in early 2020.

The lift in the regional **US** Federal Reserve surveys released to date suggest a lift in the **national ISM**. However, the regional Fed surveys have overestimated the ISM in recent months. And the US PMI has declined in recent months. Overall, we expect a small lift in the ISM to 51.5pts in February.

Eurozone headline CPI inflation is expected to remain muted near 1.2% in February. Disappointing Eurozone economic activity and low inflation expectations continue to contain price pressures. For 2020, the European Central Bank (ECB) projects headline CPI inflation of 1.1% and core CPI inflation of 1.3%.

Firmer consumer credit growth, the improvement in consumer confidence and favourable employment conditions point to a recovery in **Eurozone retail sales** activity in January.

The **US Federal Reserve’s Beige Book** is a qualitative survey of US business conditions. Given the uncertainty of COVID-19, the Federal Open Market Committee will use the Beige Book to make a judgement about the potential impact of COVID-19 on the US economy.

Low jobless claims suggest **US Non-farm Payrolls** increased at a rapid 190,000 in February. This will keep the unemployment rate near generational lows of 3.5%. We estimate the stabilisation in the unemployment rate and the low level of inflation expectations will keep earnings growth to 3.1%yoy.

Key Forecasts

ASB NZ economic forecasts

	Sep-19 << actual	Dec-19 forecast >>	Mar-20	Jun-20	Mar-21	Mar-22	Mar-23
GDP real - Q%	0.7	0.6	-0.1	0.7			
GDP real - A%	2.3	1.8	1.3	2.0	3.3	2.8	2.6
GDP real - AA%	2.7	2.3	1.9	1.8	2.4	2.9	2.7
CPI - Q%	0.7	0.5	0.5	0.4			
CPI - A%	1.5	1.9	2.3	2.1	1.9	2.0	2.1
HLFS employment growth - Q%	0.2	0.0	0.2	0.3			
HLFS employment growth - A%	1.0	1.0	1.1	0.8	1.6	1.6	1.3
Unemployment rate - %sa	4.1	4.0	4.2	4.3	4.2	3.9	4.0
Annual current account balance as % of GDP	-3.3	-3.0	-3.0	-3.2	-3.3	-3.5	-3.3

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts

	Sep-19	Dec-19 << actual	Mar-20	Jun-20	Mar-21	Mar-22	Mar-23
(end of quarter)			forecast >>				
NZ OCR	1.00	1.00	1.00	1.00	1.00	1.25	1.75
NZ 90-day bank bill	1.15	1.29	1.15	1.20	1.25	1.50	2.00
NZ 2-year swap rate	0.94	1.26	1.05	1.10	1.20	1.55	1.95
NZ 5-year swap rate	0.94	1.45	1.10	1.20	1.40	1.80	2.15
NZ 10-year swap rate	1.21	1.78	1.35	1.50	1.70	1.95	2.30
NZ 10-year Bond	1.10	1.65	1.25	1.35	1.50	1.75	2.00

ASB foreign exchange forecasts

	Sep-19	Dec-19 << actual	Mar-20	Jun-20	Mar-21	Mar-22	Mar-23
(end of quarter)			forecast >>				
NZD/USD	0.63	0.67	0.67	0.66	0.64	0.66	0.68
NZD/AUD	0.93	0.96	0.99	0.99	0.96	0.96	0.96
NZD/JPY	68	73	69	69	67	67	71
NZD/EUR	0.57	0.60	0.61	0.59	0.57	0.58	0.58
NZD/GBP	0.51	0.51	0.50	0.49	0.49	0.50	0.52
NZD TWI	70.2	73.8	72.7	71.8	69.4	70.2	71.9

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