Economic Weekly

04 February 2019

NZ labour market likely to step back after strong Q3

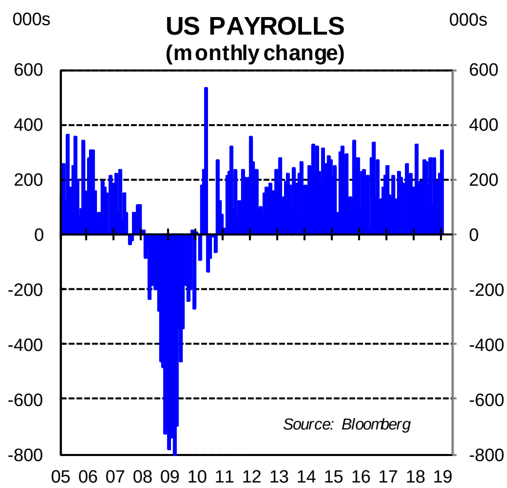
Last week was all about the US Federal Reserve and its on-hold announcement and shift to a neutral bias. The move saw the USD lose ground, with the NZD/USD lifting to above US$0.6900 during the week. The key NZ event this week is the release of the Q4 labour market data. We expect employment to retrace some of its strength from Q3, with the unemployment rate lifting to a still-low 4.1%. The fortnightly GlobalDairyTrade Auction also takes place overnight Wednesday. Key offshore economic events include rate announcements from the RBA and the Bank of England, due Tuesday and Thursday, respectively.

Key events and views

Key Insights	Q4 Labour Market Preview.
Foreign exchange	NZD up following dovish Fed announcement.
Interest rates	Fed move to neutral bias underpins curve flattening in NZ interest rates.
Domestic events	Q4 labour market data and GlobalDairyTrade auction.
International events	RBA Interest Rate announcement, BoE interest rate announcement.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: US Non-farm payrolls provide a mixed labour market picture

Friday's Non-farm Payroll data release showed strong job growth in January, despite the lengthy partial-government shutdown during the month (though we note that US federal employees were generally counted as employed during the period). The survey showed the unemployment rate also ticked up slightly from December, to around 4%.



However, the data also showed **wage growth slowing** during the month, in contrast to expectations. If wage growth continues to decelerate, that may **dampen inflationary pressures on consumer prices**.

We expect the Fed will be closely watching subsequent data releases for evidence of a trend. **Soft wage growth will lower the prospects of a rate increase in the medium term** as the Fed takes a more cautious stance.

Key insights this week: Q4 Labour Market Preview

- The Q4 labour market prints are expected to retrace some of their Q3 "strength", but still show elevated labour market utilisation and a historically-low unemployment rate.
- We expect moderate increases in labour costs, with a 0.6% qoq increase in the Private Sector Labour Cost Index (LCI), with annual LCI wage inflation ticking up to 2.0%. Risks are tilted to the downside.
- Our expectation is that the labour market will tighten over 2019, which will see pressures on core inflation firm, with the OCR set to move up from August 2020. If wages fail to fire, the OCR will remain low.

Q4 Labour Market Forecasts			
Household labour Force Survey	ASB	Prior	Market
Employment growth (QoQ)	0.1	1.1	0.3
Employment growth (YoY)	2.4	2.8	2.6
Unemployment Rate (%)	4.1	3.9	4.1
Employment Rate (%)	68.0	68.3	
Participation Rate (%)	70.9	71.1	71.1
Labour Cost Index			
Private Sector (%, QoQ)	0.6	0.5	0.6
Private Sector (%, ann)	2.0	1.9	2.0

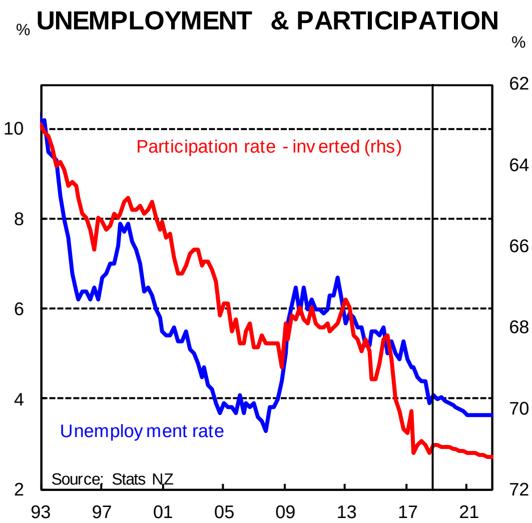
Summary & implications

We expect some modest payback from the strong Q3 HLFS labour prints, which saw employment growth firm and labour utilisation approach decade highs. However, the labour market is expected to remain tight, with the RBNZ meeting its PTA objectives in terms of "supporting maximum sustainable employment within the economy". Wage growth is expected to remain moderate and distributional measures should still depict a contained wage inflation backdrop. Our expectation is that the labour market will tighten over 2019, which will see pressures on core inflation firm, with the OCR set to move up from August 2020. However, the probability of an OCR cut is non-negligible, particularly if economic momentum remains subpar and wage growth fails to fire.

Still-tight labour market despite likely 2018Q4 retracement

It is back to becoming a lottery in trying to correctly pick outturns from the Household Labour Force Survey (HLFS). Following a period of relative calm, HLFS volatility has returned with the September 2018 quarter outturns depicting a much stronger labour market than suggested by various indicators. The Q3 unemployment rate fell to 3.9%, a decade low, with the labour force participation rate (71.1%) and employment rate (68.3%) at (or equal to) record highs. The underutilisation rate (a broader measure of labour market slack) fell to a decade low (10.9%).

We expect the Q4 HLFS figures to show some reversal of Q3's strength. HLFS employment is expected to climb just 0.1% qoq, with the 2.4% annual growth the lowest in two years. A pullback in labour force participation is to be expected (to 70.9% of the working age population), with the employment rate expected to tick lower. Other published employment measures, including filled jobs and paid hours from the Quarterly Employment Survey (QES) should post moderate annual growth rates, consistent with the modestly improving signal provided by experienced and expected employment from the 2018Q4 Quarterly Survey of Business Opinion (QSBO).



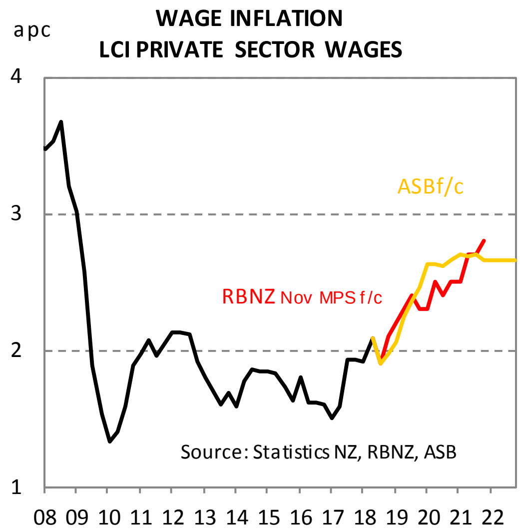
Annual growth in the working-age population is slowing. Earlier published figures from Statistics New Zealand confirmed that the working-age population increased by 0.5% in Q4 (+2.0% yoy), with the addition of just 78,000 persons over the last 12 months, the lowest in three years. Growth in the working-age population is expected to continue to cool as net permanent and long-term (PLT) immigration slows.

Looking beyond the Q4 figures, we expect the labour market to tighten as the rising demand for labour and slower growth in the labour supply combine. The unemployment rate is expected to drift below 4% by late 2019 and ease slightly thereafter. The HLFS participation rate and employment rate are expected to remain elevated, and the underutilisation rate (a proxy for slack within the existing labour market) could approach historical lows.

Wage growth contained, but poised to stir

We expect a 0.6% quarterly increase in private sector LCI wages, with annual wage inflation at 2.0%. Risks are tilted to the downside, particularly if the usual seasonal Q4 lift does not appear. We do not expect the wage data to confirm a generalised strengthening in wage increases just yet. Median and mean wage increases from the LCI are expected to remain relatively contained at around 2.5% yoy.

This year will be crunch time for the wage outlook. If a tightening labour market, minimum wage increases, moves towards more Fair Pay agreements for the lower paid and more employee activism in trying to extract better pay and conditions do not push wages higher, we don't know what will. Low wage inflation has been a global phenomenon of late, but lifting wage growth in the UK and US suggests some of the structural wage suppressants may be abating.



Our expectation is that wage pressures will firm over the course of the year. We are not the only ones, with our projections in a similar ballpark to the RBNZ (see chart). This is not a fait accompli. Anecdotal and survey evidence (notably, the 2018Q4 QSBO) suggests that firms are under increasing margin pressures and are struggling to pass on higher costs. **If economic growth fails to strengthen following its 2018H2 lull and wage growth does not pick up, we struggle to see what will push core inflation higher.**

Market reaction and policy implications

The labour market report is published on Thursday, February 7, a week before the Reserve Bank's (RBNZ) February Monetary Policy Statement (MPS). Market scepticism over the HLFS has likely grown following the surprisingly strong Q3 report. We also expect the RBNZ not to jump to too many conclusions if we get another volatile print, instead maintaining that the labour market backdrop remains broadly consistent with its Policy Targets Agreement objectives of "supporting maximum sustainable employment within the economy". Flexibility is the keyword here.

Markets are generally factoring in some modest reversal of the Q4 numbers and are unlikely to move as much as they did following the Q3 report. If, however, the Q3 labour market report was genuine and we get another strong set of prints for Q4, market pricing will likely seek to take out the close to 15bps on rate cuts currently priced in and the NZD could firm. If, however, wage inflation continues to show few signs of firming and the outlook for economic activity over 2019 is for sub-trend growth, the OCR could well move lower.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6896	0.6867	0.6705	0.7370	FLAT/UP	0.6800	0.7000	DOWN
NZD/AUD	0.9514	0.9535	0.9538	0.9198	FLAT/UP	0.9400	0.9600	DOWN
NZD/JPY	75.51	75.10	72.63	80.72	FLAT/UP	74.00	77.00	FLAT
NZD/EUR	0.6016	0.6011	0.5882	0.5895	FLAT/UP	0.5900	0.6140	DOWN
NZD/GBP	0.5274	0.5202	0.5304	0.5163	FLAT/UP	0.5160	0.5380	UP
TWI	74.6	74.1	73.2	75.01	FLAT/UP	73.5	75.5	DOWN

*^ Weekly support and resistance levels * Current as at 11.25am Tuesday; week ago as at Tuesday 5pm*

NZD Recap

The NZD lifted against most of the major crosses over the past week, although remained reasonably steady against the AUD. **The key event for currencies was the Federal Reserve policy announcement** on Thursday morning. The USD fell after the FOMC moved to a neutral bias, after removing the reference to further “gradual” rate rises from its forward guidance. The strong US employment data had little impact on the USD over the weekend. The NZD also received a small boost after S&P upgraded its NZ sovereign credit rating outlook to AA/Positive from AA/Stable. The GBP fell over the week as the UK Parliament voted to support the Prime Minister’s ‘Plan B’ which aims to replace the Irish backstop measures, despite EU officials stating that UK’s current Brexit Withdrawal Agreement won’t be renegotiated. The EUR pared back some of its post-Fed gains against the USD following the release of Eurozone Q4 GDP figures and confirmation that Italy entered a technical recession. This downward pressure was reinforced by downbeat growth comments from the German Bundesbank President.

Near-term outlook

The NZD/USD is likely to rise this week, as the USD remains under pressure, but also if the Q4 labour market report confirms a robust lift in wage inflation. We expect the USD to modestly depreciate over the course of this week, with the weaker January wage growth outturn reinforcing our view that the Federal Reserve is firmly on hold for now. The USD will remain sensitive to a perceived delay in any US-China trade negotiations. **A potential shift in RBA guidance will be the key event for the AUD this week**, with particular focus on the RBA Governor’s speech on Wednesday including any change to the previous statement “the next move in the cash rate being more likely to be an increase than a decrease”. We expect the GBP to continue to weaken this week as market participants remain confused over the current Brexit negotiations status (see above). We expect this confusion to persist until the next meaningful Brexit-related vote on February 14th.

Medium-term outlook

We have a strong USD outlook given the solid US growth outlook, high US Terms of Trade, and the weaker Chinese and emerging market outlook. We expect the NZD to oscillate in a 65 to 71 US cent range over the forecast period. Nevertheless, the NZD TWI should remain broadly supported by a solid growth outlook, our historically-high Terms of Trade and upwardly drifting NZ interest rates. The NZD/AUD has strengthened recently, but we expect the NZD/AUD to slowly grind lower over 2019 as the RBA is still expected to start tightening monetary policy ahead of the RBNZ. We expect the NZD to ease slightly over the projection period relative to EUR. The European Central Bank is expected to hike rates in September 2019, although slow growth in the Eurozone will limit the extent of ECB tightening. We also expect that Brexit risks will keep the GBP low against the NZD.

ASB foreign exchange forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.66	0.67	0.66	0.67	0.68	0.70	0.66
NZD/AUD	0.92	0.95	0.90	0.91	0.91	0.90	0.90
NZD/JPY	75	74	74	74	73	75	74
NZD/EUR	0.57	0.59	0.58	0.57	0.55	0.55	0.54
NZD/GBP	0.51	0.53	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.1	73.5	72.0	72.4	72.3	72.9	70.2

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.75	1.75	1.75	1.75	FLAT	UP
90-day bank bill	1.93	1.91	1.95	1.84	FLAT/UP	UP
2-year swap	1.92	1.90	1.95	2.17	FLAT/UP	UP
5-year swap	2.09	2.12	2.16	2.74	FLAT	UP
10-year swap	2.51	2.56	2.59	3.28	FLAT	UP
10-year govt bond yield	2.20	2.33	2.34	2.95	FLAT	UP
Curve Slope (2s10s swaps)	0.59	0.65	0.64	1.11	FLAT	FLAT

** Current as at 9.55am today; week ago as at Monday 5pm*

Market Recap

The major event for interest rate markets last week was the switch of the US Federal Reserve to a neutral bias, citing global economic and financial developments and muted inflation as reasons for dropping its tightening bias and becoming "patient" in determining future adjustments. USD yields and the USD dropped sharply following the Fed announcement, with markets now pricing in more than 50bps of Fed rate cuts by the end of the year despite the stronger Payrolls data in the weekend. NZ short-term yields rose marginally, underpinned by widening in OIS-Libor spreads and the retracement from earlier falls. Weak Australian business sentiment, low headline and core inflation and the further fall in Australian dwelling prices kept market pricing tilted towards RBA rate cuts. The NZD curve remained under flattening pressure, with the Fed-driven rally seeing yields on NZ 10-year swaps and 10-year bonds approaching 2-year lows. Weak data from Europe (Italian economy in recession in H2 2018), the lack of a break-through between the US and China on trade despite reported signs of progress and the growing (but still small) risk of a no-deal Brexit following the UK parliamentary vote kept global yields low.

Near-term NZD interest rate outlook

We have retained our curve flattening bias. Thursday's NZ household labour force report has the potential to cause volatility in NZD rates, and a set of stronger than expected prints could see markets trim the 14bps of early 2020 OCR cuts priced in. We expect the RBA to hold the cash rate at 1.50%, deliver a neutral policy assessment and retain an upbeat assessment of the Australian economy, which could also trim rate cut pricing. We expect a period of consolidation for global yields. With a potential trade deal between the US and China unlikely until the end of this month, equity market direction will be a key barometer for global yields. The Bank of England decision will be overshadowed by Brexit, with no change to settings expected and the Bank's inflation report to likely trim growth and inflation forecasts. **Despite our low outright yields, we retain the view the downward risk profile could continue to dampen longer-term yields.**

Medium-term outlook

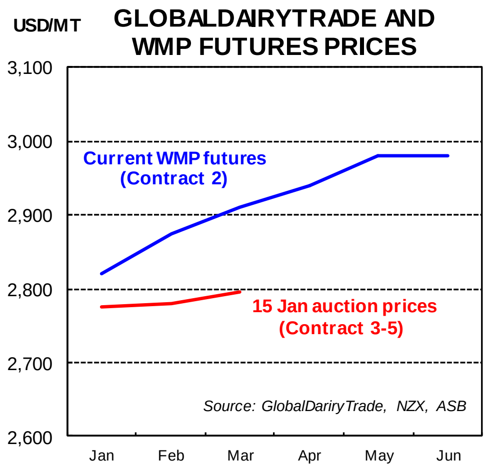
Given our low outlook for core inflation, we expect the OCR to remain on hold until August 2020. Our view is that the medium-term inflation outlook will not be strong enough to trigger OCR hikes. Proposed higher bank capital requirements will likely tighten financial conditions, lower wholesale interest rates across the curve and delay RBNZ tightening. **We expect a historically-low OCR endpoint of just 2.75% this cycle** (from late 2021). NZD long-term yields are expected to gradually firm and move above US counterparts, but mild RBNZ tightening, contained NZ inflation, and the strong allure for NZ assets should cap NZ yields at low levels.

ASB interest rate forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	2.25	2.75
NZ 90-day bank bill	1.91	1.97	2.1	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.04	1.97	2.3	2.4	2.7	3.0	3.2
NZ 10-year Bond	2.65	2.38	2.5	2.6	3.3	3.4	3.4

Major Domestic Events for the week ahead

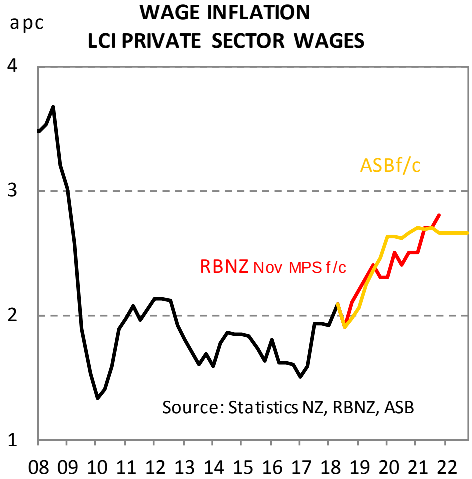
Data	Date	Time (NZT)	Previous	Market	ASB
Building Consents, Residential, Dec, %	04/02	10:45 am	-2.0	-	-
GlobalDairyTrade auction, whole milk powder, % chg	06/02	Overnight	+3.0	-	No change
Employment, Q4, % qoq	07/02	10:45am	1.1	0.3	0.1
Unemployment rate, Q4, %	07/02	10:45am	3.9	4.1	4.1
LCI, private sector, Q4, % qoq	07/02	10:45am	0.5	0.6	0.6

Residential consents fell 2% in November and consents issued are likely to remain subdued in December (reflecting the relatively short number of working days in December ahead of the Christmas break in 2018). Residential consents have remained broadly flat over the past six months, albeit down on the highs earlier in 2018. We expect residential housing construction to remain relatively elevated for some time in order for housing supply to catch up with pent-up demand. Meanwhile, there are no signs of a slowdown in commercial construction demand despite weak business confidence levels seen over the year. Non-residential consents typically fall during January and February, and sometimes this weakness can start early in December.



We expect whole milk powder prices to be unchanged at the **GlobalDairyTrade** auction overnight Wednesday. Three weeks ago whole milk powder (WMP) prices rose by 3%, boosted by news that the EU had sold down its intervention stocks. Since then, however, data showed that NZ December production was very strong. At the current juncture, futures pricing suggests WMP prices will rise by over 2%. However, we continue our practise of discounting futures pricing given their poor performance as an indicator over recent times.

The **Q4 labour market** prints from the Household Labour Force Survey are expected to retrace some of their Q3 “strength”, but still show elevated labour market utilisation and a historically-low unemployment rate. Moreover, we expect moderate increases in labour costs, with a 0.6% qoq increase in the Private Sector Labour Cost Index (LCI), with annual LCI wage inflation ticking up to 2.0%. Risks to our pick for wage growth are tilted to the downside. This year will be crunch time for the wage outlook. Our expectation is that the labour market will tighten over 2019, which will see pressures on core inflation firm, with the OCR set to move up from August 2020. If wages fail to fire, the OCR could remain flat for longer – or move lower.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
AU Building Approvals, Dec, %	04/02	1:30 pm	2.0	5.0
AU Retail Trade, volumes, Q4, %	05/02	1:30 pm	0.5	0.2
AU Trade Balance, Dec, $bn	05/02	1:30 pm	2.2	1.8
RBA Interest Rate Announcement, %	05/02	4:00 pm	1.5	1.5
BOE Interest Rate Announcement, %	08/02	1:00 am	0.75	0.75
RBA Statement of Monetary Policy	08/02	1:30 pm	-	-
US GDP, Q4, saar %	-	-	2.6	2.5
US PCE deflator, headline, Dec, % yoy	-	-	1.7	1.6

**Originally published by CBA Global Markets Research on Friday 1st February 2019 at 1.33pm.*

AU Residential Building Approvals: Approvals fell by a sharp 9.1% in November. Approvals are on a clear downtrend. But the expectation for a lift in building approvals over December is based on a partial recovery in multi-unit approvals and a flat outcome for houses.

AU Retail Trade Volumes: Across October and November retail trade printed +0.3% and +0.4%, respectively. But December looks weak. Our internal data suggest that the cumulative value of dollars spent was down by 3.7% relative to December 2017. Retail volumes are likely to grow by a soft 0.2% over Q4.

AU Trade Balance: Australia continues to post solid monthly trade surpluses. But they have narrowed a little over the past few months. We expect a further modest narrowing in the trade balance over December primarily because of a lift in imports.

RBA Policy Announcement: The RBA will leave the cash rate unchanged at 1.5%. We expect the RBA Governor to retain an upbeat assessment of the Australian economy. He may emphasise that downside risks have risen more recently. But overall we expect a positive tone to the Statement. We don't expect Lowe to telegraph in his Statement that the next move in the cash rate is likely to be up rather than down. But that is not a departure from last year. The line about "the next move in the cash rate being more likely to be an increase than a decrease" was a regular feature of RBA Minutes, speeches and the SMPs, but not the Governor's monthly Statements.

RBA Governor Speech: Speech by Philip Lowe, Governor, at the National Press Club, Sydney. We expect the Governor to reiterate that he thinks the next move in the cash rate is likely to be up rather than down. He may preview Friday's key SMP forecasts for growth and inflation.

RBA Statement of Monetary Policy: We expect that the RBA's near-term growth figures will be downwardly revised due to the soft Q3 2018 GDP outcome. But the broader profile should remain intact. We expect both core inflation and the unemployment rate projections to be largely unchanged. Such a profile for growth, inflation and unemployment implies that the Bank still expects policy to be tightened next rather than loosened. We expect the SMP to contain the line that the next move in the cash rate is likely to be up rather than down. The risk to our view is that this line is dropped. If that were to occur, the RBA would be implicitly signalling that a cut to the cash rate is as likely as a hike. We view that outcome as unlikely, but it cannot be ruled out.

US GDP: The US government shutdown has reduced the amount of official economic statistics released in the past month. Nevertheless, the data and surveys released so far indicate US economic growth has slowed from Q3's strong 3.4% rate.

US PCE deflator: We estimate the large falls in retail gasoline prices pushed headline inflation lower in December to 1.6% yoy. But core inflation should remain at 1.9% yoy, or even lift to 2.0% yoy, because the tight labour market is pushing up wage growth.

Key Forecasts

ASB NZ economic forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
	<< actual	forecast >>					
GDP real - Q%	0.3	0.5	0.8				
GDP real - A%	2.6	2.4	2.6	2.5	3.3	3.0	2.9
GDP real - AA%	3.0	2.8	2.7	2.5	3.0	3.1	2.9
CPI - Q%	0.9	0.1	0.1	0.5			
CPI - A%	1.9	1.9	1.5	1.6	2.0	1.8	2.0
HLFS employment growth - Q%	1.1	0.1	0.5	0.4			
HLFS employment growth - A%	2.8	2.4	2.4	2.2	1.7	1.6	1.4
Unemployment rate - %sa	3.9	4.1	4.0	4.0	3.8	3.7	3.6
Annual current account balance as % of GDP	-3.6	-3.9	-3.7	-3.7	-3.6	-3.5	-3.6

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-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	2.25	2.75
NZ 90-day bank bill	1.91	1.97	2.1	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.04	1.97	2.3	2.4	2.7	3.0	3.2
NZ 10-year Bond	2.65	2.38	2.5	2.6	3.3	3.4	3.4

ASB foreign exchange forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.66	0.67	0.66	0.67	0.68	0.70	0.66
NZD/AUD	0.92	0.95	0.90	0.91	0.91	0.90	0.90
NZD/JPY	75	74	74	74	73	75	74
NZD/EUR	0.57	0.59	0.58	0.57	0.55	0.55	0.54
NZD/GBP	0.51	0.53	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.1	73.5	72.0	72.4	72.3	72.9	70.2

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
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
Publication & Data Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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