Economic Weekly

04 March 2019

Swings and roundabouts

It was a mixed bag for NZ last week. Business confidence in the ANZ survey sank back, dashing hopes that the lift in sentiment late last year would continue into this year. And, while we expect economic growth to recover from a soft patch in 2018, continued weak business confidence flags a threat to that if it reflects indecision over hiring and capital expenditure. Friday's manufacturing and building data will help finalise Q4 GDP forecasts, at present shaping up to be a weak 0.3% qoq. More positively, dwelling consents surged over January – aided by apartments and retirement units – to hit a 44-year annual high. Fonterra provided a higher milk price forecast range of $6.30-$6.60 for this season, but cut the share dividend. We do see this week's dairy auction as positive, reinforcing a solid price finish for the season.

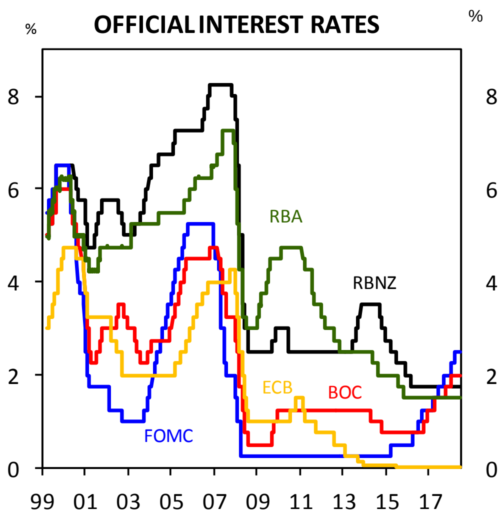
Key events and views

Key Insights	Fonterra's 2018/19 milk price forecast review.
Foreign exchange	NZD/USD softened last week, particularly against the Pound.
Interest rates	NZD and global yields started the week a touch higher, with curves marginally steepening.
Domestic events	GlobalDairyTrade Auction, Building Work Put in Place and Electronic card transactions.
International events	RBA and ECB Interest Rate Announcements, Australian GDP, retail trade due out this week.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: Front and centre

It's a big week for central banks, with interest rate announcements from the RBA, Bank of Canada and the European Central Bank. Policy interest rates have remained historically low for most global central banks, supporting economic activity. Interest rates had earlier started to move up in the US and Canada before the weakening outlook for global growth has triggered the move to a more "patient" stance in 2019.

We expect the Fed to remain on hold over the next few years, with the Bank of Canada widely expected to keep rates on hold for the foreseeable future. No changes to current settings are expected from the ECB, with the risk that policy tightening is delayed beyond mid- 2019 given the weaker outlook for the Eurozone economy.



Source: Bloomberg, ASB

Closer to home, the RBA is expected to hold rates and depict a neutral stance, with the weak Australian housing market and slowing international trade expected to encourage the RBA to maintain the cash rate at record lows for a while yet.

Key insights this week: Dairy's two steps forward, one step back

- Last week, Fonterra lifted its 2018/19 milk price forecast range by 30 cents to $6.30-$6.60/kg.
- However at the same time, Fonterra's business performance continues to disappoint, with a cut to its earnings forecast also announced.
- Meanwhile looking towards the 2019/20 season, we have set our milk price forecast at a bullish $7.00/kg.

Updated Farmgate Milk Price Forecasts

	2018/19		2019/20	Long Run
	Fonterra	ASB	ASB	ASB
Milk Price*	$6.30-$6.60	$6.25	$7.00	$6.50-$7.00

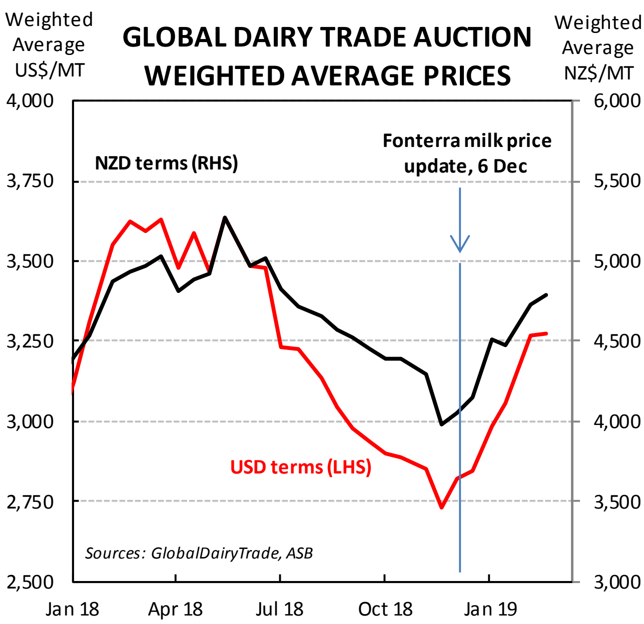
* per kg of milk solids (excluding dividend).

Two steps forward…

Last week, Fonterra lifted its 2018/19 milk price forecast range by 30 cents to $6.30-$6.60/kg. The revision was at the top end of our expectations. For example, we had revised our own forecast up by a more modest 25 cents earlier in February.

The revision reflects the tightening in dairy markets over the past three months. Dairy auction prices have lifted 17.3% since Fonterra's last update back in early December.

Fonterra also noted that the catalysts for the improvement include tighter global dairy supply and ongoing firmness in demand. "Global demand has strengthened. This is driven predominantly by stronger demand from Asia, including Greater China."



…and one step back

Meanwhile, **Fonterra's corporate performance continues to disappoint**. Fonterra has revised down its 2018/19 forecast earnings per share by 10 cents to 15-25 cents per share. Fonterra also announced that it will not pay an interim dividend this year. Using the midpoint of its forecast and Fonterra's current 70% dividend policy implies a forecast dividend reduction of 7 cents per share for the year.

Fonterra highlighted several pressure points within its business, including "challenges in our Australian Ingredients and our Foodservice businesses in wider Asia. In addition, the increase in milk price… has put pressure on margins."

The update also shines light on the ongoing concerns around the strength of its balance sheet. Fonterra has plans to reduce debt by $800m this year and it seems it has had to, in part, sacrifice the interim dividend to do so.

Lastly, **Fonterra also revised down its forecast growth in milk collections,** citing hot and dry weather this year. Fonterra now expects 2% growth over the season, from 3% previously.

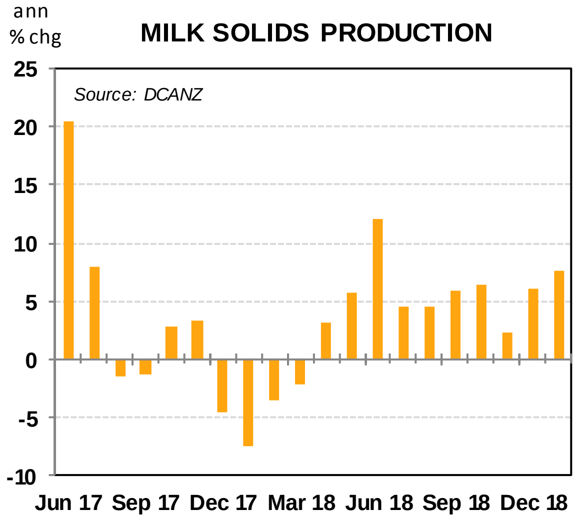
The forecast changes are net positive for farmer incomes…

On a net basis, **Fonterra's changes to its milk price, dividend and milk production forecasts add around $225m to our forecast of Fonterra farmer incomes**. Adding non-Fonterra farmers into the mix sees our forecast nationwide farm incomes lift around $345m.

The lift in dairy incomes will support broader household spending and investment growth over the year. However, with dairy sector debt levels still relatively high, more of this extra income will be diverted into debt repayment than has traditionally been the case.

Looking to the 2019/20 season…

Over 2018, very strong NZ production offset supply softness in the EU, US and Australia. EU and US supply are both set to end 2018 (once data are published) up a modest 1% or so on 2017 and we anticipate more of the same over 2019. Meanwhile, Australian production is down 5% on a season to December basis. In contrast, NZ supply is 5.6% ahead of last season on a season to January basis.

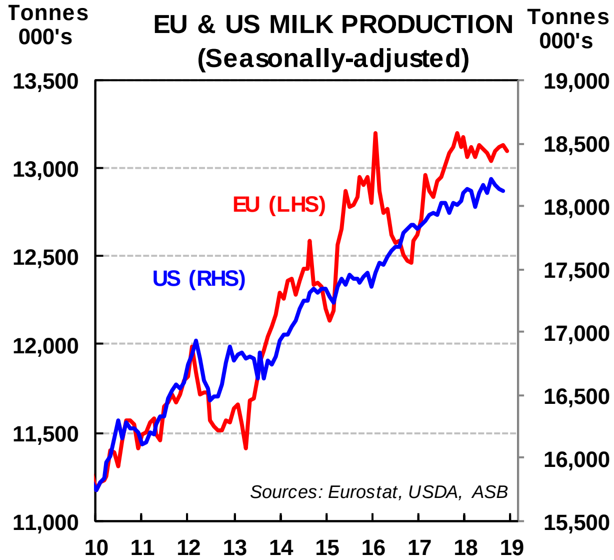


However, **we anticipate that this is as good as it gets for NZ supply**. Growing conditions were very favourable over the first eight months of the season, but this is unlikely to last. Already very hot weather has started to put the brakes on production over February and early March. In addition, despite strong recent production, NZ's dairy herd is actually smaller than in prior seasons.

Accordingly over calendar 2019, **we anticipate NZ supply annual growth to slow to around 1%**. Growth at this level across the major exporters (the EU, NZ and US) won't be enough to keep up with annual global demand growth of circa 2%.

… we set our milk price forecast is a bullish $7.00/kg

Moreover, **global dairy stocks are now much lower than in previous years**. EU intervention stocks had been a buffer against any supply tightness; however, now these stocks have been sold down, making supply vulnerable to shocks.



With the above in mind, we anticipate global dairy prices will lift over the first half of 2019. **As a result, we have set our 2019/20 milk price forecast at a bullish $7.00/kg**.

We would point out that there are still risks to this view. For now, we assume that global demand remains firm and that weakness in global growth does not spill over into weaker demand for dairy. In particular, we assume that the Chinese household sector remains a bright spot in an otherwise weaker-performing Chinese economy.

We also point out that it is still very early days for the 2019/20 season forecast. Our $7.00/kg forecast is the midpoint of a very wide forecast range. For example, from Fonterra's opening forecast in May the average difference between the start and end forecasts is around $1.30/kg.

High dairy prices and incomes are likely to underpin the NZD

Nonetheless, the outlook is positive for dairy sector incomes over the year. In turn, this bullish dairy view is also **a key factor supporting our forecasts for the NZ dollar to remain firm on a trade-weighted basis through 2019**.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6827	0.6864	0.6913	0.7267	FLAT	0.6750	0.6950	UP
NZD/AUD	0.9595	0.9607	0.9546	0.9370	FLAT	0.9500	0.9700	FLAT
NZD/JPY	76.36	75.94	75.25	77.04	FLAT	75.50	77.50	UP
NZD/EUR	0.6000	0.6051	0.6042	0.5917	FLAT	0.5950	0.6100	FLAT
NZD/GBP	0.5152	0.5252	0.5279	0.5271	FLAT	0.5050	0.5250	UP
TWI	74.1	74.2	74.4	74.92	FLAT	73.0	75.0	UP

*^ Weekly support and resistance levels * Current as at 10am Monday; week ago as at Monday 5pm*

NZD Recap

The NZD was mainly softer last week. The biggest move came against the GBP following news that UK will likely avert a 'hard Brexit' and the EU was preparing to delay Brexit until at least July. On the week, the NZD fell around one cent against the Pound. Local events last week were mixed for the kiwi, with the strong Q4 retail sales data first boosting the NZD on Monday, but then soft business sentiment on Thursday took the kiwi the other way. On Friday, strong building consents data offset weak consumer confidence and Terms of Trade data, leaving the NZD largely unchanged on the day. Meanwhile, the USD softened in early trading today as US President Trump said Saturday that the USD is too strong. He also took a swipe at Federal Reserve Chairman Jerome Powell, labelling him as someone who "likes raising interest rates." That said, we anticipate that these comments won't have a lasting impact on the direction of the USD.

Near-term outlook

This week the NZD will receive some support from Tuesday's GlobalDairyTrade auction, if prices firm as expected. There are also a handful of partial Q4 GDP indicators released on Friday. The NZD and New Zealand interest rates could soften if these indicators continue to suggest another soft quarter of NZ economic growth. The NZD may also take direction from the AUD. On that front, the AUD could ease this week, if, in their post-meeting statement, RBA officials continue to highlight downside risks to the world economy and Australian consumer spending. The EUR has scope to ease this week. The ECB may signal its key interest rates will remain on hold for longer than current guidance of "at least through the summer". Meanwhile, the GBP is likely to remain at the top end of its trading range because the chance of a hard Brexit has reduced significantly.

Medium-term outlook

We expect the NZD/USD to gradually strengthen given NZ's high Terms of Trade and continued investor interest in New Zealand assets. We expect the USD will hold some of its strength despite the market partially pricing in potential future Fed rate cuts. We have lifted our NZD/AUD forecasts and now expect the NZD/AUD is to remain close to 0.9600 over the next few years. We revised our AUD forecasts lower to reflect Australia's housing adjustment and the risk of slower growth in Australian household consumption. We have delayed the timing the EUR appreciation as Europe's economy has softened notably and we expect the ECB will now wait until the end of 2020 before raising interest rates.

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	0.68	0.68	0.70	0.72	0.74
NZD/AUD	0.92	0.95	0.96	0.96	0.96	0.96	0.97
NZD/JPY	75	74	75	76	77	78	80
NZD/EUR	0.57	0.59	0.60	0.60	0.59	0.59	0.60
NZD/GBP	0.51	0.53	0.55	0.54	0.54	0.55	0.57
NZD TWI	72.1	73.5	74.1	73.9	74.8	75.0	76.6

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	1.89	1.89	1.93	1.85	FLAT	UP
2-year swap	1.88	1.86	1.92	2.20	FLAT	UP
5-year swap	2.06	2.04	2.09	2.69	FLAT	UP
10-year swap	2.49	2.45	2.50	3.19	FLAT	UP
10-year govt bond yield	2.18	2.16	2.20	2.93	FLAT	UP
Curve Slope (2s10s swaps)	0.61	0.59	0.59	0.99	FLAT	FLAT

** Current as at 10am today; week ago as at Monday 5pm*

Market Recap

NZD and global yields started the week a touch higher, with curves marginally steepening. Stronger-than-expected US Q4 GDP data and positive sentiment on trade pushed up US Treasury yields, with higher corporate bond issuance dampening the demand for longer-term Treasuries (i.e. yields higher). According to media reports, the US and China have continued to edge close to a trade deal, with a leaders summit as early as mid-March. Fed speakers stuck to the script, emphasising the on-hold and "patient" message. UK and European yields were firmer, as risks of a hard Brexit receded, with PM May signalling that the UK Parliament would vote for a "short" extension of the March 29 Brexit date. Moreover, Brexit hardliners appeared to be softening their opposition to PM May's Brexit deal. **NZ data were mixed, but weak business sentiment from the** ANZ survey and the official Chinese manufacturing PMI at a 3-year low have kept market pricing biased towards a potential OCR cut over 2019.

Near-term NZD interest rate outlook

NZ yields are hovering around record lows and the curve has flattened considerably compared to a year to two ago. **We see little impetus for short-term yields to pop higher, with few local events this week, with global central banks likely to continue to remain "patient", and a generally solid Payrolls print expected at the end of the week**. No changes to policy settings by the Reserve Bank of Australia (RBA), Bank of Canada (BOC) and European Central Bank (ECB) are expected, although there is the risk that the ECB may adopt a more dovish stance given the slowdown in Eurozone activity and soft inflationary pressures. Fed member speeches are expected to stick to the "patient" script. The RBA is widely expected to hold the cash rate at 1.50% and provide a balanced assessment, with Governor Lowe to provide an update on the RBA's view in a speech on Wednesday. Q4 Australian GDP is expected to be weak (we expect a quarterly print in the 0.25-0.5% range), which would cap Australasian yields. **Longer-term yields could drift higher if prospects for the global economy improve, but short of a US-China trade deal being announced this week we see no immediate catalysts.** Brexit headlines could generate volatility, but with the key vote not due until March 12, this week could be the calm before the storm.

Medium-term outlook

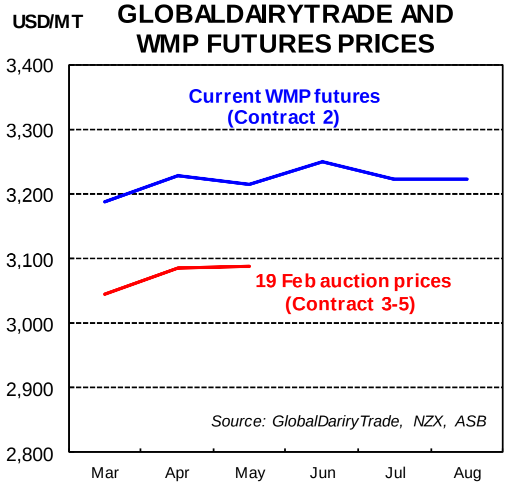
In February, we shaded down our NZD interest rate forecasts, in light of global developments, our low inflation outlook and higher proposed bank capital requirements for locally-incorporated NZ banks. **We now expect the OCR to remain on hold until February 2021** (previously August 2020). We also expect the Fed to remain "patient" and to hold policy rates at 2.25 – 2.50% over the projection period and have pushed back prospective monetary tightening from the Reserve Bank of Australia and European Central Bank (to late 2020). **We also expect a historically-low OCR endpoint of just 2.25% this cycle** (from late 2021). NZD long-term yields are expected to gradually firm, but mild RBNZ tightening and contained NZ inflation 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	2.00	2.25
NZ 90-day bank bill	1.91	1.97	1.9	2.0	2.0	2.3	2.5
NZ 2-year swap rate*	2.04	1.97	1.9	2.0	2.2	2.6	2.7
NZ 10-year Bond*	2.65	2.38	2.2	2.3	2.5	2.7	2.8

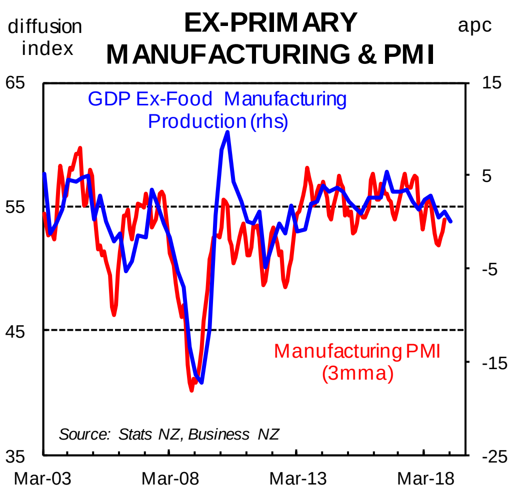
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
GlobalDairyTrade auction, whole milk powder, % change	05/03	overnight	0.3	-	2.0
Economic Survey of Manuf, sales volumes, Q4 % qoq	08/03	10.45 am	-1.6	-	-
Building Work Put in Place, volumes, Q4, % qoq	08/03	10:45 am	0.7	-	-0.7
Electronic Card Transaction, retail, January, %mom	11/03	10:45 am	1.8%	-	0.3%

We expect whole milk powder (WMP) prices to build on recent gains at the GlobalDairyTrade auction overnight Wednesday. WMP prices have lifted by over 13% so far this year. At the current juncture, futures pricing suggests WMP prices will rise by 4%. We are not as bullish as that, but still expect a rise in the vicinity of 2%.

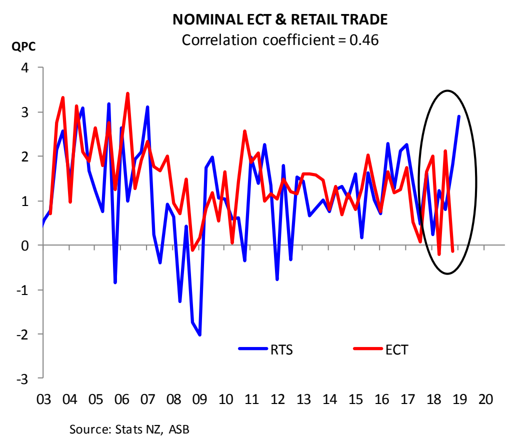


Manufacturing sales volumes fell 1.6% in Q3, dragged lower by a 6.7% fall in meat and dairy sales volumes. We use sales *and* inventory from the Economic Survey of Manufacturing as an indicator for Q4 GDP ex-meat and dairy manufacturing production. We expect Q4 GDP ex-meat and dairy manufacturing production to contract 0.5%. The BusinessNZ Manufacturing PMI survey eased over the second half of 2018, pointing to a decline in manufacturing volumes (excluding meat and dairy).



Building Work Put in Place is a survey of building-related construction activity and is a key input into GDP. We forecast the volume of building activity fell 0.7%, dragged lower by a 1.4% fall in residential building volumes. We expect a modest 0.3% lift in non-residential building volumes to provide some partial offset. Construction activity is likely at a peak, with further growth in output constrained by capacity.

We expect a modest February month for retail card spending. Rising fuel prices are expected to translate into the first increase in monthly fuel spend in five months. Modest moves are expected for most components, with a small fall possible for durable spending. Annual growth in retail and core spending is expected to remain below that of household incomes and the flat domestic housing market backdrop and slower population growth will likely cap retail spending growth over 2019. The last few months have shown considerable volatility in the ECT figures and there has been a marked disconnect between the ECT and retail sales figures, which has reduced their market and policy relevance.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Australia Company Profits, Q4, %qoq	04/03	1:30 pm	-	0.5
Australia Current Account Deficit, Q4, $bn	05/03	1:30 pm	9.1	9.0
RBA Interest Rate Announcement, %	05/03	4:30 pm	1.5	1.5
RBA Gov. Lowe to speak at Business Summit in Sydney	06/03	11:10 am	-	-
AU GDP, Q4, %qoq	06/03	1:30 pm	0.5	0.25-0.50
AU Retail Trade, January, %mom	07/03	1:30 pm	0.3	0.5
ECB Interest Rate Announcement, %	08/03	1:45 am	No change	No change
US Non-farm Payrolls, February, 000s	09/03	2:30 am	185	170

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Australian commodity prices are holding up at decent levels as the global and domestic economies are in good shape. As a result we expect a 0.5% lift in **company profits in Q4**. We expect a small positive contribution to Q4 GDP growth from inventories.

A solid set of monthly trade surpluses over Q4 should see **Australia's current account deficit** narrow over the quarter. We are expecting a current account deficit of $9.0bn down from $10.7bn last quarter. However, it looks as if the volume of imports has lifted over the quarter, while exports were broadly flat. As a result we expect net exports to subtract around 0.1ppts from Q4 GDP.

The Reserve Bank of Australia will leave interest rates unchanged at 1.5% at the March meeting. The RBA will get the opportunity to share its thinking on what looks like is shaping up to be another weak GDP result (the RBA Board meet the day before GDP is released). We expect the overall tone of the statement to be fairly positive although the downside risks will be acknowledged.

Governor Lowe is slated to speak at the Australian Financial Review's 2019 Business Summit in Sydney. The speech is titled "The housing market and the economy". The RBA seems relatively comfortable with the downturn in the housing market to date and has tended to downplay the potential for negative wealth effects. In the RBA's view income growth is the major driver of household consumption, rather than changes in wealth. The RBA expects household consumption to grow at a moderate pace over the next few years as wages growth continues its gradual upward trend.

We expect a fairly modest outcome for **Australia's Q4 GDP** following Q3's lacklustre 0.3% lift. Our forecast is for a Q4 outcome of somewhere in the range of 0.25-0.5%. This would see the annual rate come in at 2.5-2.8%. We will firm up our estimates in the days leading up to GDP once the remainder of the partial is released. At this stage it looks like household spending growth was soft in the quarter, residential construction fell and net exports made a small subtraction.

We expect a decent 0.5% lift in **Australian retail trade** in January following December's 0.4% fall. The retail sector is facing many headwinds including low wages growth, high household debt levels and falling dwelling prices and sales volumes. A strong jobs market is providing a partial offset.

The European Central Bank is widely expected to make no monetary policy changes on Thursday. But disappointing Eurozone economic activity and soft inflation pressures suggest the ECB may adopt a more dovish stance. Specifically, the ECB is expected to revise lower its Eurozone GDP growth profile and possibility push out its forward interest rate guidance.

The pick-up in jobless claims suggests **US Non-farm Payrolls** will expand by much less than last month's 304,000 and keep the unemployment rate at 4.0%. We expect earnings growth to ease to 3.0% yoy because of the modest increase in the unemployment rate in recent months and record low consumers' inflation expectations.

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	0.3	0.7				
GDP real - A%	2.6	2.2	2.3	2.1	3.2	3.0	2.9
GDP real - AA%	3.0	2.7	2.6	2.3	2.8	3.1	2.9
CPI - Q%	0.9	0.1	0.0	0.6			
CPI - A%	1.9	1.9	1.4	1.6	1.9	1.8	1.8
HLFS employment growth - Q%	1.1	0.1	0.5	0.4			
HLFS employment growth - A%	2.8	2.3	2.3	2.1	1.6	1.3	1.1
Unemployment rate - %sa	4.0	4.3	4.2	4.2	4.0	3.9	4.0
Annual current account balance as % of GDP	-3.6	-3.8	-3.6	-3.6	-3.5	-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-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	2.00	2.25
NZ 90-day bank bill	1.91	1.97	1.9	2.0	2.0	2.3	2.5
NZ 2-year swap rate*	2.04	1.97	1.9	2.0	2.2	2.6	2.7
NZ 10-year Bond*	2.65	2.38	2.2	2.3	2.5	2.7	2.8

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	0.68	0.68	0.70	0.72	0.74
NZD/AUD	0.92	0.95	0.96	0.96	0.96	0.96	0.97
NZD/JPY	75	74	75	76	77	78	80
NZD/EUR	0.57	0.59	0.60	0.60	0.59	0.59	0.60
NZD/GBP	0.51	0.53	0.55	0.54	0.54	0.55	0.57
NZD TWI	72.1	73.5	74.1	73.9	74.8	75.0	76.6

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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