

Economic Weekly

04 June 2019

How Low can he go?

The Reserve Bank of Australia makes its interest rate announcement today, with a 25bp cut widely expected.

Australian markets have all but priced in a 100% chance of a cut today and another cut by October. If the RBA cuts as expected, the new 1.25% cash rate will hit a new record low. Indeed, we expect a further cut to 1% in August. RBA Governor Lowe is also speaking this evening, while Q1 Australian GDP is due tomorrow.

It's also a busy week this side of the Tasman, with the dairy auction tonight, May house prices (due Thursday) and Q1 Building Work Put in Place (due on Friday). Offshore is equally busy beyond Trump and trade tension headlines. The key releases are the Federal Reserve Beige Book, due early Thursday morning, the ECB interest rate announcement (Thursday), and US Non-farm Payrolls (due overnight Friday).

Key events and views

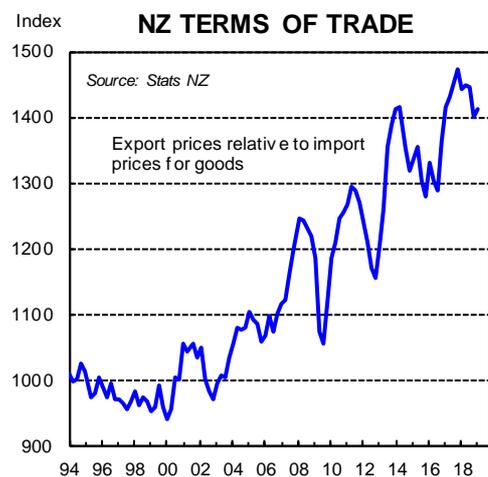
Foreign exchange	USD weakens as markets focus on the possibility of Fed Funds rate cuts.
Interest rates	NZ rates hit record lows, with curves flattening.
Domestic events	GlobalDairyTrade auction, May QV House Prices, Q1 Building Work Put in Place.
International events	RBA and ECB Interest Rate Announcements, Q1 Australian GDP, May US Non-farm Payrolls.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: High Terms of Trade supporting incomes

Data showed that NZ's Terms of Trade rose over Q1, posting a 1% lift that was bang in line with our expectations. The lift was a case of export prices (down 2.6%) falling by less than import prices (down 3.5%), resulting in the net rise.

Looking ahead, **we expect the Terms of Trade to rise further over 2019**. Dairy prices have firmed since the Q1 terms of Trade data, and we expect that strength to be reflected in the data over coming quarters. Moreover, the export price strength is broad based with lamb, forestry and horticulture prices also healthy.

The strong Terms of Trade and the subsequently healthy rural incomes are key supports for economy-wide incomes. However, despite the boost to rural incomes, **we expect economic activity on this front to remain relatively subdued**. Indeed, we anticipate that many dairy farmers will focus on paying down debt over the new season.



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6598	0.6549	0.6622	0.6993	FLAT/UP	0.6450	0.6720	UP
NZD/AUD	0.9459	0.9454	0.9464	0.9262	FLAT/UP	0.9350	0.9550	UP
NZD/JPY	71.27	71.74	73.82	76.29	FLAT/UP	69.90	72.70	UP
NZD/EUR	0.5867	0.5855	0.5928	0.5987	FLAT/UP	0.5750	0.5950	UP
NZD/GBP	0.5209	0.5167	0.5079	0.5271	FLAT/UP	0.5110	0.5310	UP
TWI	72.6	72.2	72.3	73.45	FLAT/UP	71.00	74.00	UP

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

NZD Recap

The **USD** weakened over the weekend as the market started to focus on the growing possibility of Federal Reserve interest rate cuts. Escalating trade-tensions, weak US economic data and dovish commentary from Federal Reserve Board members weighed on US interest rates and the USD. The Fed's Bullard was the first member of the voting committee to officially call for rate cuts, commenting that a "downward policy adjustment may be warranted soon". We expect the Federal Reserve to start cutting the Fed Funds rates in December, but the risk is now for an earlier move. US-China trade tensions continued to escalate with US President Trump threatened to impose a 5% tariff on Mexican goods on June 10 unless Mexico stopped people from crossing illegally to the US. The **NZD** had minimal reaction to last week's Budget.

Near-term outlook

The **RBA** is widely expected to cut its cash rate by 25 basis points on Tuesday afternoon, with the rate cut full priced in by markets. The RBA typically does not deliver too much forward guidance in its accompanying press statement, so unless the RBA flags the likelihood of more cuts to come we expect to see either minimal market reaction or for the **AUD** to lift. **Federal Reserve** chair Jay Powell is due to "Outline the Fed's Policy Strategy" on Tuesday night and we expect that Powell's comments will be dovish and contributes to a further weakening the **USD**. While the weaker USD is likely to drive this week's direction for the **NZD/USD**, ongoing trade tensions could provide some counter force. There is a risk that US President Trump continues to escalate trade-related issues ahead of the G20 meeting later in June. In addition, we anticipate another 2% fall in dairy prices at Tuesday night's Global Dairy Trade auction, which may also help cap any NZD strength. The **EUR** has scope to fall further this week. We expect the European Central Bank to lower its GDP and inflation forecasts and alter its forward guidance on interest rates at its policy meeting on Thursday.

Medium-term outlook

We have **recently updated our FX forecasts** reflecting our change in central bank forecasts, with the RBNZ and RBA cutting cash rates over 2019, and the Federal Reserve likely to be cutting the Fed funds rate from late 2019. The **NZD** is expected to soften in the near term, weighed by a lower OCR, weaker global growth and elevated trade tensions. However, we expect the NZD to remain supported over the medium term, firming against most crosses from late 2019 onwards. The **NZD/USD** will be supported by NZ's high Terms of Trade while the USD will be led lower by interest rate cuts from the Federal Reserve from late 2019. We expect the NZD/AUD to remain close to 0.94 over 2019 and to subsequently firm.

ASB foreign exchange forecasts

(end of quarter)

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
		<< actual	forecast >>					
NZD/USD	0.67	0.68	0.65	0.64	0.68	0.69	0.72	0.73
NZD/AUD	0.95	0.96	0.94	0.94	0.94	0.95	0.96	0.97
NZD/JPY	74	75	72	71	74	75	78	79
NZD/EUR	0.59	0.60	0.58	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.53	0.52	0.52	0.50	0.53	0.53	0.55	0.56
NZD TWI	73.5	73.9	71.3	70.2	72.7	73.1	75.1	75.8

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.50	1.50	1.75	1.75	UNCH/DOWN	UP
90-day bank bill	1.66	1.69	1.79	2.01	UNCH/DOWN	UP
2-year swap	1.43	1.49	1.63	2.22	UNCH/DOWN	UP
5-year swap	1.54	1.61	1.78	2.65	UNCH/DOWN	UP
10-year swap	2.00	1.99	2.20	3.12	UNCH/DOWN	UP
10-year govt bond yield	1.69	1.76	1.90	2.75	UNCH	UP
Curve Slope (2s10s swaps)	0.57	0.50	0.57	0.90	UNCH	UNCH/UP

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

Market Recap

Global and NZD yields start are lower than the start of last week, with curves under flattening pressure. Record lows were set for NZ swap interest rates, with the bellwether 2-year swap yield down close to 50bps since the start of the year, with the 10-year swap down around 75bps. NZ 10-year Government bond yields touched a record low of 1.69%, and briefly firmed after the Budget 2019 showed a slightly higher than expected profile for net public debt, with the bond tender bumped up by a cumulative NZD5bn over the 2019/23 period. Domestic business sentiment remained weak, pointing to low growth in NZ. **Escalating trade tensions, low global inflation and weaker global data continued to fuel the flight to government bonds and flatter curves.** Tit-for-tat trade measures continued to be announced between the US and China, with the US also threatening to impose tariffs on Mexico. Interest rate markets have close to 100bps of US Fed rate cuts priced in by the end of 2020, with 2019 Fed voter Bullard acknowledging that a “downward adjustment may be warranted soon”. US 10-year Treasury yields touched their lowest level since September 2017 (2.07%) and the yield curve (10 year less 3 months) was the most inverted since 2007. Australian yields continue to rally (yields lower), with the 10-year bond yield (1.51%) briefly below the 1.50% RBA cash rate. The Bank of Canada held the policy rate at 1.75% and viewed the recent lull in Canada's economy as "temporary".

Near-term NZD interest rate outlook

Given the downward momentum evident in global yields and our view of the risk profile (downwards), we are reluctant to shift from our downward bias, just yet. Partial data for NZ GDP will be released over the next few weeks and our Q1 GDP pick is in line with the May MPS view (+0.4% qoq), with NZ yields likely to struggle to fall further in the absence very weak data. **At today's RBA cash rate decision (4.30pm), our Australian colleagues expect the RBA to cut the cash rate by 25bps to 1.25%.** A June RBA cut is almost fully priced in, with about 60bps of cuts priced in by the end of the year. Australian Q1 GDP on Wednesday is expected to be weak. There are a number of speeches by Fed voters this week (including Fed Chair Powell), that will provide clues on whether the Fed is shifting its stance to an easing bias. A dovish assessment is expected from the ECB. **Global long-term yields should remain sensitive to trade headlines and signals on global growth and could dampen further if concerns over global growth escalate.**

Medium-term outlook

OCR moves by the RBNZ will depend on the tenor of domestic data, the NZD, global scene and actions of other central banks. **We have pencilled in a 25bp OCR cut in August, with the OCR to remain at 1.25% until early 2022,** before gradually drifting towards its 2.25% cyclical peak by late 2023. **Global central banks are expected to trim policy rates.** We expect 50bps of cuts from the 1.50% RBA cash rate over 2019, with the Federal Open Market Committee to start cutting the 2.25-2.5% Federal Funds rate from late 2019 (100bps of Fed cuts in total). **Global and NZD long-term interest rates are expected to remain capped at historically-levels,** although we expect NZD yields set to drift higher.

ASB interest rate forecasts

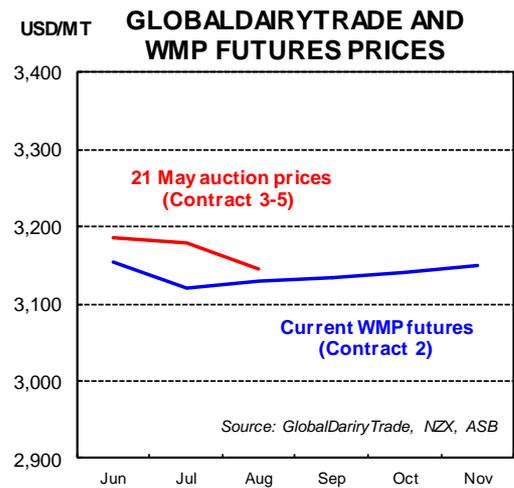
(end of quarter)	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
		<< actual	forecast >>					
NZ OCR	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.50
NZ 90-day bank bill	1.97	1.9	1.7	1.5	1.5	1.5	1.5	1.8
NZ 2-year swap rate*	1.97	1.6	1.6	1.5	1.5	1.5	1.6	1.9
NZ 10-year Bond*	2.38	1.8	1.8	1.8	1.8	1.8	2.1	2.4

Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
GlobalDairyTrade auction, whole milk powder, % change	05/06	Overnight	-2.1	-	-2.0
Building work put in place, volume, Q1, %	07/06	10:45 am	2.7	-	0.6

We expect whole milk powder prices to fall 2% at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago, whole milk powder (WMP) prices fell by 2.1%. At the current juncture, futures pricing points to a fall of around 1%. With prices relatively high, it appears that buyers are sitting on their hands and waiting for the spring lift in NZ production. This situation is leading prices to drift lower. However, we anticipate that markets are likely to be disappointed as we expect NZ spring production to undershoot production levels from a year ago.

We expect the volume of building work put in place to lift 0.6% over Q1, following the previous quarter's 2.7% increase. We expect the lift in building activity to be led by a 1.7% increase in residential construction activity, while we expect non-residential activity to ease back 1.1% following a strong increase in the previous quarter.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Australia Current Account Deficit, Q1, \$A bn	04/06	1:30 pm	-2.9	-2.1
RBA Interest Rate Announcement, %	04/06	4:30 pm	1.25	1.25
RBA Governor Lowe speech	04/06	9:30 pm	-	-
Eurozone CPI, May, %mom	04/06	9:00 pm	1.3	-
Australia GDP, Q1, %qoq	05/06	1:30 pm	0.4	0.4-0.6
ECB Interest Rate Announcement, %	06/06	11:45 pm	0.0	-
US Non-farm Payrolls, May, 000s	08/06	12:30 am	183	200

*Originally published by CBA Global Markets Research on Friday 31st May at 1:54 pm.

A record quarterly trade surplus of \$A14bn over Q1 should see **Australia's current account deficit (CAD)** narrow considerably. We are expecting a current account deficit of \$2.1bn, or 0.4% of GDP. This would be the smallest CAD since the early 1980s. We expect net exports to add 0.4 percentage points to Q1 GDP.

We expect the Reserve Bank of Australia to cut the cash rate to 1.25%, from 1.50%. Governor Lowe highlighted in his latest speech that they would consider the case for a rate cut at the June meeting. The Governor has focussed on the need for the unemployment rate to move lower to bring inflation back towards the target. This is a change of tact by the RBA and suggests the RBA thinks the natural rate of unemployment is below 5%.

Governor Lowe is slated to speak at a dinner with the business community in Sydney. This is after the RBA board decision day where we expect the cash rate to be lowered to 1.25%. Any discussion on further rate cuts or the lower bound will be of note given markets are now pricing in more than two rate cuts.

We expect a fairly modest outcome for **Australian Q1 GDP** following the weak 0.2% result for Q4 18. Our forecast is for a Q1 outcome of somewhere in the range of 0.4-0.6%. This would see the annual rate come in between 1.7-1.9%. We will firm up our estimates in the days leading up to GDP once the remainder of the partials are released. At this stage, it looks like household spending growth was soft over the quarter, while residential construction fell but net exports made a solid contribution.

Headline **CPI inflation in the Eurozone** quickened at an annual pace of 1.7% in April on higher energy prices. Excluding energy and food, CPI inflation lifted to 1.2% in April, in line with the European Central Bank's (ECB) 2019 forecast. Headline and core CPI inflation will likely ease a tad in May. Disappointing economic activity and subdued inflation expectations continue to contain price pressures.

The ECB is widely expected to keep interest rates on hold and maintain its dovish stance. In our view, the ECB will modify its forward guidance because of ongoing disappointing Eurozone economic activity and heightened global trade uncertainty. The ECB could simply highlight it expects key interest rates to remain at their present levels for as long as necessary instead of *"at least through the end of 2019, and in any case for as long as necessary"*. The new macroeconomic projections from the Eurosystem staff will also be of interest.

The pick-up in consumers' long-run inflation expectations and a cyclical low in the US unemployment rate suggest **US wage growth** will continue to accelerate to 3.4% yoy in May.

Key Forecasts

ASB NZ economic forecasts

	Dec-18 << actual	Mar-19 forecast >>	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
GDP real - Q%	0.6	0.4	0.9					
GDP real - A%	2.3	2.2	2.2	2.7	2.9	3.1	2.4	2.4
GDP real - AA%	2.8	2.6	2.3	2.4	2.5	2.7	2.6	2.4
CPI - Q%	0.1	0.1	0.7	0.7				
CPI - A%	1.9	1.5	1.8	1.6	1.8	1.9	1.7	1.8
HLFS employment growth - Q%	0.0	-0.2	0.4					
HLFS employment growth - A%	2.3	1.5	1.3	0.8	1.2	1.8	1.6	1.4
Unemployment rate - %sa	4.3	4.2	4.3	4.3	4.3	4.3	4.2	4.1
Annual current account balance as % of GDP	-3.7	-3.3	-2.9	-2.6	-2.3	-2.2	-2.0	-1.7

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

	Dec-18 << actual	Mar-19 forecast >>	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)								
NZ OCR	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.50
NZ 90-day bank bill	1.97	1.9	1.7	1.5	1.5	1.5	1.5	1.8
NZ 2-year swap rate*	1.97	1.6	1.6	1.5	1.5	1.5	1.6	1.9
NZ 10-year Bond*	2.38	1.8	1.8	1.8	1.8	1.8	2.1	2.4

ASB foreign exchange forecasts

	Dec-18 << actual	Mar-19 forecast >>	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)								
NZD/USD	0.67	0.68	0.65	0.64	0.68	0.69	0.72	0.73
NZD/AUD	0.95	0.96	0.94	0.94	0.94	0.95	0.96	0.97
NZD/JPY	74	75	72	71	74	75	78	79
NZD/EUR	0.59	0.60	0.58	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.53	0.52	0.52	0.50	0.53	0.53	0.55	0.56
NZD TWI	73.5	73.9	71.3	70.2	72.7	73.1	75.1	75.8

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