

# Economic Weekly

06 May 2019

## A close cut

The twin Tasman interest rate announcements highlight the week locally. The RBA gets first crack tomorrow, and while it's going to be a close call, **we expect the RBA to remain on hold** and ultimately to remain on hold for the rest of the year. In contrast, **we do expect the RBNZ to cut the OCR on Wednesday**, although it's also a very tight call. Either way, we expect the RBNZ will cut the OCR twice by the end of the year.

Offshore, **President Trump has re-heated US-China trade tensions by announcing a hike to tariffs on \$200 billion worth of Chinese goods**, with the threat of more to come. Trump's announcement comes ahead of another round of talks between US and Chinese officials in Washington scheduled for this week. With this announcement in mind, global financial markets are likely to be volatile this week, with Wednesday's Chinese trade data release now likely to be watched closely. All up with trade tensions on the rise again and the twin Tasman interest rate announcements, local financial markets are in for a busy week.

## Key events and views

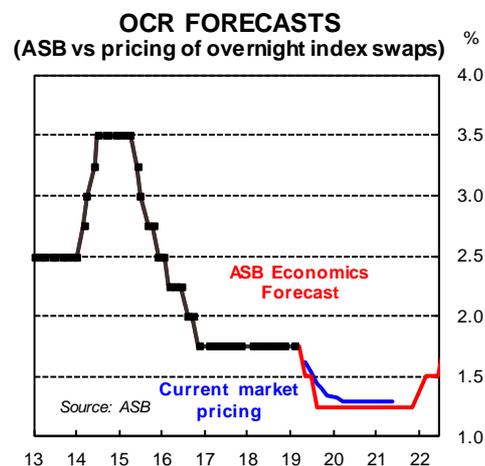
<a href="#">Foreign exchange</a>	NZD lower on weak NZ employment data, and stronger USD.
<a href="#">Interest rates</a>	Local rates are biased lower given our OCR cut view.
<a href="#">Domestic events</a>	RBNZ Interest Rate Announcement & Survey of Expectations, Dairy auction, Card Spending.
<a href="#">International events</a>	RBA Interest Rate Announcement, Chinese Trade Balance, US inflation.
<a href="#">Calendars</a>	NZ and international calendar of upcoming economic events.

## Chart of the Week: An OCR half cut

**Wednesday's OCR announcement by the RBNZ is delicately poised.** We expect the RBNZ to cut the OCR twice this year, with a cut at this week's announcement and a second one in August. But we see the probability of a cut this week as only marginally above 50%.

**Market pricing is similarly poised.** As at the time of writing, markets have nearly priced in a 60% chance of a cut on Wednesday. Notably though, the market has priced in a full cut by August.

Across the Tasman, **the RBA decision is also going to be close-run thing.** There, markets have priced in a 40% probability of a cut tomorrow. Meanwhile, in contrast to our NZ OCR view, we expect the RBA will remain on hold this year.



## Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6615	0.6678	0.6754	0.7022	DOWN	0.6450	0.6750	UP
NZD/AUD	0.9477	0.9462	0.9483	0.9298	DOWN	0.9300	0.9600	UP
NZD/JPY	73.22	74.53	75.44	76.61	DOWN	72.40	75.30	UP
NZD/EUR	0.5918	0.5984	0.6016	0.5859	DOWN	0.5810	0.6050	FLAT
NZD/GBP	0.5028	0.5162	0.5160	0.5170	DOWN	0.4940	0.5140	UP
TWI	72.4	72.8	73.3	73.20	DOWN	71.00	74.00	UP

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

### NZD Recap

**Weak NZ Q1 labour market data** sent the NZD lower against all of the major crosses on Wednesday last week.

Although the unemployment rate edged lower as expected, the details of the labour market report suggest the labour market was losing momentum and may put the RBNZ's "maximum sustainable employment" objective at risk. The USD strengthened from Thursday (putting additional downward pressure on the NZD/USD) in reaction to the Federal Reserve Chairman's post-statement press conference. **Chairman Powell** said that he viewed the current dip in US core-inflation as likely being "transitory". The NZD is lower against most crosses (except AUD) as markets opened on Monday morning as **China-US trade talks took a negative turn on Monday morning**. US President Trump threatened to lift tariffs to 25% (up from 10%) on USD200bn of Chinese goods this Friday, citing slow progress on the trade talks.

### Near-term outlook

**There is the potential for higher than usual volatility this week.** Our focus is on interest rate decisions from the Reserve Bank of Australia (RBA, Tuesday 4.30pm) and Reserve Bank of New Zealand (RBNZ, Wednesday 2pm). Both decisions are a close call according to markets (markets are currently pricing in a 45% chance of an RBA rate cut and close to 60% for a RBNZ cut) and economists. We do not expect the RBA to cut the cash rate, but to adopt an easing bias, but for the RBZ to cut the OCR by 25bps and maintain its easing bias. If this eventuates, we expect NZD/AUD to move to the lower part of its recent trading range and for the NZD to fall against most crosses. A move below 0.66 NZD/USD is certainly possible. We do not think sharp falls to the NZD will likely be sustained given the support from NZ's high Terms of Trade. If, however, the RBNZ do not cut the OCR, deliver a neutral policy assessment and do not signal pending OCR cuts in its published interest rate track, the NZD will likely to push higher.

### Medium-term outlook

**In the medium term and looking beyond any short-term reaction to possible OCR cuts, we expect the NZD/USD to gradually strengthen** given NZ's high Terms of Trade. 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 to remain close to 0.96 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. However, the NZD/AUD is currently below these expectations due to the likelihood of an imminent rate cut from the RBNZ. We have delayed the timing of the forecast EUR appreciation as Europe's economy has softened and we expect the ECB will now wait until the end of 2020 before raising interest rates.

### 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	0.68	0.69	0.69	0.70	0.72	0.74
NZD/AUD	0.95	0.96	0.96	0.96	0.96	0.96	0.96	0.97
NZD/JPY	74	75	76	77	77	77	78	80
NZD/EUR	0.59	0.60	0.60	0.60	0.59	0.59	0.59	0.60
NZD/GBP	0.53	0.52	0.54	0.54	0.54	0.54	0.55	0.57
NZD TWI	73.5	73.9	73.9	74.5	74.1	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	DOWN	UP
90-day bank bill	1.79	1.80	1.82	2.03	DOWN	UP
2-year swap	1.62	1.67	1.65	2.28	DOWN	UP
5-year swap	1.75	1.80	1.83	2.74	DOWN/UNCH	UP
10-year swap	2.17	2.21	2.27	3.21	DOWN/UNCH	UP
10-year govt bond yield	1.87	1.90	2.00	2.78	DOWN/UNCH	UP
Curve Slope (2s10s swaps)	0.56	0.55	0.63	0.93	UP	UNCH/UP

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

### Market Recap

**NZD yields were little changed over the past week, with short-term yields fractionally lower.** NZD yields started last week on a firming trajectory but then fell after the release of weaker than expected Q1 employment and wage inflation prints in last Wednesday's NZ labour market release. Modes moves took place in Australian interest rates despite generally weak data. Global yields edged higher following the Fed announcement. As was widely expected, the Federal Open Markets Committee (FOMC) kept the Funds rate target range on hold at 2.25-2.50%, and signalled no strong case for a move in either direction. The interest rate on required and excess reserves (IOER) was cut by 5bp to 2.35%. US yields rose after Fed Chair Powell watered down the prospect of Fed rate cuts and noted that the current spate of low US inflation could be "transitory". US payrolls data were strong and the unemployment rate fell to 3.6%, a 50-year low. However workforce participation was lower and wage inflation modest, dampening US Treasury yields.

### Near-term NZD interest rate outlook

With markets pricing in more than 50% odds of 25bp policy interest rate cuts, this weeks' policy interest rate decisions by the RBA (4.30pm Tuesday 7<sup>th</sup> May) and RBNZ (2pm Wednesday 8<sup>th</sup> May) are "live" and market reaction is a given.

**We expect the RBNZ to cut the OCR by 25bps and to retain an easing bias, with NZD interest rates to fall and the curve to steepen as a result.** If, however, the RBNZ do not cut the OCR and do not strongly signal cuts in the coming months, local yields and the NZD are likely to spike higher. **Market pricing prior to the RBNZ will depend on positioning following the RBA decision.** Given the timing of the Australian general election (May 18) and the still-tight Australian labour market, our CBA colleagues do not expect a RBA cut, although they expect an easing bias to be adopted. **We have a marginally downward bias on global yields, with curves under flattening biases.** Concerns over global growth are expected to dampen global yields as trade tensions resurface after President Trump noted trade talks between the US and China were going "too slowly" and pledged to raise tariffs on USD200bn of Chinese goods to 25% on Friday, and USD325bn of untaxed goods could face 25% duties "shortly". This week's US CPI prints (mkt: 2.1% yoy for headline and core CPI) will also be closely scrutinised.

### Medium-term outlook

**We expect 50bps of OCR cuts year.** The OCR is subsequently expected to remain at 1.25% until early 2022, before gradually drifting towards its 2.25% cyclical peak towards the end of 2023. The proposed higher bank capital requirements, which we assume are equivalent to an increase of roughly 50bps on customer interest rates by late 2023, will likely tighten financial conditions, lower swap interest rates across the curve and keep the OCR lower than it would otherwise be. Global central banks are expected to maintain historically-low interest rate settings. NZD long-term yields could initially dip and then drift up, before eventually settling at around 2.5-3.0%.

### ASB interest rate forecasts

	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< 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

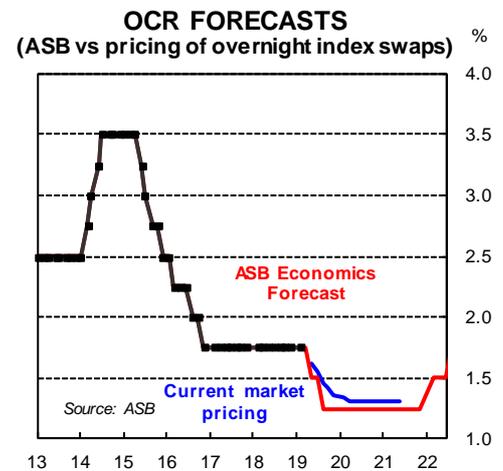
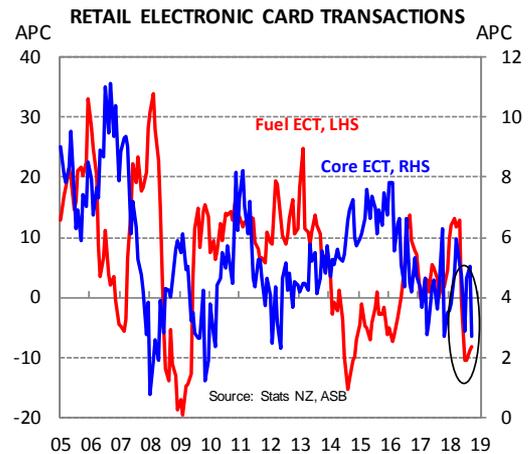
Data	Date	Time (NZT)	Previous	Market	ASB
RBNZ Survey of Expectations, Q2	07/05	3:00 pm	-	-	-
GlobalDairyTrade auction, whole milk powder, % change	08/05	overnight	-0.7	-	-2.0
RBNZ Monetary Policy Statement & OCR Review, OCR, %	08/05	2:00pm	1.75	1.50	1.50
Electronic Card Transactions, Apr, retail, %mom	10/05	10:45am	-0.3	0.8	1.0

**Inflation expectations from the RBNZ survey are likely to hover around the midpoint of the inflation target.** Rising petrol prices suggest some upside to surveyed inflation expectations, which should be broadly offset by lower recorded rates of headline inflation in the March 2019 year (1.5% yoy). **The information content of this survey is questionable given the low number of respondents who historically fill out this survey.**

**We expect whole milk powder prices to fall at the GlobalDairyTrade auction overnight Tuesday.** A fortnight ago whole milk powder (WMP) prices fell by 0.7%. At the current juncture, futures pricing points to a fall of around 1%. However, futures pricing have consistently overstated recent auction results. On this basis, we expect a circa 2% fall in WMP price rises.

**Card spending is expected to rebound from March falls.** A 6% rise in fuel prices and the timing of the Easter holidays is expected to underpin a sizeable increase in fuel spending. A more moderate monthly increase is expected for core spending, underpinned by a rebound in durable and apparel retail. **Further ahead, we expect the impact of higher fuel prices to weigh on discretionary spending, given low wage inflation, slowing demand for labour and the cooling nationwide housing market.**

It's been just over a month since the RBNZ surprised markets by shifting to an explicit easing bias in its March OCR review, openly stating that the most likely next move in the cash rate was down. The OCR decision is likely to be a close call and market reaction is a given irrespective of the policy decision. **On balance, we think the new Monetary Policy Committee will have seen enough evidence to justify acting and will deliver a 25bp OCR cut**, with the published OCR track to flag the likelihood of at least a further cut over 2019. Pushing the RBNZ over the rate cut hurdle, will be the increasing conviction that the domestic growth outlook is not consistent with meeting the RBNZ's inflation and labour market objectives under the new monetary policy remit. Even if the RBNZ does not cut the OCR next week, the weaker medium-term inflation outlook and growing slack in the labour market will likely see the RBNZ cut the OCR in the coming months.



## Major International Events for the week ahead\*

Data	Date	Time (NZT)	Market	ASB
Eurozone Retail Sales, March, %mom	06/05	9:00 pm	-0.1	-
RBA Interest Rate Announcement, %	07/05	4:30 pm	1.25	1.50
Australia Trade Balance, March, \$bn	07/05	1:30 pm	4.50	3.8
Australia Retail Trade, March, %mom	07/05	1:30 pm	0.2	0.0
China CPI, April, %yoy	09/05	1:30 pm	2.5	2.4
RBA Statement on Monetary Policy	10/05	1:30 pm	-	-
UK GDP, Q1, %qoq	10/05	8:30 pm	0.5	-
US CPI, April, %mom	11/05	12:30 am	2.1	2.1

\*Originally published by CBA Global Markets Research on Friday 3<sup>rd</sup> May at 12:38pm.

**Eurozone retail sales growth** will likely increase for a third consecutive month in March, underpinned by firm household credit growth and favourable employment conditions. However, lower consumer confidence remains a headwind to consumer spending.

Financial markets are pricing around a **40% chance of a cash rate cut at the Reserve Bank of Australia's May meeting**. Meanwhile, economist polls show a small majority in favour of a rate cut. Expectations for a cash rate cut increased following the weak Q1 inflation outcome. We think the central bank will keep the cash rate at 1.5% because the labour market is still in good shape. However we think that the weak inflation data are enough to see the RBA move to an explicit easing bias.

A record trade surplus of \$4.8bn was recorded last month as **Australian** imports posted a solid fall. We expect a smaller – but still solid – \$3.8bn surplus in March. A step-up in the iron ore price in April will support the **trade balance** next month.

Our internal data are pointing to a flat outcome for **Australian retail trade in March**, after a large 0.8% lift last month. For volumes, we are expecting another soft 0.2% lift over Q1, which would suggest that the trend of weak spending growth has continued for the third consecutive quarter.

We expect **China's CPI inflation** to edge up to 2.4% yoy in April on faster food inflation and higher oil prices. PPI inflation should have risen to 0.7% yoy because of higher ferrous metal prices and a five-month high in the April Producer Price Index.

**The Reserve Bank of Australia's Statement on Monetary Policy** will be closely watched for a change in the bank's forward guidance on interest rates. We think the RBA will move to an explicit easing bias following the weak Q1 inflation data. In terms of the forecasts, we think that the underlying inflation and GDP forecasts may be revised a little lower following weaker-than-expected outcomes. A rebound in petrol prices so far in Q1 means that the existing headline inflation forecasts may need to be revised *higher*. We think the unemployment rate forecasts will remain unchanged.

The Bank of England projects **UK GDP** growth of 0.5% in Q1 (1.8% yoy), driven by a recovery in manufacturing output and Brexit-related stock building.

Retail petrol prices in the **US** surged another 7% in April to over \$US 3.08 per gallon. The increase in petrol prices will likely push headline **inflation** back up to 2.1% yoy. The firm labour market will also keep core inflation near 2.1% yoy.

## 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	0.8	0.6				
CPI - A%	1.9	1.5	1.9	1.6	1.6	1.9	1.8	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	1.5	1.3
Unemployment rate - %sa	4.3	4.2	4.3	4.4	4.3	4.4	4.4	4.4
Annual current account balance as % of GDP	-3.7	-3.3	-2.9	-2.5	-2.2	-2.0	-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

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(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

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NZD/AUD	0.95	0.96	0.96	0.96	0.96	0.96	0.96	0.97
NZD/JPY	74	75	76	77	77	77	78	80
NZD/EUR	0.59	0.60	0.60	0.60	0.59	0.59	0.59	0.60
NZD/GBP	0.53	0.52	0.54	0.54	0.54	0.54	0.55	0.57
NZD TWI	73.5	73.9	73.9	74.5	74.1	74.8	75.0	76.6

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