Economic Weekly

10 December 2018

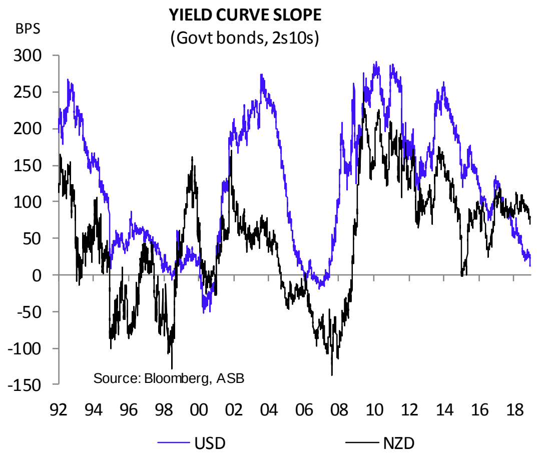
Terms of Trade remain lofty

Following the release of Q3 Terms of Trade data last week (a key barometer of economic strength), we take a closer look at New Zealand's well-performing export sector on Page 2. Offshore, focus remained on global equities as more gains were erased over the week. Our Chart of the Week, below, looks at one of the key concerns that weighed on sentiment last week. This week, focus will remain on Brexit with a UK Parliamentary vote scheduled for Tuesday night (NZT) while the local highlight will be the Government's Half-Year Economic and Fiscal Update on Thursday.

Key events and views

Chart of the Week: All eyes on the US 2-year vs. 10-year yield spread

Global equities continued their march lower last week, with the S&P 500 erasing all of its 2018 gains by the end of the week. Although there were no new catalysts for the fall in equities (trade tensions, slowing global growth, Brexit concerns and falling global rates), the recent pace of falling US long-term rates increased concerns about the message from yield curve inversion.



Yield curve inversion is when the yield on longer-term government bonds drops below short terms. Last week the US 2-year vs. 5-year government yield curve inverted, while at the same time the spread between the 2- and 10-year (2s10s) US yield dropped to near 10bp, the lowest spread since 2007.

The concern surrounds the fact that the inversion of the US 2s10s curve has predated every US recession since 1975. Falling long-term yields signal investor uncertainty about the health of the economy in the future. Due to the strong correlation with US recessions, focus is likely to remain heavily on the spread between the 2s10s this week. In comparison, the spread on the NZ 2s10s remains significantly wider.

Key insights this week: Export sector outlook

- **The Terms of Trade have remained elevated despite a somewhat tumultuous 2018.**
- **There are other supports to the export sector that are helping the NZ economy**.
- **Recent NZD strength has been consistent with the solid export sector outlook, but the higher NZD will deliver more benefits to consumers than to the export sector.**

Terms of Trade remain lofty

The Terms of Trade, denoted as the price for our exports relative to our imports, is a key barometer of economic strength, particularly for a small trade-dependent economy, such as New Zealand.

The year has seen more than its fair share of events. It has been a somewhat tumultuous 2018, with increasing trade tensions culminating in the start of a trade war between the US and China, sizeable swings in global oil prices and a slowing in world economic growth.

The September quarter did show a modest fall in the Terms of Trade, which are now close to 2% below their late 2017 peaks. This needs to be put into context. The September quarter reading was the fourth-highest recorded in the quarterly data since 1957. The Terms of Trade are close to 40% above their Global Financial Crisis trough in 2009, and are more than one-third above historical averages.

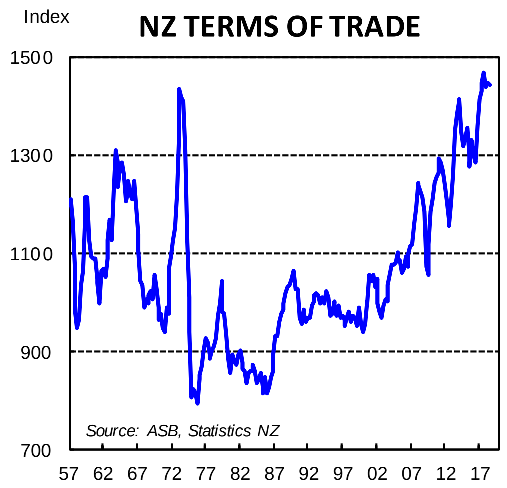
The strength of our Terms of Trade largely reflects still-elevated prices for NZ exports. Export prices rose 2.3% qoq in Q3 (+8.1% yoy), led by earlier lifts in dairy export prices (up 6.5% qoq). Other export prices, including seafood (+7.3% qoq) and meat (+1.9% qoq) showed sizeable increases.

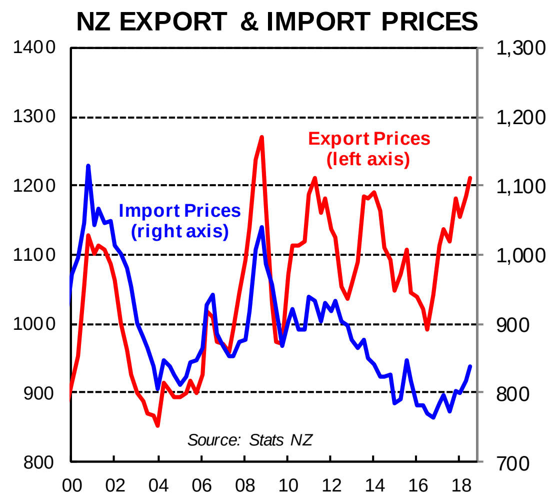
This is largely testament to the strong structural support for NZ export commodities, while the lower NZD has also helped. Export prices have increased more than 20% over the past two years in NZD terms, more than double the increase for import prices.

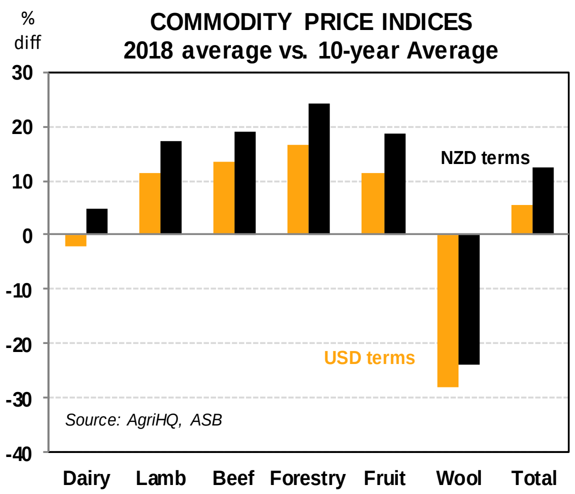
The recent increase in export prices is not just a dairy story. Commodity export prices are well above historical averages for most export commodities. Prices for lamb, beef, forestry, and fruit look particularly strong compared to decade averages. Anecdotes for these sectors have generally been upbeat. While dairy is our largest primary sector export, a diversified export base has ensured that the primary sector has not been too exposed to sector-specific shocks.

We anticipate that this resilience will largely continue. While dairy prices have been under pressure, other export prices like lamb, kiwifruit and forestry have remained at or near record highs. On the imports side, oil prices have run out of steam over recent months, while global inflation remains modest and contained.

We expect the healthy Terms of Trade to continue to structurally support the NZ economy. Over the coming quarters recent falls in dairy and oil prices will largely offset each other, but on balance we anticipate that the ToT will drift modestly lower.



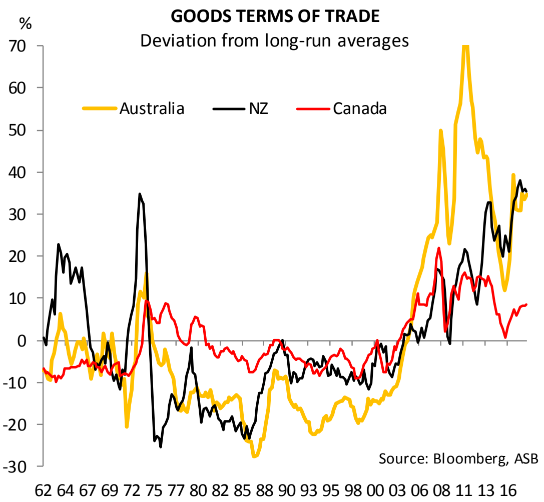




NZ is not the only one

The Terms of Trade of other major commodity exporters, notably Australia, have also remained elevated. Strong demand from emerging economies has been a key support. Lower oil prices are likely to dampen the Terms of Trade for Canada (a major energy exporter) and could potentially weigh on those for Australia.

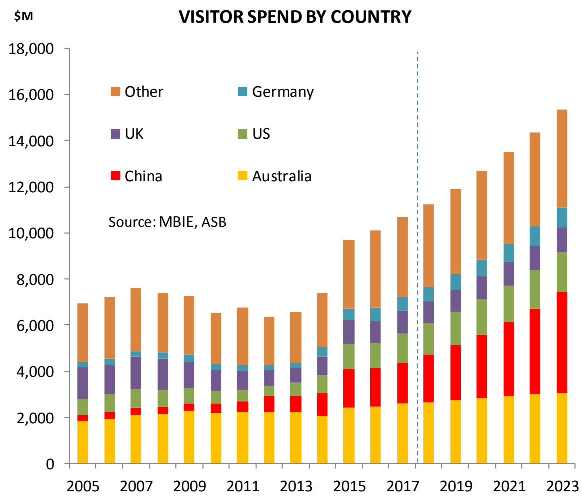
Moreover, the transition of the Chinese economy towards consumption rather than investment-led growth has seen the NZ Terms of Trade climb in relation to those for Australia. This may have currency market implications.



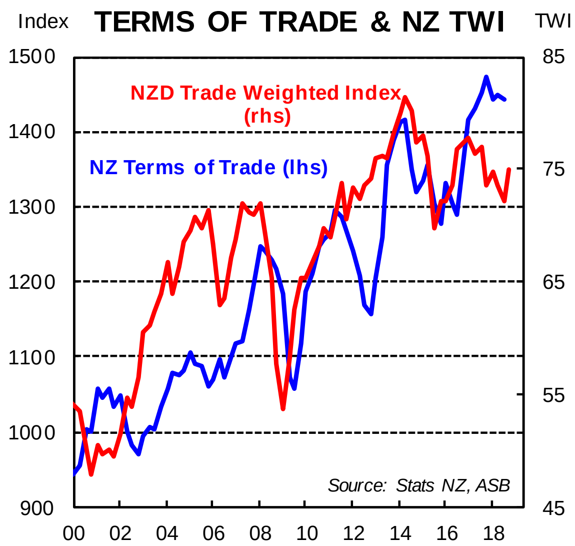
Wider export sector outlook positive

It is not just the Terms of Trade. NZ agricultural production looks set to benefit from strong agricultural production and thus exports will top up trade incomes well into 2019.

NZ has also benefitted from the global boom in tourism. According to just released figures on NZ tourism, spending by overseas tourists to NZ surged by close to 10% in the March 2018 year to more than $16bn. Tourism is our number one export earner and constitutes a sizeable chunk of export and economic activity, employment and capital stock.



There is considerable scope to grow the inbound tourism market and that this could yield significant benefits. According to figures compiled by the World Tourism Organisation, NZ accounts for just 0.3% of the global inbound tourism market. The close to 4 million annual overseas visitor arrivals to NZ is a drop in the bucket compared to the approximate 1.35 billion arrivals globally. Spending by overseas tourists in NZ pales in comparison to the USD1.4 trillion spent worldwide. A balance needs to be struck, however, between maximising visitor numbers and tourism incomes in the short term, while ensuring the long-term viability of the sector.



The NZD will determine who gets the spoils

The NZD tends to buffer commodity price movements. Hence the recent resilience of the NZD is not completely surprising considering the export sector is in good shape. We expect the positive export sector outlook to remain a key NZD support.

There are also distributional aspects, as the NZD will help determine who benefits from the high Terms of Trade. The higher the NZD, the lower the benefits are likely to directly accrue to the export sector. However, a higher NZD will benefit domestic consumers and make it cheaper for businesses to purchase capital imports. Imported inflation would also be lower. The high NZD also maintains the high hurdle to prospective OCR hikes.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6853	0.6911	0.6731	0.6834	UP	0.6720	0.7000	FLAT/UP
NZD/AUD	0.9548	0.9376	0.9298	0.9093	FLAT	0.9380	0.9650	DOWN
NZD/JPY	77.25	78.43	76.67	77.42	UP	76.20	78.60	DOWN
NZD/EUR	0.6014	0.6086	0.5932	0.5807	FLAT	0.5930	0.6110	DOWN
NZD/GBP	0.5387	0.5409	0.5158	0.5070	DOWN	0.5310	0.5470	DOWN
TWI	75.2	75.1	73.6	72.44	FLAT/UP	73.0	76.5	DOWN

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

NZD Recap

The **NZD started the week on strong footing**, buoyed by positive market sentiment on reports that a trade truce had been struck between China and the US. However, market participants soon became wary on account of inconsistent statements from US and Chinese authorities and **a risk-off tone weighed the NZD over the rest of the week**. Canada's arrest of Huawei's chief financial officer following a US extradition request reinforces our view that a speedy resolution to US China trade tensions is unlikely in the near term. The **AUD was particularly weighed** by weak Q3 GDP growth, the decrease in global equity markets and commodity prices over the past week, and the AUD underperformed the NZD. The **GBP found some support from Thursday** as market participants entertained the idea that there could be "no Brexit" (i.e. the UK remaining in the EU). The UK House of Commons will vote on the UK withdrawal agreement on Tuesday.

Near-term outlook

The key event for financial markets this week is the UK House of Commons vote on the UK withdrawal agreement on Tuesday, Dec 11. We believe MPs will bow to pressure and vote (begrudgingly) for PM May's withdrawal deal. Under our scenario GBP should stage a significant, but temporary, relief rally. If it is voted down, May could secure some changes at the 14 December EU Summit then present the amended motion to Parliament on 20 December before its Christmas recess. That would allow for a second week of debate and a vote on 21 January. One headwind facing the USD in recent weeks is the paring back of pricing for US Federal Reserve rate hikes. Any downward surprise in US core CPI this week will likely further push down US interest rates and the USD. The Treasury releases its Half Year Economic and Fiscal Update this week, but it is unlikely to be significant mover for the NZD.

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 is expected to remain in a 90-91 Australian cent zone through to the end of next year (although has recently moved above this band). 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. Low inflation is expected to keep the BOJ on hold, with the NZD/JPY modestly strengthening over the forecast period.

ASB foreign exchange forecasts	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.67	0.66	0.65	0.66	0.68	0.70	0.66
NZD/AUD	0.92	0.92	0.90	0.90	0.91	0.90	0.90
NZD/JPY	74	75	73	74	73	75	74
NZD/EUR	0.58	0.57	0.58	0.58	0.55	0.55	0.54
NZD/GBP	0.52	0.51	0.52	0.53	0.53	0.54	0.51
NZD TWI	72.5	72.1	71.4	72.0	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	1.99	1.97	1.99	1.89	FLAT	UP
2-year swap	2.05	2.10	2.20	2.16	FLAT	UP
5-year swap	2.35	2.46	2.64	2.61	FLAT	UP
10-year swap	2.79	2.91	3.11	3.09	FLAT	UP
10-year govt bond yield	2.44	2.58	2.80	2.79	FLAT	UP
Curve Slope (2s10s swaps)	0.74	0.82	0.91	0.93	FLAT	FLAT

** Current as at 9.30am today; week ago as at Monday 5pm*

Market Recap

Lower yields and flatter curves was the predominant theme. The post G20 trade truce between the US and China had a fleeting impact on global yields, which were dragged down on concerns over global growth, trade, equity market weakness (the MSCI global index was down around 4% over the week). NZD swap yields were down 3-9bps across the curve. Weaker than expected Q3 Australian GDP (+0.3% qoq) and further falls in Australian house prices saw larger falls for Australian yields, with the market now biased towards RBA rate cuts. Soft sentiment and weaker than expected US labour market data pushed US 10-year Treasury yields to 3-month lows (2.85%), with the yield curve (2s10s) flattening its most since 2007. Market expectations for Fed hikes were further scaled back, with less than 70% odds of a December 2018 Fed hike and with only 10bps of Fed hikes priced in for 2019. The rally in global wholesale interest rates has occurred at a time when pressures in credit markets may be stirring, with a widening in Libor-OIS spreads for USD, AUD and NZD funding. NZ 10-year Government bond yields also rallied, with those for the 10-year tenor (2.45%) earlier touching 2-year lows.

Near-term NZD interest rate outlook

Market direction looks set to continue to be largely dictated by global events. A stabilisation in jittery equity markets could see curves steepen, although the recent bout of equity market volatility could continue. With the US setting a March 1 deadline for negotiations with China before raising tariffs, markets will continue to be impacted by trade-related headlines. The Brexit vote in the UK parliament (Wednesday am) is expected to be a close call, with market reaction likely irrespective of the outcome. The ECB is widely expected to cap its asset purchases after spending €2 trillion since October 2015 to support growth. Other global events, including speeches by various central bank officials, US CPI, German ZEW survey and Chinese retail sales data could generate market volatility. Local data should remain consistent with moderate growth (we have currently pencilled in +0.5 qoq for Q3 GDP). A responsible fiscal message from this week's Treasury Half Year Economic and Fiscal Update, including a broadly unchanged profile for fiscal surpluses, government debt and bond issuance, should help cap NZ yields. **NZ Government bond yields remain low, with limits to how much further they can rally in the absence of OCR cuts being seriously entertained.**

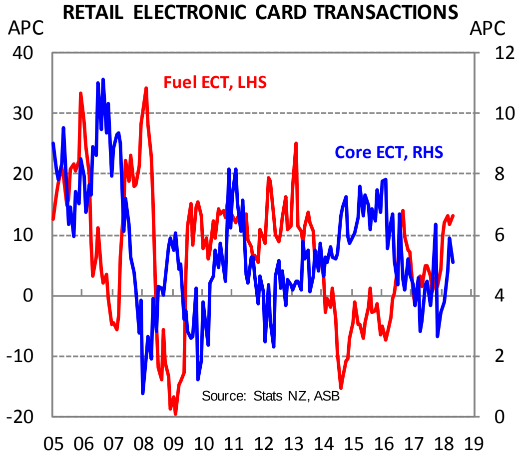
Medium-term outlook

Given our low outlook for core inflation we now 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 hikes, but we view the hurdle to OCR cuts as having risen given the solidity of recent data. **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.

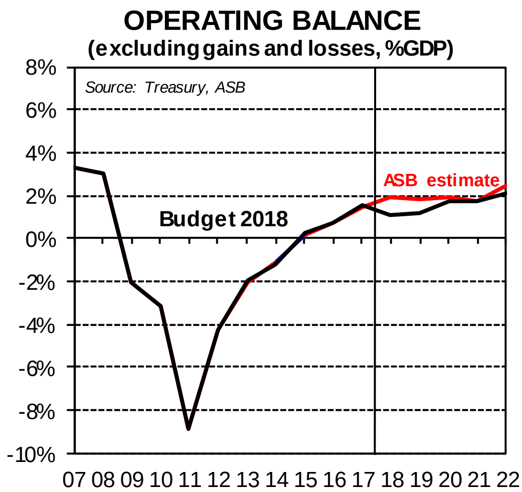
ASB interest rate forecasts	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	2.25	2.75
NZ 90-day bank bill	2.0	1.9	2.0	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.1	2.0	2.2	2.3	2.7	3.0	3.2
NZ 10-year Bond	2.9	2.7	2.8	2.9	3.3	3.4	3.4

Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
Retail Electronic Card Transactions, % mom	11/12	10:45am	0.3	0.3	0.4
HYEFU, OBEGAL 2018/19, % of GDP	13/12	1:00pm	1.9	-	1.8



October card spending was sluggish as both retail and core spending paused following sizeable increases in the previous couple of months. High fuel prices, subdued consumer sentiment and low annual house price inflation were likely catalysts for weak spending, with apparel retail declining after a solid couple of months. **We expect November retail spending to post a modest monthly increase, with core and discretionary spending benefitting from lower fuel prices** (down 11% over the month according to our estimates). Spending over the three months to November should show still-decent momentum (around 2-3% monthly growth), but we expect annual card spending growth to progressively moderate towards 4-5% over 2019 given the flat housing market backdrop and slower population growth. With the relationship between card spending and retail trade (which feeds into GDP) having weakened considerably of late, the market implications from the card spending data are limited.



We expect the Half-Year Economic and Fiscal Update to show a healthy set of Government accounts. The 2017/18 end of year accounts produced a pleasant surprise for the Government, with net debt dipping below 20% of GDP four years ahead of target. This surprise has freed up the Government to both increase spending allowances, and, at the same time, continue to maintain a strong fiscal position. Translating this into numbers, we expect a modest improvement in the forecast operating balances, with annual surpluses of at or around 2% of GDP. Similarly for net debt, we anticipate the Government to maintain debt at or around 20% over the forecast period. These forecasts also mean that the Government's bond programme is likely to be largely unchanged from Budget 2018 levels. **This update will also contain more information on how the Government intends to build the Living Standards Framework into Budget 2019.** At a basic level, the Government plans to incorporate a broader suite of indicators into its annual reporting, including things like social and natural capital along with the usual economic and financial measures.

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Australia Owner-Occupier Loan Value, Oct	10/12	1:30 pm	-	-
WBC-Melbourne Institute Cons. Conf. Index, December	12/12	12:30 pm	-	-
US CPI, November, Headline, %yoy	13/12	2:30 am	2.2	-
Australia CBA Composite PMI, December, Index	14/12	11:00 am	-	-
US Retail Sales ex-auto, November, %mom	15/12	2:30 am	0.2	-

**Originally published by CBA Global Markets Research on Friday 7th December 2018 at 15.22pm.*

Credit growth in Australia looks to continue falling for investors. But we expect it to post a rebound for owner-occupiers.

Australia's **WBC-Melbourne Institute's Consumer Confidence index** rose 2.8% over the month of November to sit well above the 100 watermark level; this indicates that the number of optimists outweigh the pessimists. This uptrend has persisted despite the negative impact of falling house prices. The fall in the jobless rate and the lift in wages growth could be offsetting that impact.

In November, **Australia's CBA Composite PMI** rose from 52.0 to 52.9. Strong signals from the manufacturing and services sectors, driven by an uptick in export orders, indicate that the economy's cycle is strengthening relative to the previous month.

The fall in US retail petrol (gasoline) prices will weigh on headline inflation for several months. But core inflation will remain sticky around 2% yoy because of the pick-up in wage costs.

We expect total **US retail sales** to expand by a slow rate of 0.2% in November compared to the spike in October. Retail petrol (gasoline) prices are starting to fall because of the collapse in oil prices. But core retail sales should expand strongly by 0.5% because of expanding jobs and a pick-up in wage growth.

Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Previous	Forecast Mkt	Forecast ASB
Mon 10 Dec	~	JN	Eco watchers survey outlook	Nov	Index	50.6	~	~
	12:50	JN	GDP	Q3 F	q%ch	-0.3	-0.5	~
	13:30	AU	Owner-occupier loan value	Oct	m%ch	-4.2	~	3.0
Tue 11 Dec	10:00	NZ	ANZ truckometer heavy	Nov	m%ch	4.6	~	~
	08:45	NZ	Card spending retail	Nov	m%ch	0.1	0.3	0.4
	11:30	AU	ANZ Roy Morgan Weekly	Dec	Index	119.5	~	~
	13:30	AU	House price index	Q3	q%ch	-0.7	~	~
	19:00	JN	Machine tool orders	Nov P	y%ch	-0.7	~	~
Wed 12 Dec	12:30	AU	WBC consumer confidence	Dec	Index	104.3	~	~
	12:50	JN	Core machine orders	Oct	m%ch	-18.3	~	~
Thu 13 Dec	10:45	NZ	Food prices	Nov	m%ch	-0.6	~	~
	13:00	AU	Consumer infl. expectation	Dec	%	3.6	~	~
Fri 14 Dec	10:30	NZ	BusinessNZ manuf. PMI	Nov	Index	53.5	~	~
	11:00	AU	CBA Australia PMI Manuf.	Dec P	Index	54.6	~	~
	12:50	JN	Tankan large manuf. index	Q4	Index	19.0	~	~
	15:00	CH	Retail sales	Nov	y%ch	8.6	8.8	~
	17:30	JN	Industrial production	Oct F	m%ch	2.9	~	~

*P = Preliminary

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Previous	Forecast Mkt	Forecast ASB
Mon 10 Dec	09:30	UK	Trade balance	Oct	€mn	-27.0	~	~
	09:30	UK	GDP	Oct	m%ch	0.0	~	~
Tue 11 Dec	09:30	UK	ILO unemployment rate 3 mths	Oct	%	4.1	4.1	~
	10:00	EC	ZEW survey expectations	Dec	Index	-22.0	~	~
	11:00	US	NFIB small business optimism	Nov	Index	107.4	~	~
	13:30	US	PPI final demand	Nov	m%ch	0.6	0.0	~
Wed 12 Dec	10:00	EC	Industrial production	Oct	m%ch	-0.3	~	~
	10:00	EC	Employment	Q3 F	q%ch	0.2	~	~
	13:30	US	CPI	Nov	m%ch	0.3	0.0	~
	19:00	US	Monthly Budget Statement	Nov	$bn	-100.5	~	~
Thu 13 Dec	12:45	EC	ECB main refinancing rate	Dec	%	0.0	0.0	~
	13:30	US	Import price index	Nov	m%ch	0.5	-0.8	~
	13:30	US	Export price index	Nov	m%ch	0.4	~	~
Fri 14 Dec	08:15	EC	ECB Vice-President Guindos speaks in Frankfurt					
	08:30	EC	Markit Eurozone manuf. PMI	Dec P	Index	51.8	51.5	~
	09:30	EC	ECB's Lautenschlaeger speaks in Frankfurt					
	13:30	US	Retail sales ex auto	Nov	m%ch	0.7	0.4	~
	14:45	US	Markit US manufacturing PMI	Dec P	Index	55.3	~	~

ASB

Key Forecasts

ASB NZ economic forecasts	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
	<< actual	forecast >>					
GDP real - Q%	1.0	0.5	0.5				
GDP real - A%	2.8	2.7	2.5	2.7	3.2	3.1	2.9
GDP real - AA%	2.7	2.8	2.7	2.7	2.8	3.2	3.0
CPI - Q%	0.4	0.9	0.1				
CPI - A%	1.5	1.9	1.9	1.9	1.7	1.8	2.1
HLFS employment growth - Q%	0.6	1.1	0.1				
HLFS employment growth - A%	3.7	2.8	2.4	2.2	1.8	1.9	1.5
Unemployment rate - %sa	4.4	3.9	4.2	4.2	4.1	4.1	4.2
Annual current account balance as % of GDP	-3.3	-3.4	-3.4	-2.9	-2.5	-2.5	-2.7

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	Jun-18	Sep-18	Dec-18	Mar-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	2.0	1.9	2.0	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.1	2.0	2.2	2.3	2.7	3.0	3.2
NZ 10-year Bond	2.9	2.7	2.8	2.9	3.3	3.4	3.4

ASB foreign exchange forecasts	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.67	0.66	0.65	0.66	0.68	0.70	0.66
NZD/AUD	0.92	0.92	0.90	0.90	0.91	0.90	0.90
NZD/JPY	74	75	73	74	73	75	74
NZD/EUR	0.58	0.57	0.58	0.58	0.55	0.55	0.54
NZD/GBP	0.52	0.51	0.52	0.53	0.53	0.54	0.51
NZD TWI	72.5	72.1	71.4	72.0	72.3	72.9	70.2

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