

Economic Weekly

11 December 2017

A glass half full

- A busy week ahead that could potentially shake markets out of their pre-holiday slumber.
- Half Year Fiscal Update is expected to reiterate a still-solid fiscal position, but tougher choices lie ahead.
- The US Federal Reserve is widely expected to hike, with the focus on the published forecasts.

Key events and views

[Key Insights](#)

Half Year Economic and Fiscal Update (HYEFU), US Federal Reserve decision.

[Foreign exchange](#)

NZD expected to range trade on light volumes ahead of Thursday's important Fed and NZ Government releases.

[Interest rates](#)

Small moves in local interest rates over the past week.

[Domestic events](#)

Half Year Economic and Fiscal Update (Thu).

[International events](#)

December Federal Reserve Decision (Thu).

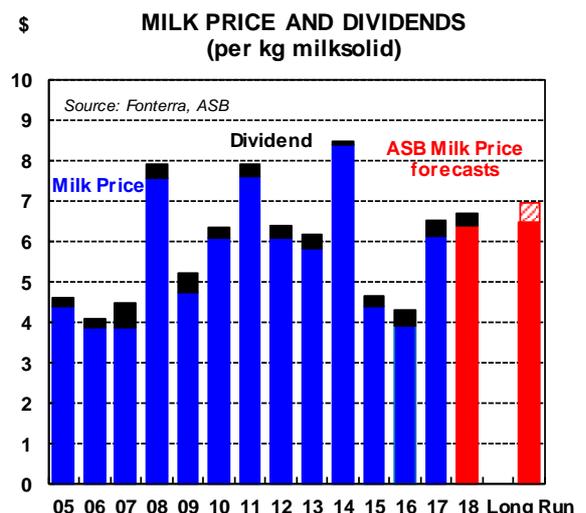
[Calendars](#)

NZ and International calendar of upcoming economic events.

Chart of the Week: Dairy payouts

Last week Fonterra cut its milk price forecast by 35 cents to \$6.40 per per kg of milk solids. Fonterra also trimmed its forecast for milk production over the coming season. This was on top of the 10c cut to the forecast dividend to 35-45 cents per kgms signalled a week earlier. Higher advance payments will help cushion the impact on farm cash-flows.

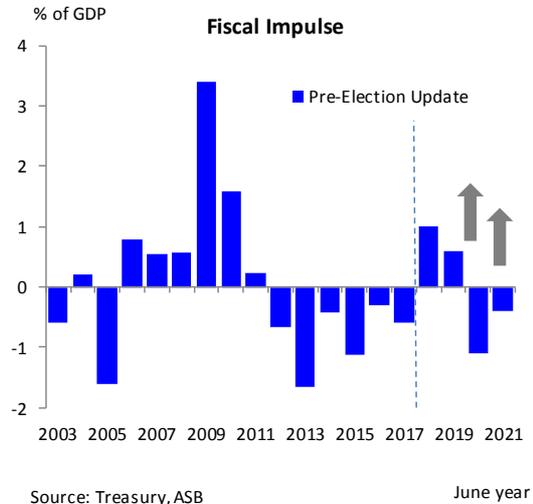
The lower payout is still well above the circa \$5/kgMS break-even level, which will enable some of the funds to be directed towards debt repayment, alleviating some concerns over elevated agricultural sector debt. As the chart shows we remain constructive on the medium-term outlook for dairy prices (and agricultural commodity prices more generally) underpinned by strong demand from rapidly growing emerging economies.



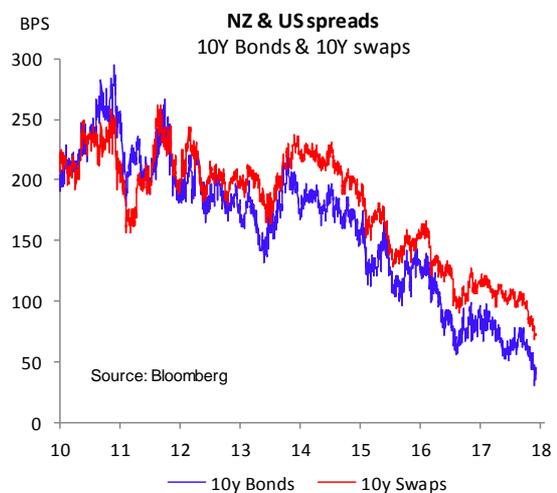
We maintain our more optimistic view on dairy prices and expect a milk price of \$6.50 per kgms will be achieved this season, with emerging dry conditions over recent weeks likely to limit NZ dairy production growth.

Key Insights this week

The major focus domestically is the **Half Year Economic and Fiscal Update (Thursday 1pm)**, the first for the new coalition Government. **We expect the published forecasts to confirm that the twin objectives of keeping government spending under 30% of GDP and lowering net public debt below 20% of GDP by 2022 will be met.** Nevertheless, largely due to higher government expenditure, the fiscal position will sail closer to the fiscal wind. We expect operational surpluses will be slightly lower and debt levels slightly higher relative to the Pre-election Economic and Fiscal Update (PREFU). **We anticipate the updated projections will add a cumulative \$12bn or so to the government bond tender programme by 2022.** The impact on Government bond yields will depend on how the additional supply is filtered through the market. Increased government support will also likely add to medium-term inflationary pressures and keep the bias on subsequent OCR moves tilted to the upside.



The major offshore development this week is the **Thursday Federal Reserve decision** and the publishing of December staff forecasts and the interest rate dot plots of Fed voters. Like the RBNZ, **the Fed faced the dilemma posed by an economy that appears to be running into capacity constraints, but where inflation has remained persistently low.** Annual inflation, from the core PCE deflator, has been below the Fed's 2% target for the last 5½ years, whilst the unemployment rate is currently around 17-year lows. With a December hike almost fully priced in, **the focus will be on the published forecasts, primarily the 'dot plots' for 2018 and 2019, which signal the intentions of Fed voters.** In September, the plots suggested a median of 3 hikes in 2018 followed by a further two in 2019. This is significantly above the current market pricing (+45bps), highlighting the potential for some form of market reaction.



An important theme of late has been interest rate convergence, as easing NZD interest rates have approached rising global yields. Spreads between NZD short-term interest rates with global counterparts have significantly narrowed of late as RBNZ rate hike expectations have pared back and global rates have generally firmed. NZD long-term wholesale interest rates have also fallen in relation to those offshore. The question for markets is how much further the narrowing in NZD long term rate differentials with global rates will continue.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6844	0.6859	0.6939	0.7173	FLAT/DOWN	0.6800	0.7100	UP
NZD/AUD	0.9112	0.9017	0.9028	0.9618	FLAT	0.9000	0.9250	UP
NZD/JPY	77.71	77.32	78.67	82.08	FLAT	76.50	78.50	UP
NZD/EUR	0.5817	0.5778	0.5957	0.6763	FLAT	0.5700	0.5900	UP
NZD/GBP	0.5113	0.5091	0.5278	0.5699	FLAT/DOWN	0.5000	0.5200	UP
TWI	72.8	72.4	73.6	78.8	FLAT	71.50	73.00	UP

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

NZD Recap

USD swings has been the key driver of FX volatility over the past week. **There have been periodic bouts of USD strength**, reflecting the still-robust US dataflow and confidence that US tax reform will be passed into law. This had followed an earlier period of euro and GBP strength, with the latter supported by progress on Brexit-related talks. Payrolls data over the weekend was solid but earnings growth continued to underwhelm, seeing US longer-term yields remain unchanged. **The passage of the tax package through the US Senate was also USD positive**, although there are still a number of hurdles to clear until the tax package can be signed off into law by the President. Brexit negotiations made a significant break-through at the end of last week, with “significant progress” made allowing trade deal talks to begin in the New Year.

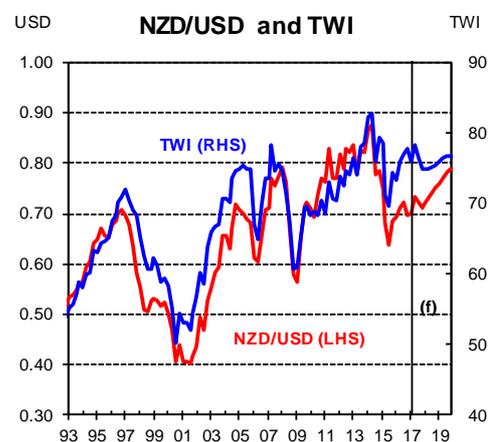
Near-term NZD outlook

The next major milestone for the NZD is Thursday’s Fed decision (see more below) and the Half Year Economic and Fiscal Update (HYEFU). With a December Fed hike close to fully priced in, the impact on the USD will depend on the tone of the statement, the published forecasts and the interest rate dot plots of the Fed voters, which captures the Fed’s median interest rate outlook for 2018 and 2019. **We see modest upside risk to the USD (downside to the NZD) if US Congress can agree on a unified tax bill for President Trump to sign by year end.**

The HYEFU is expected to be NZD supportive as it should depict a still-solid domestic outlook and respectable fiscal position despite our expectations of a further \$12bn in NZ bond issuance.

Medium-term outlook

Our medium-term bias for the NZD is still to the upside. We updated our FX forecasts in early November, to reflect the weaker NZD following the outcome of the NZ General Election and growing likelihood of a US fiscal tax package being delivered. In NZ, **political uncertainty associated with a change in Government has weighed on the NZD**, but we expect this to have mostly a fleeting impact. **The NZD is expected to remain supported by the historically high Terms of Trade and relatively high interest rates.** We expect the NZD/USD to recover to 0.72 cents by early 2018 and climb to 0.75 by the end of 2018. **NZD recovery is also expected against the euro, which is expected to average between 0.60 and 0.61 over the coming year. The NZD/AUD fell following the Labour-NZ First coalition announcement and we expect the NZD/AUD will average between 0.90 and 0.91 over the next year.** With EU-UK Brexit negotiations weighing on the UK economic outlook, the NZD is expected to remain elevated against the GBP. **We expect the NZD/GBP to average between 0.53 and 0.54 until the end of 2018.** We expect the **NZD/JPY to average around 78-80 level over the next couple of years, with the yen supported by low US Treasury yields, and no indication of further BOJ easing.**



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	1.90	1.94	2.04	FLAT	UP
2-year swap	2.15	2.15	2.21	2.30	FLAT	UP
5-year swap	2.60	2.59	2.71	2.87	FLAT	UP
10-year swap	3.08	3.09	3.21	3.40	FLAT	UP
10-year govt bond yield	2.79	2.77	2.93	3.27	UP	UP
Curve Slope (2s10s swaps)	0.93	0.95	1.00	1.11	FLAT	DOWN

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

Market Recap

NZ interest rates moves were small over the past week, with the market largely shrugging off RBNZ Acting Governor Grant Spencer's speech and the weaker Australian GDP out turn. **There was also limited reaction to the US labour market report and other weekend developments.**

New Zealand government bond yields spiked up toward the end of the week, in contrast to modest moves elsewhere. However, over the week as a whole, NZ Government bond yields are slightly lower which has seen the 2's 10's yield curve flatten slightly.

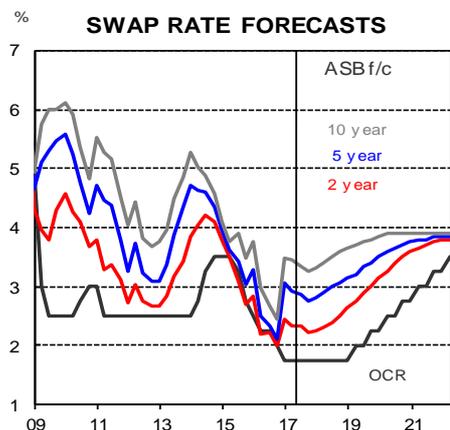
Short-term market pricing remains biased towards a higher OCR, with about 18bps of OCR hikes priced in by the end of next year.

Near-term NZD interest rate outlook

Local rates are expected to trade in reasonably narrow ranges up to Thursday's 8am FOMC decision. A December Fed hike is close to fully priced in, but the focal point for markets will be the published interest rate dot plots of the Fed voters. A scaling back of the 75bps of hikes signalled for 2018 closer to the 45bps signalled in current market pricing will likely provide the path of least resistance. Limited market reaction is expected from the Bank of England and European Central Bank decisions this week. **The Half Year Economic and Fiscal Update (HYEFU) is expected to show an additional \$12bn or in gross issuance through to 2021.** Whilst this will likely bias government bonds yields up, the impact will depend on the extent to which the Debt Management Office (DMO) decide to front-load additional issuance as opposed to drip-feed the additional bond supply to the market. We suspect the DMO will tread carefully. Friday's DMO \$200m tender of the 2025 NZ bond will provide an early test for the market.

Medium-term outlook

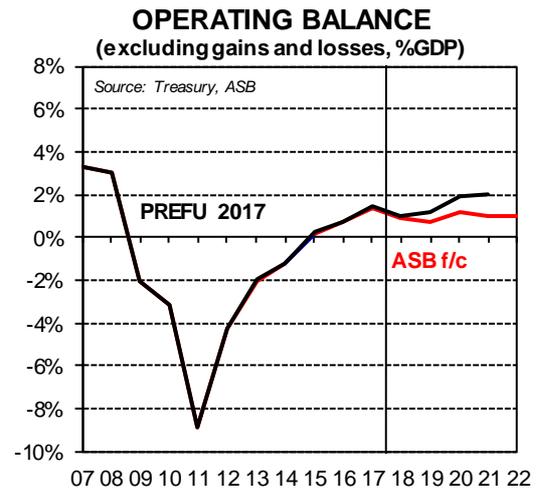
Our core macro view is that the RBNZ will start lifting the OCR in early 2019. We expect a moderate pace of tightening by historical standards, and a low OCR endpoint of around 3.5% this cycle. **This should help push up short-term NZD rates and help to flatten the local curve. Our expectation of a flatter NZD curve crucially depends on the assumption that local yields remain reasonably well anchored to global counterparts and that the lift in global yields is modest.** With ASB now expecting three Fed hikes by the end of 2018 (and the possibility of a fourth), there is the risk that the Fed may have to move more aggressively than signalled by current market pricing, which along with the resurgence of US inflation, could push up longer-term US rates. With still considerable uncertainties over the persistence of low global inflation and a downward risk profile for the global economy, we expect long-term global yields to drift, rather than markedly 'snap' higher.



Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Half Year Economic and Fiscal Update, OBEGAL 2017/18, % of GDP	14/12	1:00pm	+1.4%	-	0.9%

The new **Labour-NZ First Government** releases its **first take** on the country's fiscal accounts with the **Half-Year Economic and Fiscal Update (HYEFU) on Thursday at 1pm NZT**. The new Government has committed to the existing Budget Responsibility Rules. That, along with the existing healthy state of the accounts, ensures that we are likely to see another healthy fiscal picture in the HYEFU. In particular, **that could likely mean the HYEFU shows small operating surpluses over the forecast period**. According to our estimates, the **operating surplus will likely average 1% of GDP** over the five-year period. We also expect the HYEFU to show a strong Government balance sheet. We project that, along with achieving its operating surplus target, the Government will also be on track to deliver its net debt target. **Specifically, we expect net debt to reach 20% of GDP by 2021/22**. However, smaller surpluses do translate into higher net debt levels compared to the previous PREFU forecasts. In addition, higher debt levels translate into a larger bond tender programme. **We anticipate around \$12bn extra issuance over the 5-year forecast period**.



Major International Events for the week ahead

Data	Date	Time (NZT)	Market	ASB
Australia House Prices Q3, %qoq	12/12	1:30 pm	0.5	-1.2
RBA Governor Lowe speech	13/12	-	-	-
Australia Unemployment Rate, November, %	14/12	1:30 pm	5.4	5.4
China Industrial Production, November, %yoy	14/12	3.00 pm	6.2	6.2
US Alabama Special Senate Election	13/12	2:15 pm	-	-
UK CPI, November, %yoy	12/12	10:30 pm	3.0	2.8
US CPI, November, %yoy	14/12	2:30 am	2.2	2.1
European Central Bank Interest Rate Announcement, %	15/12	1:45 am	0.0	0.0
Bank of England Interest Rate Announcement, %	15/12	1:00 am	0.5	0.5
US Fed Interest Rate Announcement, Upper Bound, %	14/12	8:00 am	1.5	1.5

We expect a small fall in **Australian dwelling prices** over the quarter, although annual growth is still expected to remain positive (circa 5%pa). There are likely to be large variations across the eight capital cities.

Reserve Bank of Australia Governor Lowe is due to speak on “An eAUD?” at 9.30 am on Wednesday morning in Sydney

We expect a moderate rise in **Australian employment** numbers, in line with favourable forward indicators of job ads and business surveys. The unemployment rate is likely to stay unchanged.

China’s retail sales and industrial output growth is slated to stay strong going into winter.

US Polls for the Alabama special Senate election show the Republican candidate Moore is ahead of his Democrat rival Jones. But Moore’s lead is only as large as the poll margin of error. A loss of the normally safe Republican seat would make it more difficult, though not impossible, to pass a tax bill.

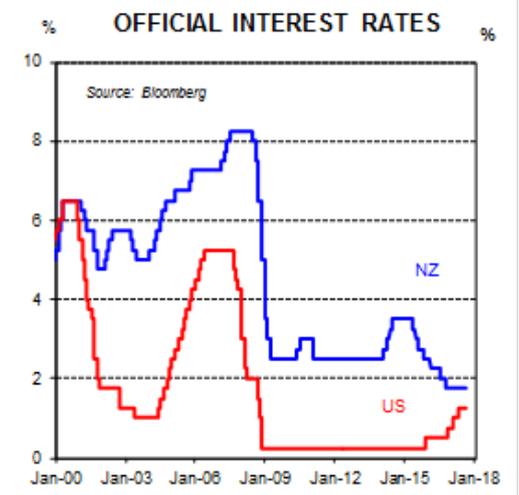
We anticipate the **UK’s November CPI** will print at 2.8% yoy. Inflation is likely to slip lower over the coming months, reflecting base effects.

A rebound in **US** gasoline prices suggests headline **inflation** accelerated to 2.1%pa. We also expect core inflation to accelerate to 1.9%pa because of stronger consumer demand and a gradual pick-up in wage growth.

We anticipate the **European Central Bank** will leave its refinancing and deposit rates unchanged at 0.0% and -0.4% respectively.

We anticipate the **Bank of England** will leave interest rates unchanged at 0.5%. We do not anticipate another rate hike until Q3 2018.

A 0.25% increase in the **US Federal Reserve’s Funds rate target** is priced into money markets and widely expected by US economists. We expect no change to the ‘dot plot’ of three interest rate increases in 2018 and two increases in 2019.



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 11	14:15	AU	HIA new home sales	Oct	m%ch	-6.1	~	~
	19:00	JN	Machine tool orders	Nov P	y%ch	49.8	~	~
Tue 12	10:00	NZ	ANZ Truckometer Heavy	Nov	m%ch	2.9	~	~
	11:30	AU	ANZ Roy Morgan Weekly Consumer	Dec	Index	115.8	~	~
	12:50	JN	PPI	Nov	m%ch	0.3	~	~
	13:30	AU	NAB business conditions	Nov	~	21.0	~	~
	13:30	AU	House price index	Q3	q%ch	1.9	~	~
Wed 13	10:45	NZ	Food prices	Nov	m%ch	-1.1	~	~
	11:15	AU	RBA Governor Lowe gives speech in					
	12:30	AU	WBC consumer confidence index	Dec	Index	99.7	~	~
	12:50	JN	Core machine orders	Oct	m%ch	-8.1	~	~
	13:00	AU	RBA's Kent gives speech in Sydney					
15:00	AU	RBA's Richard participates in Panel in Sydney						
Thu 14	13:00	AU	Consumer inflation expectation	Dec	%	3.7	~	~
	13:30	AU	Unemployment rate	Nov	%	5.4	~	~
	13:30	JN	Nikkei Japan PMI manufacturing	Dec P	Index	53.6	~	~
	15:00	CH	Industrial production	Nov	y%ch	6.2	6.2	~
	17:30	JN	Industrial production	Oct F	m%ch	0.5	~	~
Fri 15	10:30	NZ	BusinessNZ manufacturing PMI	Nov	Index	57.2	~	~
	12:50	JN	Tankan large manufacturing index	Q4	Index	22.0	24.0	~

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 11	07:30	EC	Bloomberg December Eurozone Economic Survey					
Tue 12 Dec	08:30	UK	Bloomberg December UK Economic					
	09:30	UK	CPI	Nov	m%ch	0.1	~	~
	09:30	UK	House price index	Oct	y%ch	5.4	~	~
	10:00	EC	ZEW survey expectations	Dec	Index	30.9	~	~
	13:30	US	PPI final demand	Nov	m%ch	0.4	0.3	~
	19:00	US	Monthly Budget Statement	Nov	\$bn	-63.2	-135.0	~
Wed 13	09:30	UK	ILO unemployment rate 3 months	Oct	%	4.3	~	~
	10:00	EC	Industrial production	Oct	m%ch	-0.6	~	~
	13:30	US	CPI	Nov	m%ch	0.1	0.4	~
	19:00	US	FOMC rate decision (upper bound)	Dec	%	1.25	1.50	~
	19:30	US	Yellen Holds Press Conference Following FOMC Meeting					
Thu 14 Dec	09:00	EC	Markit Eurozone manufacturing PMI	Dec P	Index	60.1	~	~
	12:00	UK	Bank of England Bank rate	Dec	%	0.5	0.5	~
	12:45	EC	ECB main refinancing rate	Dec	%	0.0	~	~
	13:30	EC	ECB President Draghi holds news conference in Frankfurt					
	13:30	US	Retail sales advance	Nov	m%ch	0.2	0.3	~
Fri 15 Dec	10:00	EC	Trade balance	Oct	€bn	25.0	~	~
	13:45	US	Bloomberg December United States Economic Survey					
	14:15	US	Industrial production	Nov	m%ch	0.9	0.2	~

Key Forecasts

ASB NZ economic forecasts

	Jun-17 << actual	Sep-17 forecast >>	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20
GDP real - Q%	0.8	0.5	0.8	0.9	0.8	0.8	0.6		
GDP real - A%	2.5	2.3	2.7	3.0	3.0	3.3	3.1	2.9	2.8
GDP real - AA%	2.7	2.5	2.5	2.6	2.8	3.0	3.1	3.1	2.8
CPI - Q%	0.0	0.5	0.5	0.4	0.0	0.5	0.1		
CPI - A%	1.7	1.9	2.0	1.4	1.4	1.4	1.1	1.3	1.8
HLFS employment growth - Q%	-0.1	2.2	-0.6	1.0	0.7	0.5	0.6		
HLFS employment growth - A%	3.1	4.1	2.7	2.5	3.3	1.6	2.8	2.3	1.8
Unemployment rate - %sa	4.8	4.6	4.8	4.6	4.5	4.5	4.5	4.5	4.7
Annual current account balance as % of GDP	-2.8	-2.8	-3.0	-2.7	-3.0	-3.2	-3.2	-3.2	-3.1

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

(end of quarter)	Jun-17 << actual	Sep-17 forecast >>	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
NZ 90-day bank bill	1.96	2.0	2.0	2.0	2.0	2.0	2.2	2.3
NZ 2-year swap rate	2.33	2.2	2.3	2.3	2.4	2.5	2.7	2.8
NZ 10-year Bond	2.97	3.0	3.0	3.1	3.2	3.3	3.4	3.4

ASB foreign exchange forecasts

(end of quarter)	Jun-17 << actual	Sep-17 forecast >>	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
NZD/USD	0.73	0.72	0.71	0.72	0.73	0.74	0.75	0.76
NZD/AUD	0.95	0.92	0.91	0.90	0.90	0.90	0.90	0.90
NZD/JPY	82	81	80	79	78	78	79	79
NZD/EUR	0.64	0.61	0.61	0.61	0.61	0.61	0.61	0.61
NZD/GBP	0.56	0.54	0.53	0.53	0.53	0.54	0.54	0.53
NZD TWI	78.4	76.4	74.9	74.9	74.9	75.3	75.4	75.8

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