Economic Weekly

14 January 2019

Back to reality

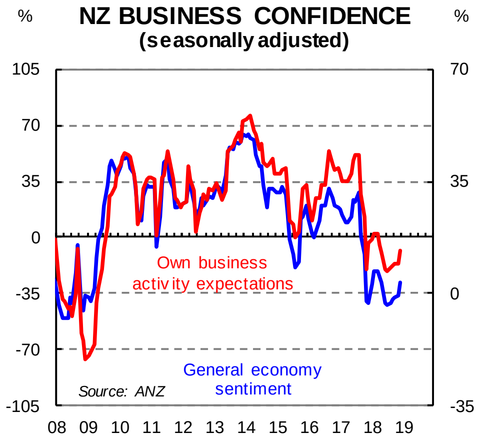
Happy New Year. We hope you enjoyed a nice relaxing break and are ready to face the year ahead. It's back to reality for those who have already returned back to work, with politics in the US and UK triggering a bumpy start to the year. The partial US government shutdown has now officially become the longest in history. Meanwhile, the UK appears it may be heading to the March 29 Brexit deadline without a deal in place, with the Prime Minister's deal with the EU lacking support ahead of a key UK vote this week. **Back in NZ, we hope to start the New Year on a more positive note,** looking to see a recovery in Q4 business confidence and signs that NZ can shake off its poor economic performance in Q3. On page 2 we discuss the weak Q3 GDP growth performance and our expectations for the economy over 2019.

Key events and views

Chart of the Week: Confidence moving on up

ANZ monthly business confidence finally staged some recovery in December, with a broad-based lift across all aspects of the survey (i.e. general business sentiment, profitability expectations, employment and investment intentions). Sentiment was likely buoyed in December by the drop in NZ fuel prices seen from mid-November. While the size of the move was relatively small, **it is a move in the right direction and one we hope is also mirrored in the NZIER Quarterly Survey of Business Opinion (QSBO)**, released on Tuesday at 10am.

We hold the QSBO survey in high regard as it has been **particularly good at predicting GDP growth** over the past year. Importantly, it correctly predicted solid H1 2018 growth, and signalled the 2018Q3 growth slowdown. As such, **we will be closely scrutinising the Q4 experienced activity (seasonally-adjusted) outcome from the QSBO (zero in Q3).**



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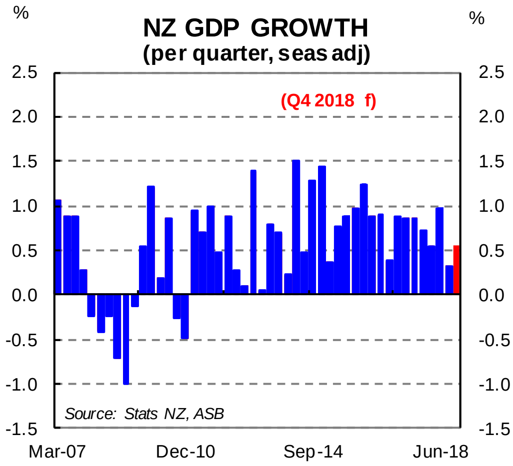
Key insights this week: Q3 2018 NZ GDP Review, and looking towards 2019

- **Growth was weak in 2018Q3 and is likely to remain muted over the remained of 2018.**
- **We believe the growth slowdown over H2 2018 will be a temporary and that growth will resume to trend rates from the start of 2019.**
- **The outlook for global growth and domestic business confidence remain the wild cards for 2019.**

Growth weak in Q3 2018

2018 finished on a low note, with the final major local data release of the year revealing much weaker-than-expected Q3 GDP growth. Economists had been expecting Q3 growth to be on the soft side, with business confidence plunging at the start of the quarter as petrol prices surged. Nonetheless, the official figures managed to undershoot modest expectations, with Q3 growth clocking in at just 0.3% for the quarter (vs 0.6% market median expectation). Furthermore, the source of soft growth over Q3 was reasonably broad-based across most industries. Activity in the goods-producing industries fell 1%, while services growth was below trend at 0.5%. We had expected growth to be soft and had seen some downside risks ahead of the release. The weaker-than-expected result was largely due to some of this downside risk materialising and activity in some industries proving even weaker than we had anticipated (for more detail, see our full review here).

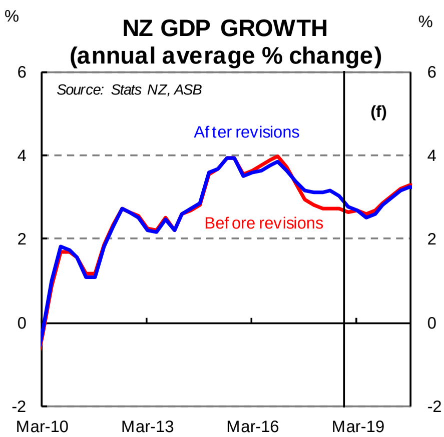


Investment was weaker than expected, led by a decline Other Construction and Plant, Machinery & Equipment. The fall in Other Construction occurred as repair work from the Kaikoura earthquake continued to wind down. **The fall in Plant, Machinery and Equipment was in line with the recent decline in investment intentions** (although weaker than import data had suggested). **We do expect investment to remain weak over the coming year** as businesses react to increased uncertainty from the change in Government and delayed investment decisions reducing the pipeline of investment activity for the coming year.

We expect GDP growth likely remained muted over Q4, but we are optimistic that economic momentum will lift in early 2019. The recent fall in petrol prices will come as a relief to squeezed household budgets (with discretionary spending starting to bounce back). Domestic business confidence also showed tentative signs of improvement in the final month of 2018.

Revisions paint a healthier picture of underlying growth

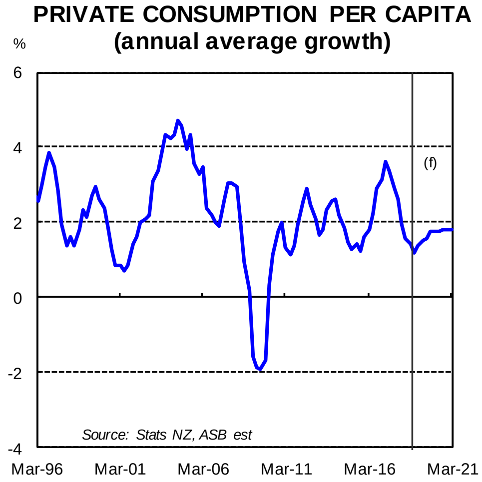
Growth over 2017 was revised higher, with annual average growth in the March 2018 year revised up to 3.1% from 2.7%. As a result, between Q1 2017 to Q2 2018 the average pace of quarterly growth was a relatively respectable 0.8%. The revisions also painted a slightly healthier picture on a per-capita basis, with growth of around 1% per annum.



H2 2018 slowdown likely a temporary

We believe the growth slowdown over H2 2018 will be temporary and that growth will rise close to trend rates (around 0.7% per quarter) from the start of 2019. The revisions to the 2017 growth profile reinforce this view. Over the first half of 2018 we continued to reiterate the reasons for growth to remain resilient due to very supportive tailwinds the NZ economy has enjoyed. This included low interest rates, high commodity export prices (and low import prices), high rates of population growth and a tightening labour market. All these factors remain in place. The only change during H2 2018 was the painfully sharp increase in petrol prices, causing a material spike in costs for households and businesses. Now this has mostly unwound, the economy should return to business as normal. In our view, this means GDP growth of around 3% per annum, led by lift in per-capita household spending growth to close to 2% per annum.

Much of NZ's economic outlook rests on the assumption of a strong healthy labour market continuing, with wage inflation starting to accelerate. The Q3 unemployment rate fell to the lowest level in 10-years, employment demand remained robust and firms continued to report difficulties in finding the labour required. **We expect the tight labour market and minimum wage increases to drive wage growth higher**, with private-sector wage inflation lifting from 2% per annum, to 2.8% per annum by early 2020. Household spending will also benefit from increased fiscal support via spending and transfers.

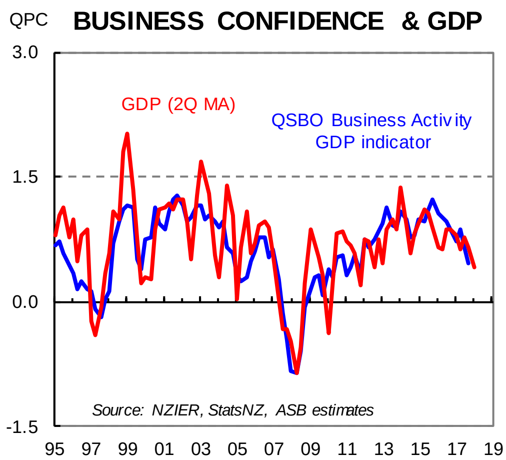


Meanwhile, as we move into the later stages of the economic cycle, the areas that provided the initial catalyst for growth are starting to fade and provide less support.

- Global growth momentum is slowing. The recent shakeout in financial markets and slowing growth in China, Australia is a worry.
- We expect domestic construction activity to be close to a peak.
- NZ population growth will continue to gradually slow as permanent and long-term migrant departures firm.
- The NZ Terms of Trade will remain elevated, but are likely to ease slightly over the coming year.
- Interest rates are already close to historical lows, with limited scope to move lower. Proposed RBNZ capital requirements could place upward pressure on retail borrowing rates in NZ.

Risks remain

Domestic business confidence stabilised over the fourth quarter of the year, albeit at low levels, and in the December month showed some tentative signs of recovery. Services-sector sentiment appears to have improved in December, which reinforces our view that the slowdown in business services demand is likely to be temporary. Nonetheless, the **low level of sentiment remains a material downside risk to the economic outlook if business decisions are altered on the back of pessimistic perceptions**. While employment demand has held up well to date, business investment appetites appear to have slowed. We will continue to watch economic developments closely.



Global growth remains the wild card for 2019. Global economic growth has become less synchronised and the escalating trade spat between US and China is now showing signs of materially impacting growth Chinese economic activity. How well the global economy can withstand geopolitical forces will also play a role in NZ's economic fortunes this coming year.

RBNZ implications

Stronger momentum in the economy over 2017 may be encouraging for the RBNZ, as it implies underlying inflation pressures are likely to continue to build. **On the other hand, the economy slowed more sharply in Q3 than expected. We expect weak growth over H2 2018 is likely to prove temporary.** If the RBNZ shares our view it may choose to look through the impact of the weaker result somewhat. If not, and if medium-term inflation shows signs of easing further below the midpoint of the 1-3% inflation target, a new record low for the OCR beckons.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6829	0.6750	0.6793	0.7254	FLAT/UP	0.6680	0.6920	FLAT/UP
NZD/AUD	0.9470	0.9459	0.9443	0.9203	FLAT/UP	0.9350	0.9600	DOWN
NZD/JPY	74.04	72.98	77.09	80.70	FLAT	72.60	75.60	DOWN
NZD/EUR	0.5959	0.5908	0.5979	0.6018	FLAT	0.5840	0.6080	DOWN
NZD/GBP	0.5316	0.5295	0.5378	0.5354	FLAT/UP	0.5220	0.5430	DOWN
TWI	74.0	73.3	74.3	75.21	FLAT/UP	73.0	76.5	DOWN

*^ Weekly support and resistance levels * Current as at 8.10am today; week ago as at Monday 5pm*

NZD Recap

The NZD lifted across all major currencies we monitor last week. The lift reflects a general improvement in risk sentiment after a relatively sombre start to 2019. The first week of 2019 was plagued by concerns including the partial shutdown of the US government, ongoing trade tensions and global growth worries. Early 2019 also saw a 'flash crash' in currency markets. The USD/JPY fell from 109 to 105 almost instantaneously while the NZD/AUD spiked to 0.98 from 0.95. The crash was short-lived, with currencies quickly reversing much of the moves. Last week, however, 'positive' US-China trade developments, comments from US Federal Reserve members about patience and the release of the FOMC meeting minutes helped to allay trade and higher US interest rate concerns. There were minimal data releases last week to create volatility in currency markets. However, the USD did lift following the release of December CPI data on Friday night. The strength was short-lived however, with the NZD/USD shortly moving back to near pre-CPI levels.

Near-term outlook

Global catalysts will remain the key driver of the NZD this week. The US government shutdown (now the longest in history) will remain in focus, as will the UK parliamentary vote on the Brexit deal (15th January UK time). Both events are likely to result in heightened uncertainty over the week. If the UK parliament does not vote in favour of the proposed deal, the UK will head towards the 29 March Brexit deadline with no deal, weighing on the GBP. Locally, tomorrow's Q4 Quarterly Survey of Business Opinion could cause some short-term volatility in the NZD, as soft business confidence remains a key downside risk to the economic outlook. However, we are expecting the release to show some slight improvement, which should support the NZD. Offshore, the data calendar remains light with few market moving releases scheduled for release. US retail sales on Thursday morning (NZ time) will be the key offshore release.

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/AUD has strengthened recently, but we expect the NZD/AUD to slowly grind lower over 2019 as the RBA is still expected to start tightening monetary policy ahead of the RBNZ. 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.

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	0.67	0.66	0.68	0.70	0.66
NZD/AUD	0.92	0.92	0.95	0.90	0.91	0.90	0.90
NZD/JPY	74	75	74	74	73	75	74
NZD/EUR	0.58	0.57	0.59	0.58	0.55	0.55	0.54
NZD/GBP	0.52	0.51	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.5	72.1	73.5	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	1.92	1.93	1.97	1.87	FLAT	UP
2-year swap	1.92	1.95	2.08	2.21	FLAT	UP
5-year swap	2.17	2.18	2.36	2.71	FLAT	UP
10-year swap	2.62	2.63	2.77	3.20	FLAT	UP
10-year govt bond yield	2.33	2.41	2.48	2.85	FLAT	UP
Curve Slope (2s10s swaps)	0.70	0.68	0.70	0.99	FLAT	FLAT

** Current as at 8.10am today; week ago as at Monday 5pm*

Market Recap

Since our last weekly report close to a month ago, domestic and global interest rates have rallied (yields lower) and the yield curve has flattened. Yields on the bellwether 2-year swap have declined by around 10bps (1.92%), approaching record lows. Markets have swung from pricing in a higher OCR over 2019 towards pricing in the modest probability of an OCR cut. Q3 NZ GDP was significantly weaker than market and RBNZ expectations, with RBNZ proposals for higher bank capital requirements potentially requiring a lower OCR if it leads to significant increases in retail borrowing rates (we don't think it will). Australian yields start the year lower, given slower GDP growth, lower house prices and slowing Chinese growth. Yields on 10-year NZ Government bonds and 10-year swaps touched 2-year lows at the end of 2018/early 2019. **Volatility in global equity markets resurfaced** after the Fed hiked rates in December (to 2.25%-2.50%), with the (now record) partial US Government shutdown continuing to drag on. Fed Chair Powell's comments that he was *"listening carefully"* to financial markets and the view in the Fed Minutes that future Fed hikes are "less clear than earlier" and that many members believed the Committee could be *"patient"* in raising rates have seen a scaling back in Fed hike expectations. Policy support has also dampened yields, with the People's Bank of China cutting banks' reserve requirement ratios (RRR) by 100bps in early January to boost liquidity.

Near-term NZD interest rate outlook

We have a broadly neutral bias for local interest rates. The focal point for this week's local calendar is tomorrow's Quarterly Survey of Business Opinion (QSBO). If activity metrics from this survey – most notably experienced and expected firms' domestic trading activity - follow the improving sign of the ANZ Business Outlook, market pricing could nudge higher. **The direction for longer-term NZ interest rates this week will continue to depend on global drivers/risk appetite.** The parliamentary Brexit vote in the UK on the 15th of January is the key risk event this week, with media reports suggesting Prime Minster May's Brexit Deal will be defeated. Longer-term rates could edge up from recent lows if the partial US government shutdown can be resolved, the US and China resolve trade issues, and forthcoming data/equity markets settle. However, a number of downside risks remain on the horizon. Slowing global growth and the resurfacing of global risks could see yields test fresh lows and flatten curves.

Medium-term outlook

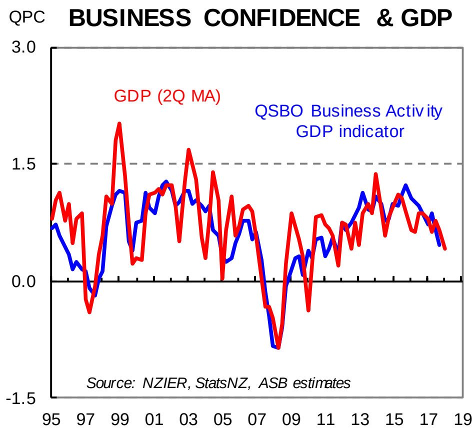
Given our low outlook for core inflation, we expect the OCR to remain on hold until August 2020. Our view is that the medium-term inflation outlook will not be strong enough to trigger hikes. Proposed higher bank capital requirements will likely tighten financial conditions, although the hurdle to OCR cuts still remains reasonably high. **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	2.0	2.3	2.7	3.0	3.2
NZ 10-year Bond	2.9	2.7	2.4	2.9	3.3	3.4	3.4

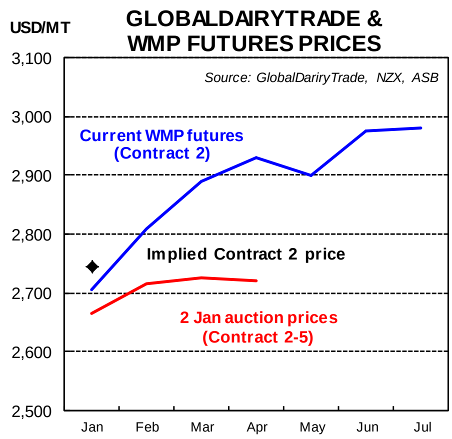
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
NZIER QSBO, Experienced Activity, Q4	15/1	10:00am	0	-	-
Food Price Index, December, % mom	15/1	10:45am	-0.6	-	-
GlobalDairyTrade auction, whole milk powder, %	15/1	overnight	1.2	-	+1.0
Retail Electronic Card Transactions, % mom	16/1	10:45am	-0.4	-	-0.4

The monthly ANZ survey showed some recovery in business confidence in December, most likely in response to the fall in petrol prices since mid-November. **We expect to see some tentative recovery in the Q4 Quarterly Survey of Business Opinion (QSBO)** but the full impact (of lower petrol prices on confidence) is likely to be more evident in next quarter's (Q1) survey. There are two main business confidence surveys in New Zealand – the NZIER Quarterly Survey of Business Opinion (QSBO) and the ANZ monthly Business Outlook survey. Following the 2017 election and change of government, business confidence fell in NZ. However, the NZIER QSBO survey has not fallen as sharply as the ANZ survey. The QSBO has remained the better predictor of GDP growth in recent years, and the survey's responses on 'experienced trading activity' correctly predicted the pace of growth over the first three quarters of 2018. Importantly, it correctly predicted GDP growth holding up relatively well over H1 2018, and then slowing sharply in Q3. As such, **we will be closely scrutinising the Q4 experienced activity** (seasonally-adjusted) outcome (zero in Q3).



December food prices are one of the last key data releases ahead of Q4 CPI (released on the 23rd of January). We expect food prices to have fallen slightly over December, take the Q4 fall to just over 1%. Our Q4 CPI forecast will be finalised following the release of the food price data. Our preliminary Q4 CPI forecast is that overall prices were flat over the quarter, with annual inflation dipping slightly to 1.8%.



We expect whole milk powder prices to post a small rise at the GlobalDairyTrade auction on overnight Tuesday. A fortnight ago, whole milk powder (WMP) prices rose by 1.2%, and at the current juncture futures pricing point to lift of up to 4%. Of late, futures pricing has consistently overstated recent auction results and we expect a more modest WMP price rise in the vicinity of 1%.

Despite a modest lift in consumer sentiment, lower fuel prices (down 4% in December) are expected to dampen overall December card spending. We expect a broadly flat result outturn for core card spending, as it followed a November outturn that had been supported by the Black Friday sales. According to one of the major providers, Paymark, annual spending growth declined sharply in December, with broadly flat annual spending growth for Auckland and Canterbury contrasting with robust spending growth in the lower North Island, Marlborough and Southland. Sluggish December card spending should see quarterly growth in card spending ease from 1.7%-2.2% growth rates evident in recent months. The tight labour market, lower fuel prices and improving consumer sentiment should underpin retail spending, but recent global equity market volatility, the flat domestic housing market backdrop and slower population growth will likely constrain retail spending growth over 2019.

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Eurozone Industrial Production, Nov, %mom	14/01	11:00 pm	-1.5	-
UK CPI, Dec, %yoy	16/01	10:30 pm	2.1	-
US Retail Sales, Dec, %mom	17/01	2:30 am	0.1	-
US Federal Reserve Beige Book	17/01	8:00 am	-	-
Eurozone CPI, Dec, %yoy	17/01	11:00 pm	1.6	-
UK Retail Sales, Dec, %moo	18/01	10:30 pm	-0.8	-
US Industrial Production, Dec, % mom	19/01	3:15 am	0.2	-

**Originally published by CBA Global Markets Research on Friday 11h January 2019 at 12.13pm.*

November industrial production numbers risk being strong if the weak October German industrial production numbers bounce back in November. The October German industrial production numbers showed the biggest monthly decline since 2009 because of poor weather, holiday-affected activity, and a spill over from the new emission-test procedures.

The Fed January Beige Book is a helpful, up-to-date assessment of local economic conditions. The Beige Book is one of the many documents the Fed takes with them into the upcoming (January 31) FOMC meeting. The Beige Book will likely show the domestic economy remains strong. In the December meeting minutes, the FOMC identified that most of the financial market risks resided offshore.

US December retail sales are set to be even stronger than the November retail sales report for both headline and core measures. An economy with full employment and modestly rising wages typically delivers strong retail activity. The risk is the headline measure of retail activity is softer than expected because of the large 19% fall in oil prices during mid-to-late December period and because of the recent decline in consumer confidence. However, the core measure of retail activity should be strong.

UK headline inflation has been easing over 2018 to 2.3% since peaking at 3.1% in late November 2017. The GBP exchange rate's recent weakness won't be enough to offset the drag on inflation from a decline in oil prices during December, and slower economic activity generated by Brexit uncertainty. We see risks of lower UK inflation in December.

Nov Eurozone December final inflation readings risk generating a slight downward revision and subsequent lower headline CPI because of the lower oil prices during December. If core measures of inflation hold at their preliminary levels of 1.0%/yr, the financial market reaction will be muted.

US December industrial production data are expected to show another modest increase in industrial activity, but stable capacity utilisation around 78.5%. The risk is lower oil prices led to a slowing in energy sector production, which affected total industrial production. Concerns of US-China trade disputes may also have affected economic activity.

UK December retail sales activity will decline from last month's 3.6%/yr rate of growth due to lower fuel prices. But retail sales ex-auto fuel will likely show an increase from the annual rate of growth of 3.8%. The upward trend in this latter measure of UK retail sales during 2018 is in direct contrast with UK industrial production over 2018 because of Brexit-related uncertainty impacting business activity.

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	0.3	0.6	0.7			
GDP real - A%	3.2	2.6	2.4	2.6	3.1	2.9	2.7
GDP real - AA%	3.1	3.0	2.8	2.7	2.9	3.0	2.8
CPI - Q%	0.4	0.9	0.0	0.4			
CPI - A%	1.5	1.9	1.8	1.8	1.8	1.8	2.1
HLFS employment growth - Q%	0.6	1.1	0.1	0.4			
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	-3.6	-3.7	-3.2	-2.7	-2.7	-2.9

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	2.0	2.3	2.7	3.0	3.2
NZ 10-year Bond	2.9	2.7	2.4	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	0.67	0.66	0.68	0.70	0.66
NZD/AUD	0.92	0.92	0.95	0.90	0.91	0.90	0.90
NZD/JPY	74	75	74	74	73	75	74
NZD/EUR	0.58	0.57	0.59	0.58	0.55	0.55	0.54
NZD/GBP	0.52	0.51	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.5	72.1	73.5	72.0	72.3	72.9	70.2

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