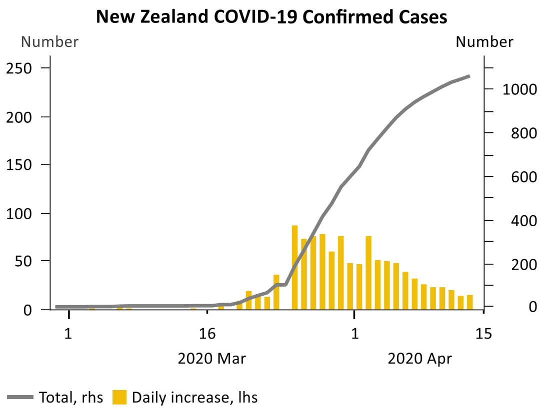
Economic Weekly

14 April 2020

## Channelling Mr Schuker

Back in my intermediate school days, we all did woodwork – parents were blessed with spice racks of varying quality. Whenever our teacher, Mr Schuker, did a demonstration around his workbench, he would swiftly swing a long piece of dowel back and forth in an arc. That kept us at a safe distance – and you learnt that lesson pretty quickly.

Our containment of the COVID-19 virus appears encouraging, with the curve flattening. But it is important that we maintain our lockdown discipline. The lockdown is coming at significant cost to the economy, and we need to ensure we get the maximum benefit in containing the virus from that economic sacrifice.



Source: Macrobond, ASB

We are all getting a lesson in why this thing called "the economy" matters. Ultimately it is what delivers our standard of living, through all those transactions and interactions we make. And the economic cost of the lockdown will be felt for a generation or more. We will have several 'lost' years in which earnings stagnate, debt surges, unemployment soars, career opportunities shrink (particularly for current students), inroads into absolute poverty will face headwinds, mental health issues will sprout. That is the real social toll of the actions NZ has taken to combat the virus. The Government is acutely aware of the hard trade-offs it faces, and our political leaders are in the unenviable position of bearing the burden of deciding what path will minimise overall health and social costs.

So let's channel a bit of Mr Schuker and keep distancing appropriately. That swinging piece of dowel demarks a safe space. Its length is also about the maximum distance we should be driving to the beach.

And increasingly, businesses need to get their focus onto what their plans are for exiting the lockdown and adapting to what will be a very different world. Financial positions have been weakened. Working practices will remain quite different as will our individual behaviours. We need to get ready. Good luck – Nick. nick.tuffley@asb.co.nz

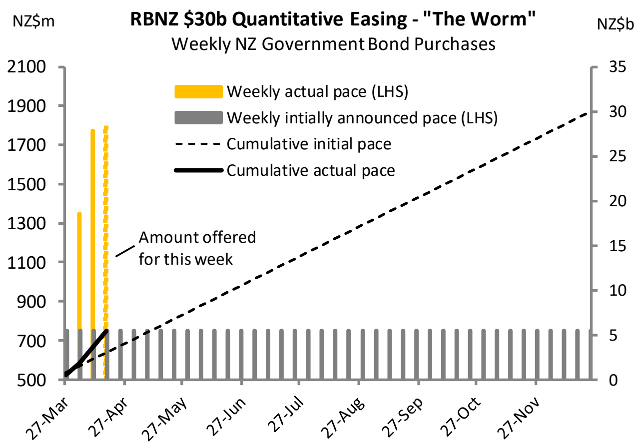
| Recent COVID-19 publications | Where to find support |
|---|---|
| COVID-19 and the economic path ahead | ASB financial support package |
| RBNZ policy actions | Government support package |
| Fiscal fights back | COVID-19 alert system explainer |
| RBNZ OCR cut March 16 | |
| Housing immunity about to be tested | |
| COVID-19: Market impacts, responses, and ideas | |
| Thinking about coronavirus impacts on business: Be prepared – it doesn't hurt | |
| Government support – quick guide to accessing it | |

## Super-size me

- **RBNZ has been front-loading bond purchases.**
- **We estimate they are $1.4b ahead of the initially communicated run rate.**
- **Additional government debt issuance still warrants a QE-upsize.**
- **We think the programme could lift from $33b, to $40-50b in May.**
- **Inflation-linked bonds to be added, but not corporate bonds.**

The RBNZ has made a strong quantitative easing (QE) debut, but we think it's going to have to go harder.

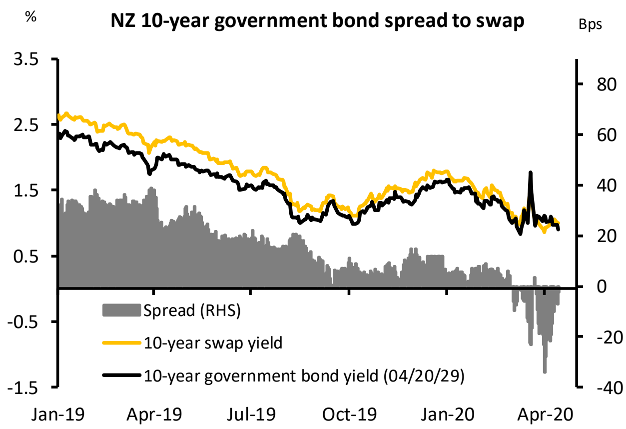
Recall the Bank initially announced a $30b, twelve-month programme of government bond purchases. A $750m per week cadence was the early plan, but with on-the-ground implementation decisions delegated to Bank staff. At that time, $30b amounted to about half of the entire nominal government bond market.



Source: RBNZ

Of course, since that announcement, the NZ government has upsized massively its debt issuance plans, effectively diluting the yield-moving power of the RBNZ's $30b QE programme. As we outlined in our note last week, this mix of more bond supply but the same amount of RBNZ buying saw government bond yields move well above swap rates – a historically unusual event (chart opposite).

Last week, the RBNZ hinted fairly strongly that it will go harder on the QE front, but that this is a decision for the Monetary Policy Committee, which next meets on 13 May. That is when they will receive the next full economic assessment from RBNZ staff.



Source: Bloomberg

But how big will they go? A couple of points on this.

First, they have moved already. Following the government's bond programme upsize, the Bank has been using its operational flexibility to buy bonds at a run-rate well above what was initially outlined. As the chart above shows, just under $1.8b in bonds were bought last week with a further $1.8b planned for this week. In the three weeks QE has been running, the cumulative "worm" is $1.4b ahead of the initial plan.

Second, by the end of June we estimate that the (nominal) government bond market will be around $15b larger – at around $75b – than what the RBNZ *thought* it would be at the time their $30b QE plan was hatched. It will continue to grow beyond June as well. Last week, Assistant Governor Hawkesby confirmed the ideal state for the Bank is still to own 40-50% of the market. Indeed, this is a broadly similar ownership percentage to the RBNZ's offshore QE-happy counterparts.

Then there's the question of scope.

The Bank confirmed last week that it will add Local Government Funding Agency bonds to its QE mandate, to the tune of $3b (around 30% of the market). We also expect inflation-indexed government bonds to be added to the list in May. There's around $18b of 'linkers' on issue and, applying a similar percentage as LGFA QE buying, we expect the Bank could purchases $5b or so of such.

At this stage we don't expect the Bank to start buying corporate bonds in the same way the likes of Fed are now doing in earnest. There are a few difficulties associated with doing so. For one thing, there is a dearth of highly-rated corporate bonds on issue in NZ. Buying corporate paper also raises the thorny issue of which corporates to buy, and which not to. Who gets the special treatment, in other words. Finally, for QE buying to actually benefit the borrowing entities (rather than simply the institution who is holding their paper) corporates need to be issuing bonds, and they're not at present.

We think the Bank's approach of buying government and LGFA bonds to (1) directly target lower base interest rates and (2) splash cash around the system is the best approach. There should be indirect positive effects on corporate bond spreads in doing so. Assistant Governor Hawkesby toed a similar line in his interview with Bloomberg last week.

Based on all of the above, we think the total RBNZ QE programme could lift from the current \$33b (including the \$3b of LGFA bonds) to \$45-50b in May.

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# Foreign Exchange Market

| FX Rates | Current* | Week ago | Month ago | Year ago | ST Bias | Support^ | Resistance^ |
|---|---|---|---|---|---|---|---|
| NZD/USD | 0.6088 | 0.5978 | 0.6129 | 0.6772 | FLAT/UP | 0.5860 | 0.6340 |
| NZD/AUD | 0.9542 | 0.9728 | 0.9741 | 0.9445 | FLAT | 0.9350 | 0.9750 |
| NZD/JPY | 65.60 | 65.05 | 64.32 | 75.80 | FLAT/UP | 63.00 | 67.00 |
| NZD/EUR | 0.5579 | 0.5522 | 0.5465 | 0.5987 | FLAT | 0.5360 | 0.5700 |
| NZD/GBP | 0.4864 | 0.4869 | 0.4880 | 0.5172 | FLAT | 0.4680 | 0.5070 |
| TWI | 69.2 | 68.6 | 69.1 | 73.29 | FLAT/UP | N/A | N/A |

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

### NZD Recap

The NZD lifted against the USD and JPY over the week, as cautious optimism filtered through financial markets on hopes that global COVID-19 infections may be starting to plateau. Furthermore, the prospect of further policy stimulus from various countries also supported market sentiment in the face of very weak economic data. In NZ, the market managed to largely shrug off the steep plunge in April business confidence. The USD itself has eased last week, in part as various Federal Reserve actions over the past few weeks have increased the availability of USD liquidity and reduced pressure on the USD. Over the past week, the Federal Reserve widened the scope for its Secondary Market Corporate Credit Facility to include corporate bonds which have been recently downgraded from investment grade to below-investment grade. This is significant and positive for financial markets because it reduces the risk US credit markets seize up again. With a gentle 'risk on' rally supporting both the NZD and AUD over the past week, the NZD edged back against the AUD.

For more discussion on recent market themes, please see the Economic Note released last week here.

### Near-term outlook

Over the week ahead, we expect the USD to remain heavy, which along with continued gradual improvement in global risk sentiment may see the NZD continue to move higher against the USD and JPY. There is some short-term risk the NZD rises against the AUD if Australian employment data for March is weaker than expected. However, we expect this lift to be temporary and for the NZD to underperform the AUD as we expect the NZ economy to contract 6% over 2020 compared to just a 3.4% contraction for the Australian economy. The EUR has scope to lift this week after Eurozone finance ministers agreed on a common economic response to the COVID 19 pandemic. The agreement includes provisions for unemployment benefits, guaranteed lending for small to medium-sized businesses and a special credit line to fund health-care costs.

### Medium-term outlook

Although volatility appears to have eased somewhat in the past week or so, it remains too early in the pandemic to draw strong conclusions on our medium-term outlook for the NZD. ASB modelling suggests further material declines in the NZD/USD are unlikely from here unless the NZ outlook fundamentally changes. But we'd reiterate previous advice around focusing less on the (highly uncertain) outlook and more on stress-testing exposures, using lower hedge ratios or FX options to retain flexibility, and trying to use volatility to your advantage. jane.turner@asb.co.nz

| **ASB foreign exchange forecasts** | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Mar-22 | Mar-23 |
|---|---|---|---|---|---|---|---|---|
| (end of quarter) | | << actual | forecast >> | | | | | |
| NZD/USD | 0.67 | 0.60 | 0.55 | 0.58 | 0.60 | 0.61 | 0.64 | 0.65 |
| NZD/AUD | 0.96 | 0.97 | 0.96 | 0.97 | 0.95 | 0.94 | 0.94 | 0.94 |
| NZD/JPY | 73 | 65 | 54 | 58 | 61 | 63 | 67 | 69 |
| NZD/EUR | 0.60 | 0.54 | 0.47 | 0.51 | 0.53 | 0.54 | 0.57 | 0.58 |
| NZD/GBP | 0.51 | 0.49 | 0.46 | 0.47 | 0.48 | 0.48 | 0.49 | 0.50 |
| NZD/CNY | 4.7 | 4.3 | 3.9 | 4.1 | 4.2 | 4.3 | 4.5 | 4.6 |
| NZD TWI | 73.8 | 68.8 | 62.1 | 64.8 | 66.2 | 66.7 | 69.0 | 69.9 |

## Interest Rate Market

| Wholesale interest rates | Current | Week ago | Month ago | Year ago | ST Bias | MT Bias |
|---|---|---|---|---|---|---|
| Cash rate | 0.25 | 0.25 | 1.00 | 1.75 | UNCH | UP |
| 90-day bank bill | 0.45 | 0.47 | 0.90 | 1.84 | UNCH | UP |
| 2-year swap | 0.45 | 0.48 | 0.79 | 1.72 | UNCH | UP |
| 5-year swap | 0.61 | 0.64 | 0.89 | 1.88 | UNCH | UP |
| 10-year swap | 0.99 | 1.00 | 1.17 | 2.31 | UNCH | UP |
| 10-year govt bond yield | 1.16 | 1.10 | 1.20 | 2.05 | UP | UP |
| Curve Slope (2s10s swaps) | 0.54 | 0.52 | 0.38 | 0.59 | UNCH | DOWN |

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

### Market Recap

Last week, increased optimism in the fight against COVID-19 brightened market sentiment, with a firming evident in global longer-term yields. The S&P500 rose 12%, its largest one-week gain since 1974. Oil prices initially rose and then settled after OPEC and its allies agreed to withhold oil supply. Yields have subsequently retraced recent climbs and yield curves have flattened. Equities have started this week on a softer footing, with forthcoming US corporate earnings reports expected to be poor. Data was soft – record lows for some metrics from the April NZ Business Outlook, weak NZ March card spending, 6.6 million US jobless claims for the week ended April 4 (17m over the last 3 weeks) – and may well get worse before it gets better.

Actions by central banks are helping to dampen yields. Quantitative easing (QE) has continued, with the RBA targeting latter tenor bonds for QE and the RBNZ front-loading QE purchases and signalling it will also add an additional $3bn of Local Government Funding Agency (LGFA) debt to its $30bn QE programme over 12 months. RBNZ Assistant Governor Hawkesby said that the RBNZ is open to increasing the size and scope of its QE, but there is a limit to how much the RBNZ can buy (about 40-50% of individual issues).The US Federal Reserve unveiled a massive USD2.3 trillion package to bolster liquidity, reduce funding market pressures and increase credit to firms and households. This has helped to dampen yields and to narrow credit and corporate bond spreads.

### Near-term NZD interest rate outlook

Our concern is that the economic damage associated with COVID-19 should become more evident in the data and could trigger another bout of risk aversion, dampening yields and flattening curves. The IMF Global Outlook should highlight a sizeable and geographically broad-based slump in global economic activity for 2020. Chinese Q1 GDP is expected to show an 8.2% qoq contraction, but March monthly data should start to point to a gradual recovery. US March retail sales is expected to be very weak. Moderate falls are expected for Australian March employment (-30k) as this preceded the shutdown. NZ yields eased after the RBNZ said it would look to buy $1.8bn in NZ Government bonds in this week's auctions, which should help dampen upward pressure on NZ bond yields from NZ fiscal support packages potentially unveiled this week. We expect the RBNZ will likely lift their asset purchase programme in the coming months (see this week's feature article above).

### Medium-term outlook

Central bank policy rates are expected to maintain highly accommodative settings. Given the risks to the outlook we don't expect the OCR to move above its 0.25% operational lower bound until 2024 at the earliest. The OCR could move lower if the RBNZ deemed this to be operationally feasible. Weak global growth, negative risks and the prospect of central bank asset purchases should cap long-term NZ interest rates, although we are wary over the impacts of sizeable global and NZ public debt issuance on government bond yields. mark.smith4@asb.co.nz

| **ASB interest rate forecasts** | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Mar-22 | Mar-23 |
|---|---|---|---|---|---|---|---|---|
| (end of quarter) | | << actual | forecast >> | | | | | |
| NZ OCR | 1.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| NZ 90-day bank bill | 1.29 | 0.51 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| NZ 2-year swap rate | 1.26 | 0.53 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.60 |
| NZ 5-year swap rate | 1.45 | 0.63 | 0.65 | 0.65 | 0.65 | 0.65 | 0.65 | 1.05 |
| NZ 10-year swap rate | 1.78 | 0.93 | 1.00 | 1.00 | 1.50 | 1.50 | 1.10 | 1.50 |
| NZ 10-year Bond | 1.65 | 1.03 | 1.40 | 1.40 | 1.40 | 1.40 | 1.40 | 1.45 |

## Major International Events for the week ahead*

| Data | Date | Time (NZT) | ASB |
|---|---|---|---|
| China Trade Balance, March, US$bn | 14/04 | - | 46 |
| Australia Unemployment, March, % | 15/04 | 1:30 pm | 5.4 |
| US Retail Sales, March, %mom | 16/04 | 12.30 am | -5.0 |
| Bank of Canada Interest Rate Announcement, % | 16/04 | 2:00 am | 0.25 |
| China Retail Sales, March, %yoy | 17/04 | 2:00 pm | -8.0 |
| China GDP, Q1, %yoy | 17/04 | 2:00pm | -4.0 |

**Originally published by CBA Global Markets Research on Thursday 9th April at 13:07 pm*

We forecast **China's** exports to grow by 1% in March following a slump of 17.2% in January and February. The notable recovery in the March new export orders PMI suggests Chinese exporters had a large backlog to fill. Korean March trade with China also suggests a meaningful recovery in China trade. However, the external demand shock emerged from mid-March and weighed on Chinese exports. We expect imports to fall by 7%yoy because of a slow recovery and falling commodity prices. Overall, we estimate the **trade balance** rebounded to US$46bn. Given the widespread and sizeable impact of the COVID-19 outbreak, we expect a sizeable contraction of Q1 Chinese GDP (-8.2% qoq,-4.0% yoy).

**Australia's March labour survey** was completed over two weeks from 8th-22nd March. We are expecting 30k job losses for March. We have pencilled in an unchanged participation rate and the unemployment rate rising to 5.4%. Given the survey was before the shutdown measures, the March labour force numbers are not expected to fully capture the impacts from COVID-19. The underemployment rate, average hours worked and the participation rate will be watched closely for the early effects of coronavirus. Over the next few months we see a falling participation rate and the job keeper wage subsidies partially offsetting the rise in the unemployment rate. In Q2 we have both the unemployment rate and job losses peaking at 7.8% and 585k respectively. There are significant downside risks to our forecasts.

We expect the pace of contraction in **China's retail sales**, industrial production and fixed asset investment to ease as the economy gradually recovers. Consumers remain cautious amid elevated imported infections. We forecast a GDP growth slump from 6%yoy in Q4 2019 to -4%yoy in Q1 2020 (quarter on quarter contraction of 8.2%).

We expect weak **US retail sales** activity in March. A 7% fall in gasoline prices and large-scale job losses will have constrained spending. We expect headline retail sales declined by 5%mom. We expect "control" sales declined 3%mom. Panicked stockpiling of essentials early in the month will provide some offset to slower sales activity because of the rising unemployment rate in March.

We expect no policy change from the **Bank of Canada** this week. Like other central banks, the BoC has already cut the policy rate to the effective lower bound and introduced programs to support liquidity and bank lending.

# Key Forecasts

| ASB NZ economic forecasts | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Mar-22 | Mar-23 |
|---|---|---|---|---|---|---|---|---|
| | << actual | forecast >> | | | | | | |
| GDP real - Q% | 0.5 | 0.0 | -14.7 | 8.5 | 1.8 | | | |
| GDP real - A% | 1.8 | 1.3 | -13.6 | -7.0 | -5.9 | -5.5 | 2.8 | 4.5 |
| GDP real - AA% | 2.3 | 1.9 | -2.1 | -4.4 | -6.3 | -8.0 | 4.8 | 4.3 |
| CPI - Q% | 0.5 | 0.4 | 0.1 | 0.6 | 0.2 | | | |
| CPI - A% | 1.9 | 2.2 | 1.7 | 1.6 | 1.4 | 1.5 | 1.2 | 1.4 |
| HLFS employment growth - Q% | 0.0 | 0.0 | -5.4 | -1.4 | 0.2 | | | |
| HLFS employment growth - A% | 1.0 | 1.0 | -5.2 | -6.8 | -6.6 | -6.2 | 3.2 | 2.6 |
| Unemployment rate - %sa | 4.0 | 4.4 | 8.7 | 8.8 | 8.4 | 8.2 | 6.8 | 6.0 |
| Annual current account balance as % of GDP | -3.1 | -3.2 | -3.6 | -3.8 | -4.3 | -4.8 | -3.4 | -2.4 |

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-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Mar-22 | Mar-23 |
|---|---|---|---|---|---|---|---|---|
| (end of quarter) | | << actual | forecast >> | | | | | |
| NZ OCR | 1.00 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 | 0.25 |
| NZ 90-day bank bill | 1.29 | 0.51 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 |
| NZ 2-year swap rate | 1.26 | 0.53 | 0.50 | 0.50 | 0.50 | 0.50 | 0.50 | 0.60 |
| NZ 5-year swap rate | 1.45 | 0.63 | 0.65 | 0.65 | 0.65 | 0.65 | 0.65 | 1.05 |
| NZ 10-year swap rate | 1.78 | 0.93 | 1.00 | 1.00 | 1.50 | 1.50 | 1.10 | 1.50 |
| NZ 10-year Bond | 1.65 | 1.03 | 1.40 | 1.40 | 1.40 | 1.40 | 1.40 | 1.45 |

| ASB foreign exchange forecasts | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 | Mar-21 | Mar-22 | Mar-23 |
|---|---|---|---|---|---|---|---|---|
| (end of quarter) | | << actual | forecast >> | | | | | |
| NZD/USD | 0.67 | 0.60 | 0.55 | 0.58 | 0.60 | 0.61 | 0.64 | 0.65 |
| NZD/AUD | 0.96 | 0.97 | 0.96 | 0.97 | 0.95 | 0.94 | 0.94 | 0.94 |
| NZD/JPY | 73 | 65 | 54 | 58 | 61 | 63 | 67 | 69 |
| NZD/EUR | 0.60 | 0.54 | 0.47 | 0.51 | 0.53 | 0.54 | 0.57 | 0.58 |
| NZD/GBP | 0.51 | 0.49 | 0.46 | 0.47 | 0.48 | 0.48 | 0.49 | 0.50 |
| NZD/CNY | 4.7 | 4.3 | 3.9 | 4.1 | 4.2 | 4.3 | 4.5 | 4.6 |
| NZD TWI | 73.8 | 68.8 | 62.1 | 64.8 | 66.2 | 66.7 | 69.0 | 69.9 |


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