Economic Weekly

15 June 2020

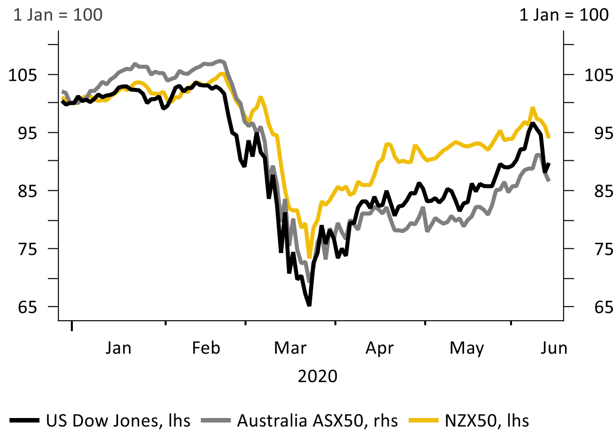
Equities wobble and NZ Q1 GDP due

Last week saw global equities stumble as rising COVID-19 infection rates in some US states saw investors wake up to the prospect of a second wave of US infections and the potential for reinstated lockdowns. Over recent months we have seen a surprisingly strong recovery in global equities, with many equity indices close to fully recovering the sharp falls seen through March. This recovery has been surprising as the strength in equity markets now appears out of step with the underlying economic outlook. In saying this, the excess equity demand may be a by-product of the global policy response to the Pandemic, with typical safe-haven assets now an unattractive investment option in a zero interest rate world, encouraging investors to take on additional risk.

The key event for domestic markets this week is StatsNZ's first estimate of Q1 GDP (see our full preview here). We expect StatsNZ's first estimate of Q1 GDP to show a 1.1% quarterly contraction – roughly in line with the median expectation of a 1% fall as polled by Bloomberg – bringing an end to 9 years of uninterrupted economic expansion in NZ. The impact of COVID-19 on economic growth is highly uncertain and StatsNZ has acknowledged methodology limitations will require revisions to its initial Q1 estimate. Ultimately, it's not the size of the fall that matters for policy, but the degree and timing of the recovery. We expect the economy will be slow to recover over 2020, although acknowledge recent indicators have been encouraging.

On Page 2 Mark Smith updates our estimates on the neutral OCR, the current OCR floor of 0.25% and the implications for the RBNZ's Quantitative easing programme. jane.turner@asb.co.nz

Equity Indices



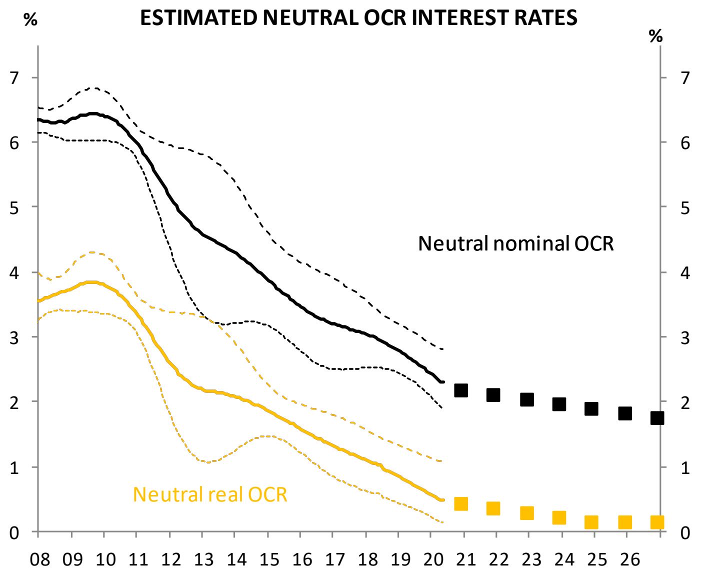
Source: Macrobond, ASB

Recent COVID-19 publications	Where to find support
ASB Economic forecasts and monitoring:	ASB financial support package
Quarterly Economic Projections	Government support package
Housing Confidence	COVID-19 alert system explainer
ASB COVID-19 Chart pack	
NZ Sector outlook	
Financial market trends:	For these publications and more COVID-19 research, see here
Corporate Hedging Toolbox	
ASB Podcast for investors	
Policy response:	
RBNZ confirms increase to QE at May Monetary Policy Statement	
Budget 2020 delivers huge support, huge debt	

Updating our neutral OCR estimates and looking at RBNZ QE

- Our current estimates suggest the neutral OCR has continued to decline and is currently 2¼%.
- On its own a 0.25% OCR will not provide enough monetary stimulus to support the economy as it struggles with the impact of COVID-19.
- Rather than drop the OCR, the RBNZ has chosen to go down the Quantitative Easing path. Results to date have been encouraging. Retail deposit and lending interest rates are on our watchlist.

In the NZ context, the neutral cash rate can be thought of as the level of the Official Cash Rate (OCR) that is neither stimulatory nor contractionary for the economy. It is one of the major anchors for the economy, but is not observable, with a large margin of error around estimates. Our previous work in September 2018 suggested that neutral real interest rates in NZ had been trending lower since the Global Financial Crisis as part of a globally synchronised move lower in yields. Back then we estimated that the neutral nominal Official Cash Rate (NOCR) was just below 3%, as opposed to around 6% at the start of the decade. Moreover, we had expected the NOCR to decline further given the pending impact of higher bank capital requirements (which raise bank funding costs) and trends in the four P's; productivity, population, preferences, and prices (inflation). This would have important implications for savers, borrowers, investors and policymakers over and above the cyclical swings were would usually expect to see.

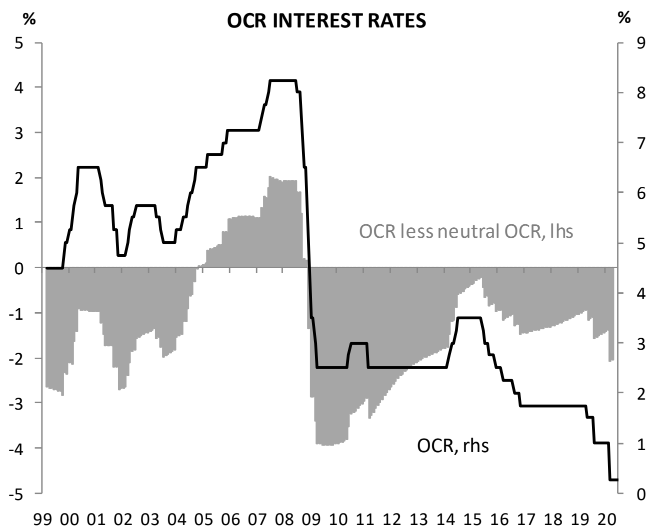


Source: Bloomberg, Statistics NZ, ASB

Our updated estimates of the neutral nominal OCR are now around 2¼%. Signalled increases in bank capital requirements (which would act to lower the NOCR via raising bank funding costs) have been postponed, but New Zealand's neutral interest rates have likely continued their downward trend as yield curves have flattened and markets have come across to the view that recent lulls attributable to COVID-19 were likely to persist for some time. Markets have stabilised of late and yields have firmed as some optimism has returned as global economies start to reopen post-COVID-19 lockdowns. However, a long road lies ahead and while the outlook is inherently uncertain, our "gut feel" is that the neutral OCR will continue to drift lower, particularly if higher bank capital limits are imposed.

A 0.25% OCR on its own is unlikely to be sufficient

If our estimates of the neutral OCR are in the ballpark, a 0.25% OCR is only 200bps below neutral, about half of the amount of interest rate stimulus provided at the time of the Global Financial Crisis (GFC, see chart). **To provide a similar degree of interest rate support, all else equal, a circa -2% nominal OCR would be needed. Even more monetary support may be needed given that COVID-19 represents a larger negative shock to the global economy.** Our forecasts have a 6% decline in NZ GDP over 2020, around twice the cumulative fall in GDP during the GFC. **We also need to take into account the weaker outlook for inflation and inflation expectations.** Both real and nominal short-term interest rates dropped by more than 500bps during the GFC. Our estimates suggest real 90-day interest rates have only dropped 50bps so far in 2020. **Admittedly the fiscal policy easing this time around is more front-loaded compared to the GFC**. However, the magnitude of planned fiscal easing over the next 3 fiscal years is broadly comparable to the fiscal stimulus put in place over the 2009/11 period according to the Treasury Fiscal Impulse in Budget 2020 (6.5% of GDP over 2020/21 versus 5% of GDP over 2009/11).

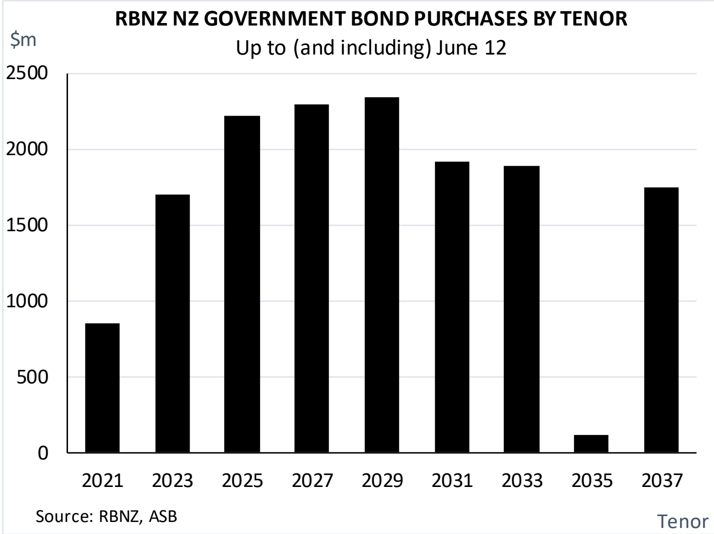


Source: Bloomberg, RBNZ, ASB

RBNZ Signalling and Quantitative Easing have helped dampen yields

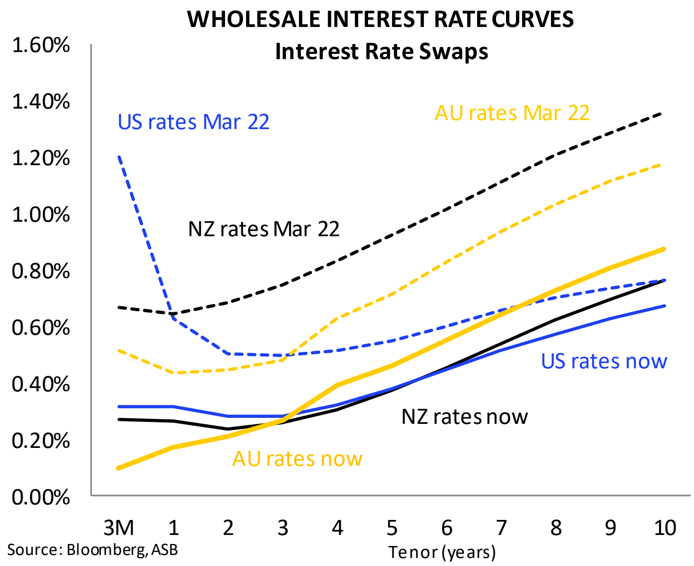
The lack of operational readiness by financial institutions to cope with a lower OCR is cited by the RBNZ as the major reason it has pledged to hold the OCR at 0.25% until early next year. However, by signalling it is contemplating OCR cuts and by prompting financial institutions to prepare for negative rates, the RBNZ has kept the market guessing and has dampened NZ yields.

The RBNZ has also opted to use the broader array of tools available. On March 23, the RBNZ announced they will be following other global central banks down the Quantitative Easing path. To date $15.2bn of NZ Government bonds have been purchased as part of their $60bn Large Scale Asset Programme (see chart). **Our assessment is that to date the RBNZ asset purchases and policy signalling have been highly effective in keeping NZ interest rates low across the yield curve (see second chart).**

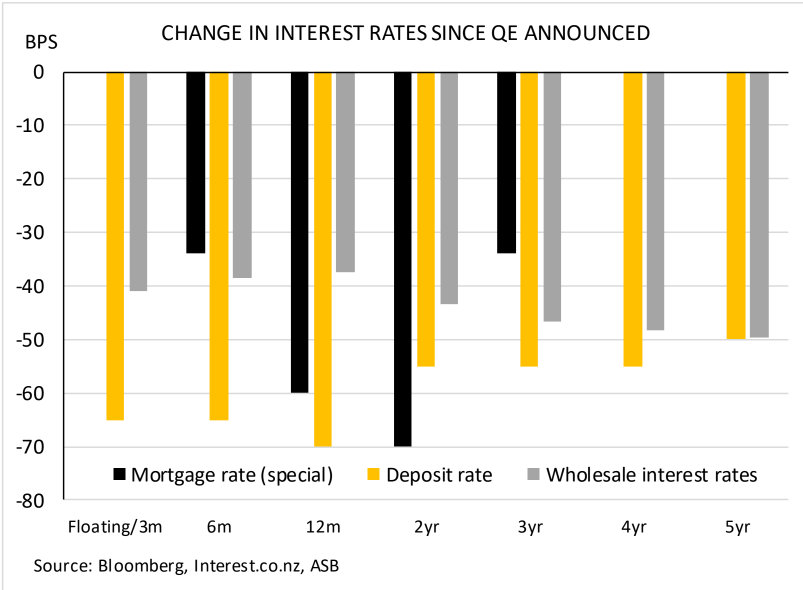


Retail deposit rates are on our watchlist

One of the major objectives of QE is to increase liquidity (cash) in the banking system and provide a source of lower cost funding to facilitate borrowing compared to domestic deposits or even wholesale funding. This has reduced the demand for wholesale funding. Bank bills to OIS spreads have narrowed significantly, with the 90-day bank bill down about 40bps since RBNZ QE was launched. **RBNZ QE, combined with a flood of household and non-household deposits, has helped lower retail deposit rates by more than wholesale interest rates (see chart).** NZ retail deposit and mortgage interest rates have fallen (see bottom chart).



Further falls in retail interest rates are possible. RBNZ QE is still in its infancy, and further increase in liquidity generated by RBNZ QE may act to lower retail deposit interest rates. Mortgage interest could well follow. We acknowledge the prospect of lower retail interest rates won't be greeted with much enthusiasm by savers, but it could prove to be a saving grace for borrowers.



However, much will depend on how flush the system is for funding. The flood of deposit funding could slow to a trickle if households and corporates run down their deposit balances. Borrowing could also pick up. This could act to slow the decline in retail interest rates.

QE in NZ is still in its infancy. The test will be how effective QE will be in capping yields and flattening the yield curve as markets mover past the emergency stage of COVID-19 and focus on the path ahead for the economy and interest rate settings. NZ retail deposit and lending interest rates remain on our watchlist. mark.smith4@asb.co.nz

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6422	0.6514	0.5995	0.6534	FLAT/DOWN	0.6200	0.6580
NZD/AUD	0.9415	0.9347	0.9276	0.9467	FLAT	0.9250	0.9450
NZD/JPY	69.06	71.30	64.27	70.78	DOWN	66.50	71.50
NZD/EUR	0.5716	0.5770	0.5547	0.5796	FLAT	0.5570	0.5800
NZD/GBP	0.5139	0.5125	0.4906	0.5154	FLAT	0.5005	0.5160
TWI	71.5	72.0	68.0	71.89	FLAT/DOWN	N/A	N/A

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

NZD Recap

The NZ dollar registered its first weekly fall in a month last week. After hitting 4½ month highs around 0.6580 early in the week, the NZD/USD finished up around ½ cent lower than where it started the week at 0.6450. Rather than any NZ-specific news, the fall was driven by a sudden reassessment in investors' risk appetite. A sharp correction in global equity markets on Thursday saw risk assets offloaded and global growth sensitive currencies like the AUD and NZD suddenly found themselves out of favour.

It was difficult to find any specific catalyst for the move. It looks to us like an arguably overdue speed bump in the equity market rally which had probably run a little ahead of the recovery in global growth. The global economy is certainly in a recovery phase but the level of activity is still miles below pre-COVID levels and there are many risks to the outlook, most notably the second waves of COVID-19 infections that are cropping up in some parts of the world.

Outlook

Overstretched equity valuations and concerns over longer-term economic scarring from the Covid-19 crisis suggest the correction in risk assets including the NZD/USD could run a little further this week. Certainly, a break through the 0.6580 NZD/USD resistance level tested last week looks unlikely in the new environment of more fragile equity market sentiment and increased volatility.

Still, the fundamental backdrop has not markedly changed. We retain our view that the trend in the NZD/USD has probably shifted to the upside. The global economy is recovering, liquidity remains plentiful and central banks have been successful in containing financial market stress.

NZ-specific fundamentals are also supportive. NZ commodity export prices appear to have turned, supporting our view that NZ's Terms of Trade will hold near record highs. NZ economic data have also impressed recently (admittedly relative to a low base), pointing to a faster rebound from April lulls than most expected.

This week brings Q1 NZ GDP data which shouldn't ruffle currency markets given how dated the data are. We expect a 1.1% qoq contraction. There will probably be more attention on May Aussie labour market figures (we expect the unemployment rate to rise to 7.7% from 6.2%). There's also RBA minutes, and central bank meetings in England and Japan. We expect the BoE to increase its asset purchase target by £100b, taking it to £745b. mike.jones@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	0.63	0.64	0.65	0.66	0.68	0.66
NZD/AUD	0.96	0.97	0.93	0.91	0.90	0.88	0.88	0.86
NZD/JPY	73	65	66	66	66	67	69	67
NZD/EUR	0.60	0.54	0.56	0.55	0.57	0.58	0.60	0.58
NZD/GBP	0.51	0.49	0.53	0.52	0.52	0.52	0.52	0.51
NZD/CNY	4.7	4.3	4.5	4.6	4.6	4.7	4.8	4.6
NZD TWI	73.8	68.8	70.9	71.1	71.7	72.1	73.6	71.4

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	0.25	0.25	0.25	1.50	UNCH	UP
90-day bank bill	0.28	0.26	0.27	1.57	UNCH	UP
2-year swap	0.25	0.26	0.12	1.37	UNCH	UP
5-year swap	0.38	0.45	0.21	1.48	UNCH	UP
10-year swap	0.76	0.91	0.61	1.84	UNCH	UP
10-year govt bond yield	0.81	0.99	0.64	1.65	UNCH	UP
Curve Slope (2s10s swaps)	0.52	0.65	0.49	0.47	UNCH	DOWN

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

Market Recap

Markets adopted a more guarded tone, with local yields lower and the curve flatter. COVID-19 continues to cast a shadow on the global outlook with equity markets and yields down on the realisation from markets that a V-shaped economic recovery may not happen. The easing of lockdown restrictions saw new daily cases of COVID-19 hit a record global high last week, with fears of a second wave of infections potentially derailing the pending economic recovery.

NZ and global yields eased after the Federal Reserve presented a gloomy outlook (6.5% contraction in US GDP, a 9.3% unemployment rate) and pledged not to hike rates until at least 2023, maintained its current USD20bn weekly pace of Quantitative Easing and pledged to use its full range of tools to support the economy. The Fed "dot plots" showed Fed officials expected to maintain the 0.0% to 0.25% Fed funds rate until at least 2023. Economic forecasts from the OECD now have a 6%-7.6% fall in global GDP, the largest drop since the Great Depression. The fall in local yields was despite the generally improving tone of NZ data, with a modest improvement in (still-weak) business sentiment from the ANZ Business Outlook and a strong pick-up in May card spending, albeit from very low levels.

Near-term interest rate outlook

Current market pricing – OCR endpoint of 0.05% - looks to be a nod to the risk profile. The hurdle to an OCR cut is high in our view given NZ looks to have been able to contain COVID-19 and with the RBNZ still adding policy stimulus via Quantitative Easing.

Local and global yields are expected to take their cues from global equities. If the recent equity market sell-off continues, we expect yields to continue to decline and the curve to flatten. If markets rebound, last week's decline in yields should prove short-lived. We have maintained our bias for NZ yields to move higher relative to global counterparts given NZ's success in containing COVID-19 and reopening more of its economy.

RBNZ QE has seen swap spreads narrow sharply to OIS (overnight index swaps) and the financial system is flush with liquidity. We expect spreads to remain tight, providing markets are confident this liquidity tap will not be turned off. The RBNZ is set to purchase another $1.075bn of NZ Government bonds and $50m of LGFA bonds this week, which should also help dampen NZ yields and keep the curve flat. The RBA Minutes will be looked for clues on the Australian economic outlook and whether the RBA is confident that the current hiatus from QE (the last on which was May 6) will persist. The Bank of England is expected to increase its stock of asset purchases by £100bn to £745bn.

NZ Q1 GDP headlines this week. A considerable range of uncertainty lies around the outlook, but our expectations of a 1.1% fall and the market consensus (-1.0% qoq) are well above the -2.4% qoq RBNZ pick. The focus for yields, however, is Q2 and beyond. Australian labour market data for May will be closely watched.

Medium-term outlook

We don't expect the OCR to move above its 0.25% operational lower bound until 2024 at the earliest. If more policy stimulus was needed the RBNZ will likely increase its $60bn asset purchase programme before cutting the OCR. Subpar global activity and RBNZ asset purchases should help to cap longer-term NZ interest rates despite a mountain of global public debt issuance. mark.smith4@asb.co.nz

Domestic events

Data	Date	Time (NZT)	Market	ASB
GlobalDairyTrade auction, whole milk powder, % change	17/03	overnight	-	-
Current Account annual balance, Q1, % of GDP	17/06	10:45am	-	-2.6
GDP, Q1, %qoq	18/06	10:45am	-	-1.1

We expect NZ's current account deficit to narrow to 2.6% of GDP over Q1. NZ should record a seasonally-adjusted increase in its goods and services balance over Q1, as imports of goods fell faster than exports of goods over the quarter as COVID-19 started to disrupt trade flows. Meanwhile, the income deficit is likely to narrow on reduced profitability of NZ firms. NZ's current account deficit is likely to narrow over the coming year. The traded goods surplus should expand as demand for NZ food exports hold up better over the coming year than demand for NZ imports. The investment income deficit will shrink on reduced outflows of domestic profits and lower debt-servicing costs. These shifts should more than offset the sharp drop in tourism-related earnings.

We forecast that Q1 GDP contracted 1.1% qoq, however, there is a higher degree of uncertainty around this estimated due to the impact of COVID-19. Nonetheless, StatsNZ Q1 GDP figures are likely to show a milder contraction in GDP than the 2.4% qoq fall the RBNZ forecast at the May Monetary Policy Statement. Q1 caught the first 6 days of the Level 4 lockdown, with the bulk of the lockdown impacts expected to cause a considerable contraction in Q2 GDP.

Major International Events for the week ahead*

Data	Date	Time (NZT)	ASB
China Retail Sales, May, %yoy	15/06	2:00 pm	-2.0
RBA Board Meeting Minutes, May	16/06	1:30 pm	-
Bank of Japan Interest Rate Announcement, %	16/06	-	-0.1
US Industrial Production, April, %yoy	17/06	1:15 am	4.0
UK CPI, May, %yoy	17/06	6:00 pm	-
Australia Unemployment Rate, May, %	18/06	1:30 pm	7.7
Bank of England Interest Rate Announcement, %	18/06	11:00 pm	0.1

Originally published by CBA Global Markets Research on Friday 12th June at 2:40 pm

We expect **China's** domestic recovery to continue. A notable lift in May Service PMIs implies consumption growth might accelerate. We anticipate **retail sales** might have contracted by only 2%yoy in May. We predict the contraction in fixed assets investment might have eased to 5%yoy from 10.3%yoy in April, supported by public infrastructure investment. We expect industrial production to grow by 5%yoy.

The **Reserve Bank of Australia (RBA)** was widely expected to leave the official cash rate on hold at its May meeting at 0.25%. The three-year bond yield target was also left on hold at 0.25%. The RBA Governor noted in the statement that "it is possible that the depth of the downturn will be less than expected". The focus in the **Minutes** will be what has prompted this change of thinking and any hints of what a revised outlook for the Australian economy could look like. Any discussion around the outlook for bond purchases will be closely scrutinised given the RBA has not purchased any bonds since 6 May and yields on both three-year Australian Government Bond Yields and ten-year Australian Government Bond Yields have drifted higher.

We expect the Bank of Japan (BoJ) will maintain its status quo as the Abe administration lifted its state of emergency in late May. There is a small risk that the BOJ might expand ¥30tn of new SME lending, introduced at its unscheduled May 22 meeting. However, the potential expansion will not alter the outlook for Japan's economy.

The **Australian labour market** is still expected to deteriorate from here. In April 594k jobs were lost, more would have been lost without the JobKeeper package. The unemployment rate rose from 5.2% to 6.2%, constrained by the collapse in the participation rate from 66.0% to 63.5%. Since April some restrictions have been eased and there have been mixed labour market reports globally, including last week's US Payrolls report which saw jobs added back into the US economy. In May, we expect employment to fall a further 100k, the unemployment rate to rise to 7.7% and the participation rate to lift to 64.0%, as people start to look for work again as the worst of the pandemic is past.

US industrial production should start to recover because employment in manufacturing is also recovering. Nevertheless, it will take months for industrial production to return to 2019 levels.

Headline **UK CPI inflation** eased in April to 0.8%yoy (lowest rate since August 2016) weighed down by lower housing services and transport prices. The BoE projects headline CPI inflation to average about 0.5% in Q2 2020 and to ease towards 0% by the end of 2020.

We expect the BoE to leave the Bank rate at 0.10% but increase the target for the stock of asset purchases by an additional £100 billion to £745 billion. Firstly, the prospects for the UK economy are tilted more on the side of a slower recovery, stemming largely from high uncertainty. Secondly, two out of nine committee members (Saunders & Haskel) already voted to increase the target for the stock of asset purchases at the May meeting. Thirdly, MPC member Ramsden noted recently that it's possible the BoE will do more quantitative easing (QE) at the June meeting. Finally, the BoE's stock of asset purchases will reach its current £645 billion target by the beginning of July, at the current pace of purchases. The BoE's cumulative purchases of gilts and corporate bonds currently totals about £585bn.

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	-1.1	-16.9	13.3	0.5			
GDP real - A%	1.8	0.2	-16.7	-6.3	-6.4	-5.6	2.7	4.7
GDP real - AA%	2.3	1.6	-3.1	-5.3	-7.3	-8.8	4.4	4.5
CPI - Q%	0.5	0.8	-0.4	0.2	-0.1			
CPI - A%	1.9	2.5	1.6	1.1	0.5	0.1	1.4	1.7
HLFS employment growth - Q%	0.1	0.7	-2.7	-2.0	-1.5			
HLFS employment growth - A%	0.8	1.6	-1.8	-3.9	-5.4	-5.4	1.7	2.7
Unemployment rate - %sa	4.0	4.2	6.3	7.6	8.4	7.8	7.9	7.0
Annual current account balance as % of GDP	-3.0	-2.6	-2.3	-1.7	-1.5	-1.8	-0.7	-0.3

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	0.30	0.30	0.30	0.30	0.30	0.30
NZ 2-year swap rate	1.26	0.53	0.25	0.30	0.35	0.40	0.40	0.60
NZ 5-year swap rate	1.45	0.63	0.30	0.40	0.50	0.55	0.65	0.85
NZ 10-year swap rate	1.78	0.93	0.65	0.75	0.85	0.90	0.95	1.05
NZ 10-year Bond	1.65	1.03	0.65	0.75	0.85	0.95	1.05	1.15

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	0.63	0.64	0.65	0.66	0.68	0.66
NZD/AUD	0.96	0.97	0.93	0.91	0.90	0.88	0.88	0.86
NZD/JPY	73	65	66	66	66	67	69	67
NZD/EUR	0.60	0.54	0.56	0.55	0.57	0.58	0.60	0.58
NZD/GBP	0.51	0.49	0.53	0.52	0.52	0.52	0.52	0.51
NZD/CNY	4.7	4.3	4.5	4.6	4.6	4.7	4.8	4.6
NZD TWI	73.8	68.8	70.9	71.1	71.7	72.1	73.6	71.4

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