Economic Weekly

16 September 2019

Serving up a modest portion of growth

It's a key week for NZ data this week, with the US Federal Reserve also a heavyweight event. Thursday's Q2 GDP is shaping up to be important. Our newly-launched Recession Probability Model flags that underlying growth is losing pace, and the probability of a recession has lifted (see Key Insights). Our formal GDP forecast is 0.5% qoq, for muted 2.1% annual growth, with services doing all the heavy lifting. The RBNZ is expecting a similar figure for Q2, and its 50bp cut in August was in effect pre-empting slow near-term growth. But if indicators point to future growth not recovering in line with its expectations then the door for further aggressive action will open. Also up this week is another GDT dairy auction (Tuesday night) and the Q2 current account on Wednesday.

The US Federal Reserve steps up to the plate our Thursday morning. We expect a further 25bp rate cut given the growing economic risks from the US-China trade war. But a cut this week is by no means guaranteed, given that core inflation has lifted. The Bank of England and the Bank of Japan are also meeting this week, but both are expected to remain on hold at this point.

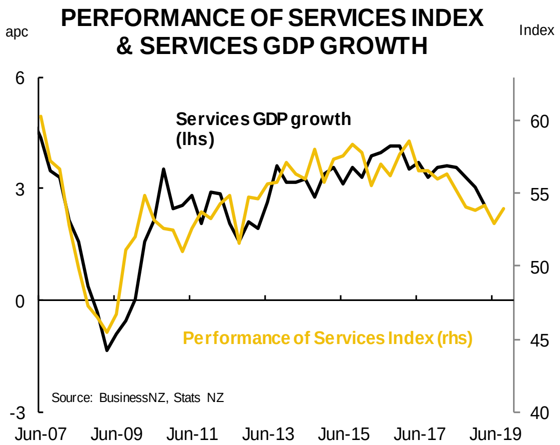
Key events and views

Key Insights	The ASB Recession Probability Model (RPM) predicts a 30% of recession in NZ for mid-2019.
Foreign exchange	NZD underperforms on NZD/AUD weakness. Consolidation likely ahead of Fed meeting.
Interest rates	Higher yields and steeper curves in NZ and abroad. NZ yields are biased lower.
Domestic events	GDT dairy auction, Q2 current account, Q2 GDP.
International events	US Federal Reserve, Bank of England, Bank of Japan meetings. AU employment, Chinese data.

Chart of the Week: Growth relying on good service?

Growth in the services sector was likely robust over Q2, as indicated by strong labour demand and pockets of strength in in the Selected Services Survey. We expect strong growth in Arts and Recreation services along with reasonably firm growth in business support services (professional, scientific, technical, admin and support).

But softness in other key sectors is likely to rein growth in to 0.5%. Construction has been soft, though after a surge in growth. Retail spending volumes grew only 0.2% over the quarter, and meat processing activity fell.



Key insights this week: Recession?

- ASB estimates a 30% probability that the NZ economy was in recession from Q2 2019.
- Top-down indicators point to an underlying quarterly growth rate in Q2 of around 0.3-0.4%, with risks skewed to the downside (although our formal forecast is for 0.5% GDP growth in Q2).
- Consumer confidence is the key variable to watch – if the labour market weakens and consumer confidence falls, the odds of a recession will likely spike higher.

ASB RECESSION PROBABILITY ESTIMATES	
	Jun-19
Model A	37%
Model B	37%
Model C	15%
AVERAGE	30%

Introducing the ASB Recession Probability Model (RPM)

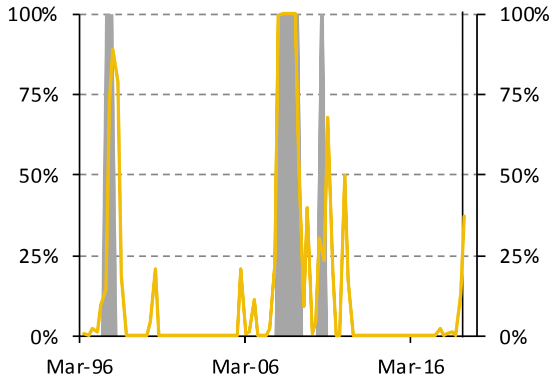
With NZ and global economic growth slowing over the past year, many have started to ask - how likely is it we are in, or heading into, a recession? In response, we set out to **build a model using key GDP growth indicators to estimate the probability that we are currently in, or about to head into, a recession.** NZ GDP data are not published in a particularly timely fashion, with the first estimate released nearly a full quarter after the fact. In addition, these early estimates are subject to (potentially sizable) revisions, particularly so once the annual survey data are incorporated at the end of the year. In the case of the 2010 recession, we did not know at the time the NZ economy was in a 'technical' recession (i.e. 2 negative quarters) until a few years later!

The aim of our model is to provide some additional clarity on the current state of the NZ economy by flagging the economy's vulnerable moments. **The average of our top 3 models suggests a 30% probability that the NZ economy entered recession during the June quarter**. This implies that there is some cause for concern about the growth outlook and, in our view, justifies the Reserve Bank of New Zealand's (RBNZ) bold action of slashing the Official Cash Rate (OCR) 50 basis points in August. In light of this work, we have also lowered our H2 2019 GDP growth forecasts, and now expect calendar year annual growth to slow to just 2.1%.

However, all is not lost! At 30%, it's still more likely than not that NZ economic growth remains positive. Historically, a lift in the recession probability of this magnitude tends to be more consistent with below-potential GDP growth rather than recession. **Our key top-down indicators point to an underlying rate of quarterly GDP growth of 0.3-0.4% in Q2 2019, while our formal forecast is for quarterly growth of 0.5%.**

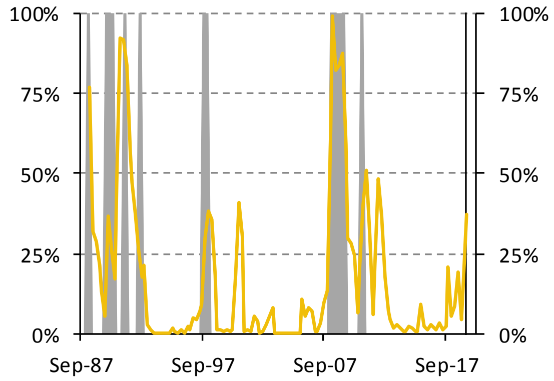
Meanwhile, the front-line policy response to the recent growth slowdown has been relatively quick, with the Reserve Bank of New Zealand and other central banks moving swiftly to cut interest rates. Hopefully, this prompts a pick-up in economic growth, led by the interest-rate sensitive parts of the economy, and avoids a recession taking hold in NZ. However, if business confidence and other early growth indicators do not respond to the 75 basis points of OCR cuts already delivered,

ASB RECESSION PROBABILITY MODEL A



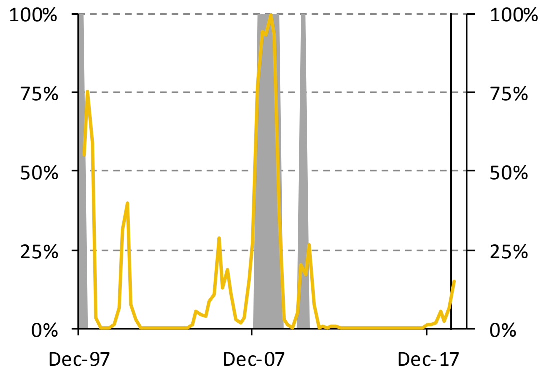
Source: ASB estimates

ASB RECESSION PROBABILITY MODEL B



Source: ASB estimates

ASB RECESSION PROBABILITY MODEL C



Source: ASB estimates

our recession model results highlight the downside risk to our economic growth and OCR outlook going forward.

Key indicators to watch

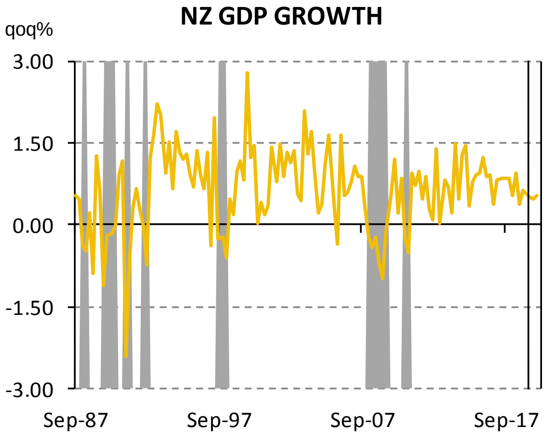
We estimated a range of multivariate probit models and narrowed our results down to our top 3 performing models, with the **average forecast suggesting a 30% probability the economy was in recession during Q2 2019**. **We also looked at how well individual GDP indicators performed in predicting a recession on their own.** A summary of each indicator's prediction of recession is included in the table (below), with the strongest performing variables highlighted in bold.

RECESSION RISK BY GDP INDICATOR		
GREEN LIGHT *All is hunky dory*	ORANGE LIGHT *Warning, check engine*	RED LIGHT *Call in the cavalry*
WMM Consumer Confidence	**BusinessNZ PMI**	**QSBO Own Activity**
Architects Housing Activity	**Yield Curve Slope**	**Short-term Visitor Arrivals**
BusinessNZ PSI	Architects Commercial Activity	
GDP growth factor model	Commodity Prices	
Net migration		
Consents Residential		
Consents Non Residential		

*Strongest recession indicators in bold

What is a recession?

Not all recessions are created equal. A technical recession is defined as two consecutive quarters of contraction in GDP. Another (stricter) definition of recession is a fall in annual GDP. **NZ's experiences with recession have – fortunately – moved from being commonplace to relatively infrequent.** In the GDP data available from late 1987 to 2019, NZ experienced 7 recessions in over 30 years. Four of those alone happened over 1988 to 1992, a period impacted by deregulation, share market and commercial property crashes, the Mother of All Budgets, and spiking oil prices. After this period of upheaval and the bedding in of inflation targeting, **NZ has had 3 recessions over the past 25 years (i.e. 1997/8, 2008/9 and 2010), which on average is a recession every 8 years – or at any given time a 12% chance of recession.**



Source: ASB estimates

NZ experienced technical recessions in 1992 and again in late 2010 (following monetary tightening, weak business confidence and the first Canterbury earthquake). In both periods, the recession was relatively short lived and the size of the recession relatively small. In contrast, NZ spent 18 months in recession during the 2008 Global Financial Crisis which had a much larger economic impact. And the 1991 recession is the deepest over the period analysed.

We find that the indicators and models are less confident of predicting when a technical recession strikes, but assign a stronger probability to the larger recessions, such as the Global Financial Crisis and the 1991 recession. We also found that the top 3 models did generally well at highlighting a small risk of recession risk during historical periods when the quarterly growth slowed and underperformed potential growth estimates.

We also looked at calculating the probability of a recession occurring out into the future. However, the indicators selected performed best when predicting a recession in the current quarter and provide little forward guidance at the year-ahead horizon. There is scope for future work in searching for an indicator which can robustly provide some earlier indication of a recession (say 1-year ahead).

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6371	0.6424	0.6442	0.6585	FLAT	0.6315	0.6450	DOWN
NZD/AUD	0.9274	0.9366	0.9479	0.9150	FLAT/DOWN	0.9260	0.9340	FLAT
NZD/JPY	68.52	68.67	68.36	73.64	FLAT	67.00	69.65	UP
NZD/EUR	0.5751	0.5825	0.5802	0.5629	FLAT	0.5690	0.5840	FLAT/UP
NZD/GBP	0.5102	0.5233	0.5327	0.5019	FLAT/DOWN	0.5055	0.5200	UP
TWI	70.8	71.4	71.6	71.44	FLAT/DOWN	N/A	N/A	FLAT

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

NZD Recap

Incrementally more positive news on US-China trade relations, constructive economic data (US CPI in particular) and a less-dovish ECB all helped drive a brightening in financial market sentiment last week. A sharp rebound in global bond yields was the key outcome. Despite the more optimistic backdrop, currency markets, particularly the NZD/USD, didn't experience the same updraft.

NZD/USD rallies above 0.6420 were met with stiff resistance, and the currency ultimately ended the week lower around 0.6380. Part of the reason for the NZD's underperformance looks to be related to NZD/AUD selling. The cross slumped to 18-month lows around 0.9280 last week. Rather than any specific catalyst, there looks to be an element of 'catch-up' here to the recent deterioration in the NZ-AU commodity export price ratio. NZ-AU 2-year swap differentials also moved back to flat last week, having been in positive territory since March.

Near-term outlook

All of this week's key market-moving events have been crammed into Thursday, and we suspect it's going to be relatively quiet ahead of that. NZD/USD will likely consolidate inside the familiar 0.6300-0.6415 range (albeit with a modest downside bias).

The range of possibilities surrounding Thursday's NZ GDP/US Federal Open Market Committee (FOMC) meeting double-act is large, but for choice we're siding with the risk of a stronger USD/weaker NZD/USD coming out of the Fed meeting if the FOMC fail to ratify market pricing for an additional US rate cut by year end (another 25bps cut is widely expected to be delivered at this meeting). We retain a downside bias for NZD/AUD, reflecting recent falls in both interest rate and commodity price differentials.

Medium-term outlook

Our updated forecasts have the NZD/USD dribbling lower for the best part of the next nine months, to a low of 0.6200 in March 2020. We'd characterise this profile as a sideways NZD/USD trend inside a low 0.6200-0.6400 range. The recent downward revision is consistent with the trade war, and attendant negative global growth impacts, dragging on for longer than we'd previously anticipated. The domestic slowdown is also occurring at a slightly faster rate than we'd expected. Our constructive view on NZ's terms of trade, and the front-loaded nature of RBNZ policy easing, are key reasons why we believe there is only limited NZD downside from here.

ASB foreign exchange forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.68	0.67	0.64	0.63	0.62	0.67	0.68	0.68
NZD/AUD	0.96	0.96	0.94	0.94	0.94	0.94	0.94	0.94
NZD/JPY	75	72	68	66	64	70	71	71
NZD/EUR	0.60	0.59	0.58	0.57	0.57	0.59	0.60	0.60
NZD/GBP	0.52	0.53	0.53	0.53	0.53	0.54	0.52	0.52
NZD TWI	73.9	73.2	70.5	69.3	68.3	71.7	72.1	72.1

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	1.00	1.00	1.75	UNCH	UP
90-day bank bill	1.15	1.17	1.21	1.88	UNCH	UP
2-year swap	1.02	0.96	0.93	1.98	UNCH	UP
5-year swap	1.09	0.99	0.93	2.31	UNCH	UP
10-year swap	1.42	1.27	1.19	2.82	UNCH	UP
10-year govt bond yield	1.33	1.13	1.01	2.56	UNCH	UP
Curve Slope (2s10s swaps)	0.40	0.31	0.26	0.84	UNCH	UNCH/UP

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

Market Recap

Local and global yields have continued to firm with yield curves steepening. Moves in long-term yields have been sizeable since early September, with US 10-year Treasury yields up close to 45bps, European yields up 20-35bps, a 20bp increase in Australian bond yields and an approximate 30bp climb for NZ counterparts. **The dilution of trade and geopolitical risks has seen markets trade with a spring in their step and pushed yields higher.** China provided an olive branch on trade by announcing that it will be waiving import tariffs on 16 US goods that had 25% tariffs imposed last year, with the US reciprocating by pushing out the increase in tariffs USD 250bn of Chinese goods from 1 October to 15 October. With the UK Parliament adjourned, Brexit concerns were less prominent. Yields briefly eased after the ECB cut the deposit rate by 10bps to -0.50% and launched a fresh round of €20bn in asset purchase from November and modified its forward guidance by reiterating the need for a highly accommodative stance of monetary policy for a prolonged period of time. Drone Strikes crippled oil production in Saudi Arabia and look set to boost oil prices.

Near-term NZD interest rate outlook

The recent journey to higher yields and steeper curves may have further to run if the trade ceasefire continues, higher oil prices stoke inflation fears and markets remain confident that downside risks to the outlook do not flare up. A 25bp cut by the US Federal Open Market Committee (FOMC) on Thursday is close to being fully priced in, with a total of 70bps of Fed cuts priced in by mid- 2020. We expect a 25bp Fed cut on Thursday, but note interest rate markets could be braced for disappointment (i.e. yields higher) if the Fed fails to deliver on dovish market expectations. The Bank of Japan has not eased policy of late and could potentially announce new stimulus measures to take pressure off the yen. With the fluid Brexit situation, the Bank of England should hold rates at 0.75%. We are not expecting the RBA Minutes to signal a departure from the RBA's easing bias, with upcoming labour market data pivotal. **We remain wary on the global outlook and have maintained our mild downward (and curve flattening) bias for local yields.** An outcome for NZ GDP either side of the 0.4% qoq market median will have a bearing on the 70% priced in for a 25bp cut priced in by November. Our +0.5% qoq pick suggests some modest upside to NZ yields. Chinese industrial production/retail sales and European inflation data will likely impact yields at the margin.

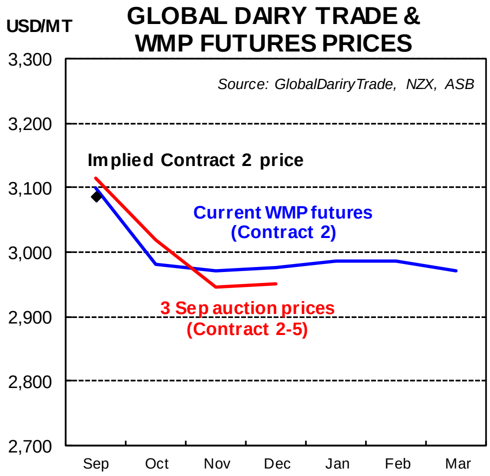
Medium-term outlook

Our forecast is for the curve to initially steepen and then to flatten as policy easing this year precedes mild policy tightening. There is still the risk that longer-term yields could fall if downside global risks crystallise. We expect a 25bp OCR cut in November and a 0.75% OCR trough this cycle, with downside risks. We also expect 50bp of cuts by the RBA (Nov 2019, Feb 2020), a further 75bp of cuts by the Fed (Sep 2019, Dec 2019, Mar 2020), and policy easing in Canada, the Eurozone and China. Inflation looks set to remain low and interest rate normalisation from global central banks a long way off, capping long-term interest rates at historically-low levels.

ASB interest rate forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>					
NZ OCR	1.75	1.50	1.00	0.75	0.75	0.75	1.00	1.50
NZ 90-day bank bill	1.9	1.7	1.2	1.0	1.0	1.0	1.2	1.7
NZ 2-year swap rate	1.6	1.4	1.0	0.9	0.9	0.9	1.2	1.7
NZ 5-year swap rate	1.8	1.4	1.0	1.0	1.0	1.0	1.4	1.9
NZ 10-year swap rate	2.2	1.8	1.2	1.1	1.1	1.2	1.6	2.0
NZ 10-year Bond	1.8	1.6	1.0	0.9	0.9	1.0	1.4	1.8

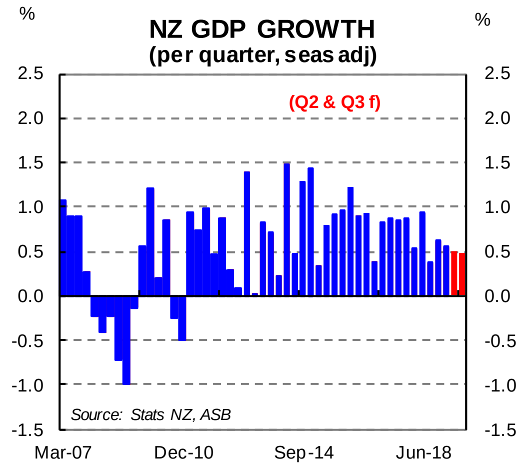
Domestic events

Data	Date	Time (NZT)	Market	ASB
GlobalDairyTrade auction, whole milk powder, % chg	17/09	overnight	-	+1.0
Current Account balance, Q2, % of GDP	18/09	10:45 am	-3.4	-3.4
GDP, Q2, %qoq	19/09	10:45 am	0.4	0.5



We expect whole milk powder prices to rise modestly at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago, whole milk powder (WMP) prices posted a 0.8% fall. We anticipate that the increase in the CNY against the USD since the last auction will support prices at this auction, albeit modestly. Note that Chinese buyers are the largest group participating on the platform and that auction prices are set in USD. Notably, fallout from the US-China trade war escalation has been relatively modest in global dairy markets so far.

We expect NZ's current account deficit to narrow to 3.4% of GDP over Q2. The Q1 deficit came in at 3.6% of GDP, narrowing from 3.8% in Q4. Over the first half of 2019, NZ posted record dairy export values, which will boost the current account balance. Over the remainder of 2019 and into 2020, we expect the deficit as a % of GDP to largely track sideways.



We expect Q2 GDP lifted by 0.5% qoq (production basis) which should see annual growth slow to 2.1% from 2.5%. NZ economic growth has remained sub-trend over H1 2019 and ongoing weakness in business confidence suggests growth is likely to remain weak over H2 2019 as well. The Reserve Bank of New Zealand (RBNZ) also expects quarterly growth of 0.5%, with annual growth slowing to 2%. The August OCR decision had a fair degree of 'bad' economic news already baked into the underlying economic forecasts, so it would take a material surprise on GDP to prompt the RBNZ to cut the Official Cash Rate (OCR) again at the September meeting. But we continue to expect another 25bp OCR cut at the November Monetary Policy Statement.

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
China Retail Sales, August, %yoy	16/09	2:00 pm	7.9	8.0
China Industrial Production, August, %yoy	16/09	2:00 pm	5.8	5.4
RBA Meeting Minutes, September	17/09	1:30 pm	-	-
UK CPI, July, %yoy	18/09	8:30 pm	1.9	-
US Federal Reserve Interest Rate Announcement, %	19/09	6:00 am	1.75-2.00	1.75-2.00
Australia Labour Market, Employment, August, 000s	19/09	1:30 pm	15	20
Bank of Japan Interest Rate Announcement, %	19/09	-	-	-0.1
UK Retail Sales Volumes, August, %yoy	19/09	8:30 pm	2.7	-
Bank of England Interest Rate Announcement, %	19/09	11:00 pm	0.75	0.75
Japan CPI, August, %yoy	20/09	11:30 am	0.3	0.7

**Originally published by CBA Global Markets Research on Friday 13th August at 2.05pm*

China's retail sales growth might have rebounded to 8%yoy in August mainly because of an expected normalisation in car sales. Industrial production growth likely rebounded to 5.4%yoy following July's sharp fall.

There is unlikely to be much new information in the **Reserve Bank of Australia's September Board Minutes**. In its Board statement, the bank noted that "time will tell" whether or not it needs to cut the cash rate again to reach full employment and inflation in line with the target. We continue to expect the RBA to cut the cash rate in November 2019 and again in February 2020.

Headline and core July CPI inflation in the UK quickened to 2.1%yoy and 1.9%yoy, respectively, because of higher household services costs. The Bank of England (BoE) projects headline CPI inflation to slow to 1.7% in Q3, reflecting lower energy prices. The central bank also expects core inflation (excluding the effects of energy, food, alcohol and tobacco) to be closer to 1.8% over much of H2 2019.

The US Federal Reserve is widely expected to cut the Funds rate by 25 basis points because of growing downside risks to the US economy such as uncertainty about future trade policy. However, in our view, the recent pick-up in core inflation suggests a rate cut this month is not guaranteed.

There was a strong 41.1k lift in the number of **Australian jobs** last month with the participation rate rising to a new record high of 66.1%. Leading indicators suggest a reasonable level of jobs growth should continue. We expect a 20k lift in the number of jobs and the unemployment rate should remain steady at 5.2%.

Inflation remains well below the Bank of Japan's 2%yoy inflation target and downside risks to Japan's exports are growing. A scheduled increase in the value-added tax next month raises the risk of recession. While **we expect the Bank of Japan to leave monetary policy unchanged**, the risks are growing for further policy easing.

The British Retail Consortium (BRC) and CBI surveys combined with weak consumer confidence and housing market conditions point to a decline in core **retail sales volumes in the UK** in August. Still, higher real wage growth and favourable employment conditions will continue to underpin consumer spending over the medium term.

The BoE is widely expected to leave the bank rate at 0.75% and maintain the stock of its asset purchases at £445bn. The risk is that the central bank removes its "gradual" and "limited" tightening bias if it no longer assumes a smooth Brexit and some recovery in global growth.

Already-released **inflation measures for Tokyo suggest Japan's national inflation** picked up slightly to 0.7%yoy, well below the Bank of Japan's 2%yoy inflation target.

Key Forecasts

ASB NZ economic forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
	<< actual	forecast >>						
GDP real - Q%	0.6	0.5	0.5					
GDP real - A%	2.5	2.1	2.2	2.1	2.1	2.4	2.4	2.4
GDP real - AA%	2.7	2.5	2.3	2.2	2.1	2.4	2.4	2.4
CPI - Q%	0.1	0.6	0.5	0.2				
CPI - A%	1.5	1.7	1.3	1.4	1.8	1.8	2.0	1.9
HLFS employment growth - Q%	-0.1	0.8	0.2	0.3				
HLFS employment growth - A%	1.5	1.7	0.9	1.3	1.7	1.5	1.4	1.2
Unemployment rate - %sa	4.2	3.9	4.1	4.2	4.3	4.3	4.0	4.1
Annual current account balance as % of GDP	-3.6	-3.4	-3.4	-3.4	-3.3	-3.2	-3.3	-3.4

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	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>					
NZ OCR	1.75	1.50	1.00	0.75	0.75	0.75	1.00	1.50
NZ 90-day bank bill	1.9	1.7	1.2	1.0	1.0	1.0	1.2	1.7
NZ 2-year swap rate	1.6	1.4	1.0	0.9	0.9	0.9	1.2	1.7
NZ 5-year swap rate	1.8	1.4	1.0	1.0	1.0	1.0	1.4	1.9
NZ 10-year swap rate	2.2	1.8	1.2	1.1	1.1	1.2	1.6	2.0
NZ 10-year Bond	1.8	1.6	1.0	0.9	0.9	1.0	1.4	1.8

ASB foreign exchange forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.68	0.67	0.64	0.63	0.62	0.67	0.68	0.68
NZD/AUD	0.96	0.96	0.94	0.94	0.94	0.94	0.94	0.94
NZD/JPY	75	72	68	66	64	70	71	71
NZD/EUR	0.60	0.59	0.58	0.57	0.57	0.59	0.60	0.60
NZD/GBP	0.52	0.53	0.53	0.53	0.53	0.54	0.52	0.52
NZD TWI	73.9	73.2	70.5	69.3	68.3	71.7	72.1	72.1

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