ASB

Economic Weekly

19 August 2019

Red light or red herring?

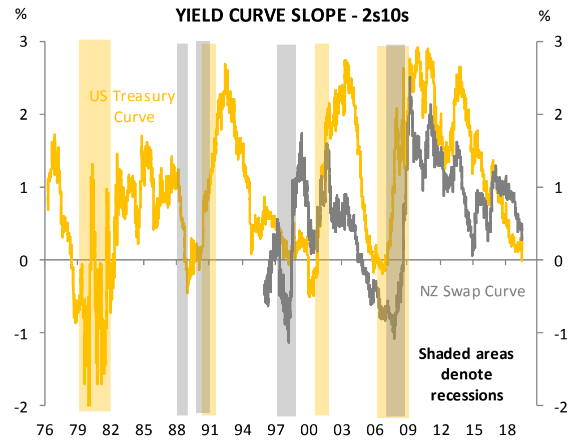
It's getting a bit panicky. Investors are now starting to price a real risk of global recession. Economic data hasn't been too bad, although last week's Chinese industrial production falling to the lowest annual growth rate since 2002 raised a few eyebrows. It's more about the politics. The US-China trade war could get worse before it gets better. The chances of a hard-Brexit are growing by the day. Add into the mix tensions in Hong Kong and the Argentine crisis and it's not hard to see why markets are nervous. The MSCI World Equity Index is now down 6% from its recent highs, risk aversion indicators are rising, safe-havens are back in demand, and suddenly everyone's talking about inverted yield curves (see below). Economic data will remain in the backseat. It's all about stocks and tweets at the moment.

Key events and views

Foreign exchange	NZD underperforms on global growth concerns as US yield curve inverts.
Interest rates	Record lows for NZ yields last week. We retain our downward and flattening bias.
Domestic events	Quarterly retail sales, credit card spending, GDT auction, and Performance of Services index.
International events	RBA minutes, Eurozone PMIs, Fed minutes.

Chart of the Week: Curves are back in

All eyes this past week have been on global yield curves. On Wednesday, the US 2s10s yield curve inverted, meaning 10-year Treasury bond yields fell below 2-year yields. Equities markets lost it, falling around 3% in short order. Why? The last 9 times that the US yield curve has inverted, the US economy has gone into recession within fourteen months. A few points on this. First, the US curve needs to *remain* inverted to provide a strong recession signal. As far as we can tell the US 2s10s curve spent around five hours below zero last week.



Source: ASB, Bloomberg

Second, the NZ (swap) curve has a pretty good track record of picking recessions too. We only have data as far back as 1996 but 2s10s inversion preceeded both the 1998 and 2007 NZ recessions, albeit with a lag. The NZ 2s10s bond curve – for which we have a longer data history – inverted prior to the 1989/91 NZ recessions.

Third, the NZ curve is still positively sloped (currently 26bps for 2s10s swaps), and we're not picking an inversion either. What all this does highlight is that curves are incredibly flat everywhere and there are opportunities for corporates needing to hedge long-dated interest-rate exposures. For example, to pay a 3-year swap in 3 year's time, a corporate would be looking at a rate starting with a "1". That's never happened before 2019.

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Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6427	0.6469	0.6776	0.6589	FLAT/DOWN	0.6320	0.6600	UP
NZD/AUD	0.9475	0.9527	0.9588	0.9070	FLAT/DOWN	0.9350	0.9650	UP
NZD/JPY	68.38	68.18	72.90	73.03	DOWN	67.00	69.80	UP
NZD/EUR	0.5792	0.5771	0.6017	0.5790	FLAT	0.5180	0.5390	UP
NZD/GBP	0.5290	0.5373	0.5403	0.5178	FLAT	0.5180	0.5390	UP
TWI	71.7	71.9	73.9	71.69	FLAT/DOWN	N/A	N/A	UP

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

NZD Recap

The NZD underperformed most of the major crosses over the past week (with the exception of the EUR). Market sentiment had started the week on a more upbeat note after the US announced it will delay some of the recently-announced tariffs on Chinese goods from 1 September to 15 December. However, **market sentiment turned pessimistic Thursday morning after a fall in 10-year Government bond yields triggered an inversion in the US yield curve**, sparking US recession fears. Growth fears also fuelled speculation that the Federal Reserve will respond with a 50 basis point cut at its 18 September meeting. Along with weak sentiment, **the NZD was weighed by domestic growth concerns as the BusinessNZ Manufacturing PMI dropped below 50 in July,** consistent with a contraction in manufacturing activity. While the AUD/USD also remains under pressure from global growth concerns, **the AUD outperformed the NZD over the past week in part due to above-expectations Australian labour market data.** Meanwhile, the **GBP was supported** by stronger-than-expected economic data and by reports that UK lawmakers were drawing up plans to force Prime Minister Boris Johnson to seek a Brexit extension.

Near-term outlook

NZD/USD will remain heavy this week. **Subdued New Zealand economic data** could see NZD/USD depreciate toward its 7 August low of 0.6378. Global Dairy Prices are expected to fall around 1% this week and we expect Q2 retail sales to lift just 0.2% qoq (released Thursday). The AUD/USD will also remain under pressure due to slowing global growth. We now expect the Reserve Bank of Australia (RBA) to cut the cash rate at least twice more, to 0.5%. NZD/AUD will likely find near-term resistance around the 200-day moving average of 0.9511. **The Federal Reserve's meeting minutes for the 1 August meeting due this week may provide some insight into the likely size of the Fed's "mid-cycle adjustment" interest rate cuts**. Interest rate markets are currently pricing a 30% chance of a 50 basis point cut at the 18 September Fed meeting. GBP/USD has so far shown little reaction to weekend news that leaked British Government documents suggest a no-deal Brexit will likely result in severe delays for the transport of food and medical supplies at British borders. **The risk is GBP/USD depreciates on this news over the next 48 hours**.

Medium-term outlook

We expect the NZD to track in a broadly sideways range over the next few months. Most G10 central banks maintain easing biases. With global monetary policy relatively synchronous, relative interest rate expectations won't be a particularly strong driver of currency markets. We expect the RBNZ, RBA and US Fed to all continue cutting policy interest rates over the coming months. Further ahead, we expect the NZD to strengthen against most currencies from late 2019 onwards. Ongoing strength in NZ's Terms of Trade will be an important source of support for the NZD. We expect NZD/AUD to remain close to 0.95 over 2019 and to subsequently firm.

ASB foreign exchange forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.68	0.67	0.64	0.68	0.69	0.72	0.73
NZD/AUD	0.96	0.96	0.94	0.94	0.95	0.96	0.97
NZD/JPY	75	72	71	74	75	78	79
NZD/EUR	0.60	0.59	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.52	0.53	0.50	0.53	0.53	0.55	0.56
NZD TWI	73.9	73.2	70.2	72.7	73.1	75.1	75.8

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	1.00	1.50	1.75	UNCH/DOWN	UP
90-day bank bill	1.20	1.22	1.52	1.90	UNCH/DOWN	UP
2-year swap	0.94	0.98	1.34	2.05	UNCH/DOWN	UP
5-year swap	0.94	1.00	1.42	2.40	UNCH/DOWN	UP
10-year swap	1.20	1.30	1.77	2.89	UNCH/DOWN	UP
10-year govt bond yield	1.01	1.09	1.58	2.58	UNCH/DOWN	UP
Curve Slope (2s10s swaps)	0.26	0.33	0.43	0.85	UNCH/DOWN	UNCH/UP

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

Market Recap

Local and global yields start the week lower, with curves flattening. **NZ yields touched fresh record lows (again!) and it has been a race to the bottom since the RBNZ 50bps OCR cut on August 7,** with 10-year NZ Government bond yield falling below 1% for the 1st time on record. **Increased global risk aversion was evident**. Threats of Chinese retaliation on trade, weak data in China and Europe, signals that the ECB will be unveiling a "significant and impactful policy package" next month (rate cuts and fresh bond purchases), protests in Hong Kong and political turmoil in Italy and Argentina dampened yields. **The US Treasury yield curve (10s less 2s) briefly inverted for the first time since 2007, signalling impending US recession and prompting markets to price in greater likelihood of policy support**. Markets are fully priced for at least a 25bp Fed cut in September, with around one-third odds of a 50bp cut. The stubbornly-high Australian unemployment rate (5.2%), weaker outlook for employment and heightened global risks have seen our CBA colleagues lower their cash rate expectations, with 50bps of RBA cuts expected by early 2020.

Near-term NZD interest rate outlook

We have maintained our downward (and curve flattening) bias despite sizeable falls and outright low levels of NZ yields. We remain wary of the global scene and believe this will be a more influential driver of NZ yields and yield curve slope than domestic catalysts. This week could see markets seek to bring forward the timing of OCR cuts and OCR trough if the global scene deteriorates. We also expect a weak Q2 NZ retail trade print to reinforce this. The August RBA meeting minutes (Tuesday) should provide few insights into the RBA's easing bias, given the subsequent publication of August Statement on Monetary Policy and in-depth testimony from Governor Philip Lowe. We expect global manufacturing sentiment data to remain weak. Minutes from the July meeting of the Federal Open Market Committee may provide guidance of what a "mid-cycle adjustment" to US rates means and provide views on risks to the US economy. UK Prime Minister Johnson is due to travel to Europe, and is expected to ask for a new Brexit deal. **Signs of weakness in global growth and increasing global downside risks – including Chinese retaliation on trade, fiscal challenges in Europe, increasing risks of a no-deal Brexit – could push global yields lower and flatten curves**.

Medium-term outlook

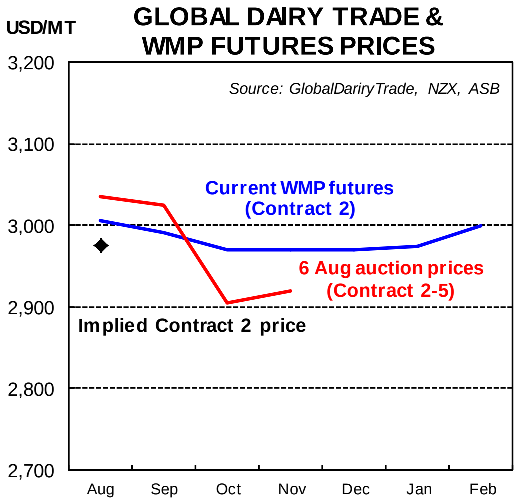
Our forecast is for the curve to initially steepen and then to flatten as policy easing this year precedes mild policy tightening. **However, the growing risk is that longer-term yields could rally further (i.e. fall) if downside global risks crystallise.** We expect a 25bp OCR cut in November and 0.75% OCR trough this cycle, with downside risks. Gradual OCR tightening is expected from early 2022, with an OCR endpoint of just 2.25% by late 2024. 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

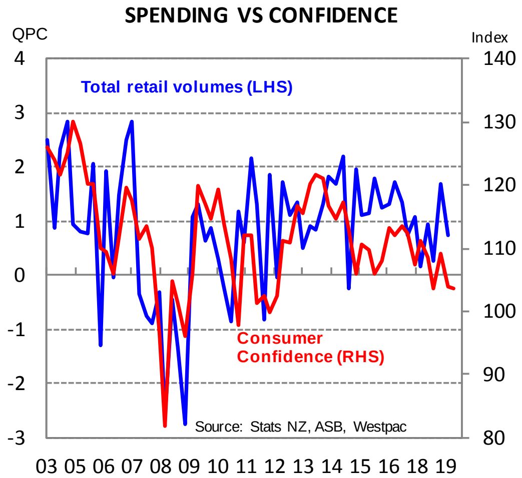
Domestic events

Data	Date	Time (NZT)	Market	ASB
GlobalDairyTrade auction, whole milk powder, % change	20/08	Overnight	-	-1.0
Retail Sales, Q2, % qoq	23/08	10:45am	0.2	0.2
Merchandise trade balance, June, $m	19/08	10:45am	-	-300

We expect whole milk powder prices to fall 1% at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago, whole milk powder (WMP) prices posted a 1.7% drop. At the current juncture, futures pricing also points to a drop of around 1%. So far, dairy prices posted modest falls against the context of the escalating US-China trade war. Indeed over coming months, we anticipate that the strength, or otherwise, of NZ spring production will have the largest influence on the direction of dairy auction prices.



Retail trade started 2019 on a resilient note, with 0.7% quarterly increases in total and core volumes. **It remains our core view that the best times for the retail sector are behind it, and we expect a sluggish Q2 result for retail volumes.** Card spending barely budged in Q2 (0.2% increases for both total and core values) and a tick-up in quarterly consumer price inflation (+0.5% qoq for CPI, +0.3% qoq CPI ex-fuel), will also likely weigh on retail volumes. We expect to see a bounce-back in accommodation volumes consistent with the sizeable lift in domestic visitor guest nights, although the 2nd consecutive quarterly decline in international guest nights is worrying. Vehicle registrations were lower in Q2 pointing to lower vehicle retail activity, and lower consumer sentiment will weigh on overall retail. The Q2 numbers have a historical feel to them given recent events, but they will nonetheless characterise a weak starting point for retail spending (and likely GDP). **The RBNZ will be hoping for signs that the 50bps of OCR cuts will be the catalyst to boost domestic demand.** We are not so sure and will be looking at business and consumer sentiment for signs of a rate cut boost. If this does not eventuate and domestic spending remains in the doldrums, the OCR will likely move lower.



We expect a modest trade deficit of circa $300m in June – note that the June trade balance is normally in deficit as agricultural export volumes slow over winter. Looking over the month, dairy and meat export values in seasonally-adjusted terms are likely to rebound after some weak prior months. On the import side, we expect import values growth to remain modest in line with generally modest domestic demand. **The annual trade deficit is likely to widen a touch towards $5.0 billion.**

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
RBA Board Minutes, August	20/08	1:30 pm	-	-
AU CBA PMIs, August	21/08	11:00 am	-	-
Eurozone PMIs, August	22/08	8:00 pm	-	-
US Federal Reserve Meeting Minutes, August	22/08	6:00 am	-	-

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It's hard to envisage the August **Reserve Bank of Australia (RBA) Board Minutes** containing any new information. Since the RBA Board meeting, we have had the August Statement on Monetary Policy and a very in-depth testimony from Governor Philip Lowe before the House of Representations Standing Committee on Economics. The Minutes should reiterate the Bank's easing bias. The policy rate will be cut further if the data make the case.

The **Australian CBA Composite PMI** eased back in July. But at 52.1, the index remains above the critical 50 level that separates expansion from contraction.

The **Eurozone's manufacturing PMI** is projected to remain below the 50 threshold, consistent with a contraction in manufacturing activity. The manufacturing sector accounts for about 20% of the Eurozone economy. The services PMI is expected to point at further growth slowdown in the more important services sector. The service sector accounts for over 70% of the Eurozone economy.

In the **US Federal Reserve's August Meeting Minutes**, market participants will be looking for evidence of what the central bank means by a "mid-cycle adjustment" along with guidance on its view on risks to the US economy of protracted trade tensions. However, the most recent escalation in US-China trade tensions has occurred since the Federal Open Market Committee's 31 July rate cut.

Key Forecasts

ASB NZ economic forecasts	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
	<< actual	forecast >>					
GDP real - Q%	0.6	0.7	0.5				
GDP real - A%	2.5	2.3	2.4	2.5	2.6	2.8	2.3
GDP real - AA%	2.7	2.5	2.4	2.4	2.4	2.7	2.5
CPI - Q%	0.1	0.6	0.5	0.2			
CPI - A%	1.5	1.7	1.3	1.4	1.7	1.7	1.9
HLFS employment growth - Q%	-0.1	0.8	0.2				
HLFS employment growth - A%	1.5	1.7	0.9	1.3	1.9	1.7	1.4
Unemployment rate - %sa	4.2	3.9	4.1	4.1	4.2	4.0	3.7
Annual current account balance as % of GDP	-3.6	-3.2	-3.3	-3.5	-3.5	-3.7	-3.6

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

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(end of quarter)		<< actual	forecast >>				
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NZ 90-day bank bill	1.9	1.7	1.2	1.0	1.0	1.0	1.2
NZ 2-year swap rate	1.6	1.4	1.0	0.9	0.9	0.9	1.2
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NZ 10-year swap rate	2.2	1.8	1.2	1.1	1.1	1.2	1.6
NZ 10-year Bond	1.8	1.6	1.0	0.9	0.9	1.0	1.4

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NZD/USD	0.68	0.67	0.64	0.68	0.69	0.72	0.73
NZD/AUD	0.96	0.96	0.94	0.94	0.95	0.96	0.97
NZD/JPY	75	72	71	74	75	78	79
NZD/EUR	0.60	0.59	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.52	0.53	0.50	0.53	0.53	0.55	0.56
NZD TWI	73.9	73.2	70.2	72.7	73.1	75.1	75.8

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