Economic Weekly

21 January 2019

Flat NZ inflation in focus

Last week was busy on the international front with a failed Brexit vote and confidence vote in the UK government, ongoing trade negotiations between the US and China and the now-record long US Government shutdown continuing. This week promises to be just as eventful with a host of major data releases including Q4 Chinese GDP, NZ Q4 CPI and Australian employment data. On Page 2 we take a closer look at our expectations for Q4 CPI as well as recap on last week's NZIER QSBO release. Meanwhile the Chart of the Week (below) focuses on Chinese GDP.

Key events and views

Chart of the Week: Has the Chinese growth miracle run out of steam?

Q4 Chinese GDP data is due for release today at 3pm. Chinese economic growth data generates widespread attention as it's the second-largest economy and has been the source of much of recent global growth. Today's data is likely to garner even more interest than normal given the recent run of weak Chinese data. Market expectations are for annual average growth to slow to 6.6% in 2018, the slowest for a calendar year in 28 years.

Although a lot of focus recently has been on the any consequences of the US-China trade spat, the slowing in Chinese economic momentum largely reflects weaker domestic conditions. With Chinese officials introducing numerous policies to help support demand (including tax cuts announced last week) we don't see any imminent risk of a sharp slowdown in the Chinese economy.

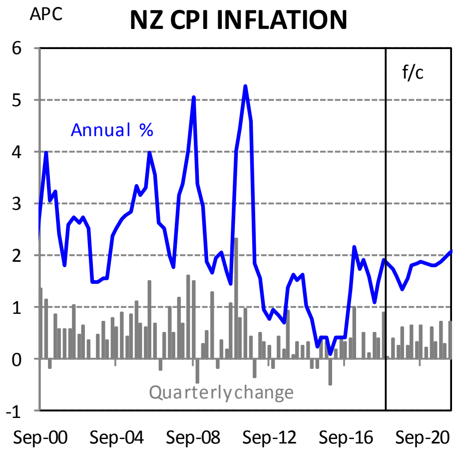
For NZ, we continue to view the slowing Chinese economy as a key downside risk to the outlook. A gradual slowdown in growth to still-decent rates is more manageable than a sharp contraction. We will continue to monitor developments closely, particularly trends in Chinese retail sales.

Key insights this week: Low inflation and squeezed profits

- NZIER QSBO suggests economic momentum was still modest over the latter stages of 2018.
- Profitability continued to deteriorate as firms struggle to pass on cost pressures, with Q4 CPI inflation expected to reflect muted pressure on core inflation.
- This could likely weigh on future investment and employment and could stymie the NZ expansion paving the way to a lower OCR.

Looking beyond the headline

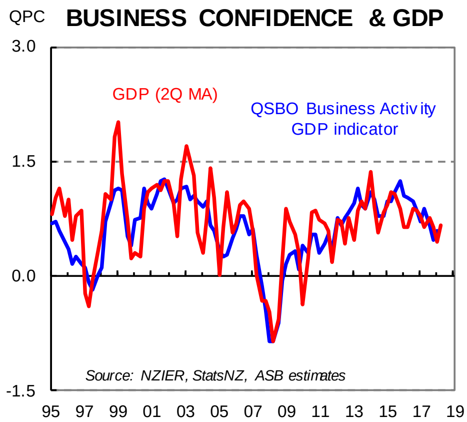
The latest NZIER Quarterly Survey of Business Opinion (QSBO) showed that while firms are now slightly more optimistic on the future outlook, **it still remained a challenging time for many firms.** The survey revealed that **trading activity was broadly flat over the quarter, with firms struggling to pass on rising costs.** The **deterioration in profitability** is concerning and if it continues would present a material headwind to growth.



With firms struggling to pass on cost increases, there is **some risk that inflation pressures may not continue to build in line with our own and the RBNZ's current expectations.** We expect this week's Q4 Consumer Price Index (CPI) release to show annual inflation dipping to 1.8% (from 1.9%).

QSBO revealed that Q4 activity remained subuded

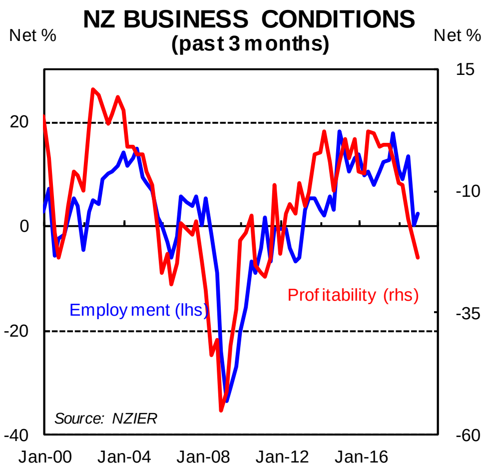
The NZIER Quarterly Survey of Business Opinion showed economic momentum likely remained relatively subdued in Q4, with only slight improvement evident in activity gauges in the survey. Firms experienced domestic trading activity marginally improved in Q4 (to +4 from 0). It points to a modest firming in quarterly GDP to around 0.5% in Q4 from +0.3% qoq in Q3. **Other QSBO metrics were also relatively subdued over Q4.** Firms' experienced profitability deteriorated (to -23.5 from -20.5) with profitability expectations also deteriorating (-12.3 from -11.2). Employment gauges recovered (+2), but remained at low levels and well below recent historical averages (+14% over the past 5 years).



KEY INDICATORS	Dec-18	Sep-18	Jun-18
Business Confidence (seasonally adjusted)	*-18.5*	-28.2	-21.3
Own Activity (expected, s.a.)	*17.3*	10.6	12.8
Number Employed (Past 3 Months, s.a.)	*2.4*	0.1	13.6
Investment Intentions (plant)	*6.7*	4.3	1.5
Selling Prices (Past 3 Months, s.a.)	*20.5*	23.1	23.5

Weak Profitability a concern

While we expect growth momentum to strengthen over 2019, we are cognisant of a number of downside domestic and global risks. **Some details within of the QSBO have raised a few red flags** which, if they continue, could become material headwinds to our forecast recovery in economic growth. We remain concerned over the deterioration in profitability. The deterioration in profitability seems to stem from margin compression, with firms not fully passing on increased costs into selling prices. The proportion of firms who reported an increase in costs rose in Q4, but the proportion raising or intending to raise prices actually fell (see table below). Indeed, pricing intentions actually fell in this quarter's QSBO (to net 21% from net 30%) despite the increase in cost pressures, suggesting some firms had hoped to raise prices back in Q3, but



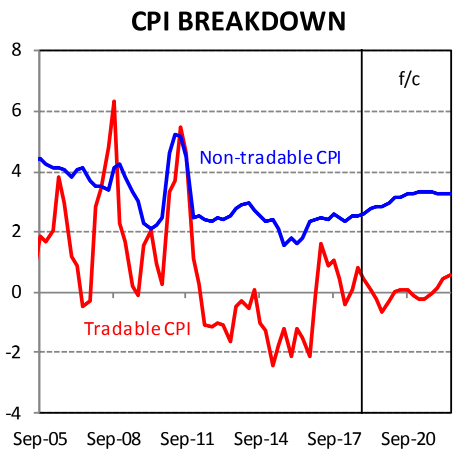
no longer think they are able to. The pattern of increased cost pressure but a muted response in selling prices was shared across the sector breakdown provided by the QSBO.

INFLATION INDICATORS	Dec-18	Sep-18	Jun-18
Capacity Utilisation (%)	*92.8*	93.2	92.8
Costs (Past 3 Months, s.a.)	*47.6*	42.5	36.3
Costs (Next 3 Months, s.a.)	*39.5*	40.5	40.0
Selling Prices (Past 3 Months, s.a.)	*20.5*	23.1	23.5
Selling Prices (Next 3 Months, s.a.)	*20.5*	29.9	29.1

Why are firms not increasing prices to recoup margin? And in the face of deteriorating profitability, how will firms respond, if they cannot recoup margins through raising prices? There has traditionally been a reasonably close relationship between profitability and employment (see chart above). Our economic forecasts assume inflation begins to accelerate and employment continues to grow, but the Q4 QSBO flags some risk that this may not happen if profitability does not improve.

Q4 CPI inflation flat

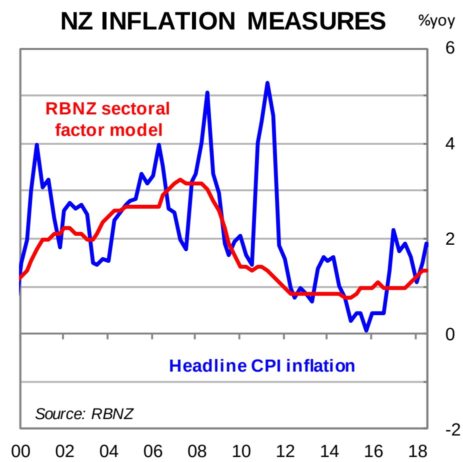
Also confirming modest prices pressure, we expect CPI prices to have remained flat over the December quarter, with **annual inflation likely to ease slightly to 1.8%.** Weak Q4 CPI number partly reflect the impact of falling fuel prices (unwinding the previous quarter's 5.6% increase) and a seasonal fall in food price. **Nonetheless, looking through these volatile components, underlying inflation trends have remained subdued**. Annual inflation excluding food, fuel and household energy was just 1.2% in Q3.



We expect non-tradable prices to have lifted 0.5% over the quarter (2.6% yoy), which is slightly higher than the RBNZ's 2.5% yoy forecast. Annual non-tradable inflation has been slowly ticking higher in recent quarters, in large part due to the tight housing market contributing to stronger rental inflation along with cyclically-strong construction activity pushing construction inflation higher. **However, rising non-tradable inflation has been offset by subdued trends in the tradable components, leaving core inflation steady over recent quarters**. Tradable prices excluding fuel fell 1.3% over the past year, reflecting the subdued global inflation environment.

Core inflation pressures the key focus

Given the high degree of volatility in fuel prices distorting headline inflation over recent quarters, **a key focus for the RBNZ will be core inflation trends.** Financial market participants are likely to await the release of the **RBNZ's key measure of core inflation, the sectorial factor model, at 3pm on Wednesday.** We expect core inflation pressures have likely remained steady, with an annual print for the sectoral factor model at around 1.7%. We believe that rising wage inflation over 2019 will gradually push core CPI inflation higher. **However this is dependent on firms having sufficient profitability (and the willingness) to be able to fund a higher wage bill. If not, annual core inflation could languish below 2% and a lower OCR could result.** We will be closely following forthcoming profit reports and corporate tax receipts to see whether the sentiment measures are an accurate representation of the state of play for New Zealand firms.



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6752	0.6808	0.6772	0.7304	DOWN	0.6650	0.6900	FLAT/UP
NZD/AUD	0.9413	0.9466	0.9521	0.9107	DOWN	0.9250	0.9600	DOWN
NZD/JPY	74.06	73.62	75.40	80.94	FLAT/DOWN	72.50	75.50	FLAT
NZD/EUR	0.5942	0.5935	0.5916	0.5954	FLAT	0.5810	0.6050	DOWN
NZD/GBP	0.5245	0.5299	0.5353	0.5247	FLAT/DOWN	0.5130	0.5340	FLAT/UP
TWI	73.4	73.6	74.0	74.94	DOWN	72.0	75	DOWN

*^ Weekly support and resistance levels * Current as at 9.55am today; week ago as at Monday 5pm*

NZD Recap

The NZD was flat to lower against major crosses as the **USD firmed against the major currencies** over the past week on generally positive US economic data. The UK House of Commons rejection of the proposed Brexit plan last Tuesday night was largely expected by market participants and saw minimal market reaction. Likewise, the market showed little reaction to the defeat of the no confidence motion brought against the U.K.'s May government. **The GBP rose towards the end of the week on growing speculation of a second referendum.** Polls indicate a majority of those surveyed leaning towards remaining in the EU. **The EUR was been dragged lower by dovish comments from European Central Bank President Mario Draghi.** Draghi said the Eurozone economy was weaker than expected, and the weakness could last longer than expected.

Near-term outlook

The NZD will be driven by Q4 CPI this week and we expect the market will pay attention to estimates of NZ core inflation (the RBNZ's sectoral factor model is released at 3pm on Wednesday). **Confirmation of low inflation** in the New Zealand economy will likely apply further **downward pressure to the NZD/USD**, and we see risk that the NZD/USD breaks below technical support levels (0.6650). We also expect the NZD/AUD to maintain its modest downtrend in place over the past month. We expect **further USD upside to be limited this week**, as growing evidence highlights the economic impact of the ongoing US Government shut down. Meanwhile, **we see some downside to the EUR** from the possibility of a more dovish stance delivered by the ECB Governing Council. **The GBP appreciation should pause this week** awaiting next week's 29 January vote in the U.K. House of Commons on Theresa May's Plan. With PM May refusing to rule out a no deal outcome ahead of the 29 March deadline, the **possibility of a hard Brexit continues to increase**.

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	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.66	0.67	0.66	0.67	0.68	0.70	0.66
NZD/AUD	0.92	0.95	0.90	0.91	0.91	0.90	0.90
NZD/JPY	75	74	74	74	73	75	74
NZD/EUR	0.57	0.59	0.58	0.57	0.55	0.55	0.54
NZD/GBP	0.51	0.53	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.1	73.5	72.0	72.4	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	1.90	1.92	1.98	1.88	FLAT	UP
2-year swap	1.92	1.91	1.98	2.26	FLAT	UP
5-year swap	2.16	2.15	2.23	2.78	FLAT	UP
10-year swap	2.61	2.60	2.68	3.29	FLAT	UP
10-year govt bond yield	2.32	2.30	2.40	2.97	FLAT	UP
Curve Slope (2s10s swaps)	0.69	0.69	0.70	1.03	FLAT	FLAT

** Current as at 9.55am today; week ago as at Monday 5pm*

Market Recap

NZ wholesale interest rates rose towards the end of last week, riding on the coat-tails of higher global yields. Earlier in the week saw a retreat in local yields following weaker than expected local data. The Q4 increase in business sentiment from the QSBO was more modest than we had expected, the housing market remained firmly on ice, and the slump in card spending highlighted risks to Q4 GDP. Reasonable demand has remained evident for NZ Government bonds, with a successful tender of the 2029 bond last week. **Global yields edged up over the last week on hopes of a break-through in trade negotiations between the US and China (unconfirmed), with generally solid US data supporting US Treasury yields.** This was despite the partial US government shutdown dragging on, with the head of the New York Fed calling on policymakers to show "prudence, patience, and good judgment" - interpreted to mean fewer Fed rate hikes in 2019. Markets have largely ignoring the worsening political crisis in UK following the rejection of the Government's Brexit deal.

Near-term NZD interest rate outlook

We have a neutral bias for local interest rates. Markets have about 15bps of OCR cuts priced in by early 2020, which seems a little excessive given our OCR view**.** However, absent a lift in economic prospects for NZ and the attendant firming in inflationary pressure, we expect markets to continue to side with OCR cuts. Our NZ Q4 CPI pick (+0.0% qoq, 1.8% yoy) is in line with the market consensus and is unlikely to facilitate much market reaction. However, a decent Australian employment report on Thursday could push against 50% market odds of a 2019 RBA rate cut. Longer-term rates could edge up if the partial US government shutdown can be resolved, Brexit risks recede, and the US and China resolve trade issues. **However, slowing global growth and the downward risk profile could see longer-term yields test fresh lows and flatten curves.** Q4 Chinese GDP (+6.6% exp for 2018) should confirm the slowest pace of calendar year growth since 1990, paving the way for more policy stimulus from the People's Bank of China**.** We also expect the ECB to confirm slowing growth and highlight the need for policy support.

Medium-term outlook

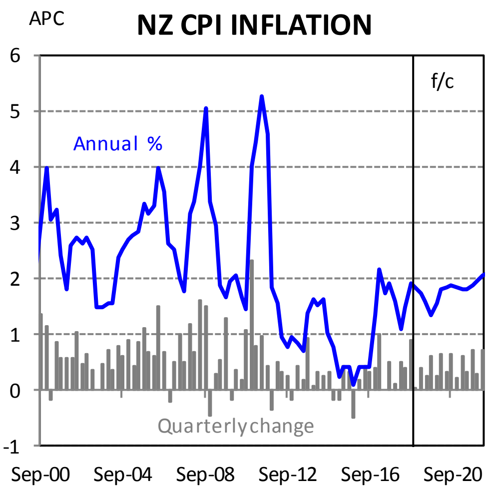
Given our low outlook for core inflation, we expect the OCR to remain on hold until August 2020. Our view is that the medium-term inflation outlook will not be strong enough to trigger OCR hikes. Proposed higher bank capital requirements will likely tighten financial conditions, although the hurdle to 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	Sep-18	Dec-18	Mar-19	Jun-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	1.9	2.0	2.1	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.0	2.0	2.3	2.4	2.7	3.0	3.2
NZ 10-year Bond	2.7	2.4	2.9	3.0	3.3	3.4	3.4

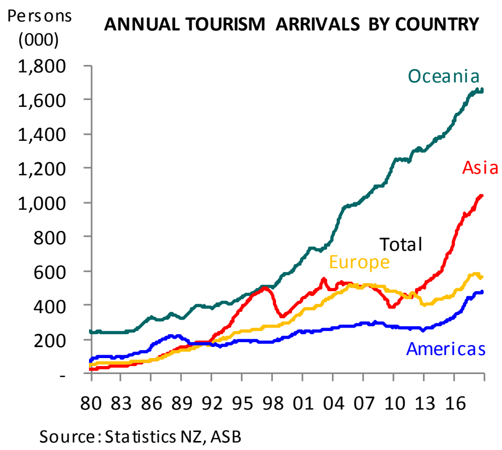
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
Consumer prices, Q4, % qoq	23/1	10:45am	0.9	0.0	0.0
Consumer prices, Q4, % yoy	23/1	10:45am	1.9	1.8	1.8
Travel and migration, Nov change	25/1	10:45am	4,660	-	4,500
Overseas Merchandise Trade, December, $m	29/1	10:45am	-861	-	+250

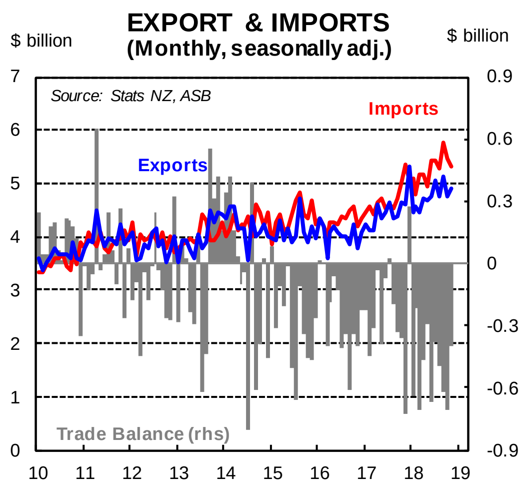
Our forecast of no change in Q4 consumer prices (+1.8% yoy) is softer than the RBNZ November Monetary Policy Statement pick of a 0.2% quarterly increase (2.0% yoy). Some of the difference likely reflects the ongoing fall in fuel prices in December. Outside of the seasonal price movements and falling petrol prices, the underlying inflation picture is expected to remain moderate. The RBNZ's sectoral factor model (an estimate of core inflation) will be released at 3pm on the 23rd January and is expected to remain near 1.7% yoy. As a result, the RBNZ is likely to remain comfortable leaving monetary policy settings unchanged and maintain the view that underlying inflation pressures will slowly build. We expect the RBNZ to leave the OCR on hold until at least August 2020.



Following the phasing out of departure cards for travellers to NZ in early November, Statistics NZ have introduced an outcomes based modelling approach to produce provisional estimates for permanent and long-term immigration. These provisional series could potentially be somewhat different from the intentions based approach obtained from departure cards and some volatility is to be expected. The new estimates are also liable to significant historical revision over time. **Abstracting from the statistical noise, we expect the figures to show a gradual decline in annual net immigration inflows as departures pick up from low levels and arrivals slow.** On a like-for like basis, we expect annual permanent and long-term (PLT) immigration inflow to be around 30,000 persons below its mid-2017 peak by the end of the year. **Visitor numbers are expected to remain elevated and should continue to test new record annual highs**, given ongoing strong growth in US and Asian visitor numbers. As well as expanding capacity, the tourism sector should focus on attracting higher spending tourists.



We expect a trade surplus of $250m for December. Agricultural production has had a strong start to the season, which we expect to be increasingly reflected in the export figures. Meanwhile, import values are likely to soften given weaker oil prices. We expect the annual trade balance to improve over the next year as agricultural export volumes and values continue to rise, while oil prices remain modest.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
China Retail Sales, Dec, %yoy	21/01	3:00 pm	8.1	8.2
China Industrial Production, Dec, %yoy	21/01	3:00 pm	5.3	5.2
China Fixed Assets, Ex Rural YTD Dec, %	21/01	3:00 pm	6.0	6.0
China, Q4 GDP, %yoy	21/01	3:00 pm	6.4	6.4
Bank of Japan, Policy rate, %	23/01	-	-0.1	-0.1
AU CBA Purchasing Manager Indexes (PMIs), Jan	24/01	11:00 am	-	-
AU labour force, Dec, unemployment rate, %	24/01	1:30 pm	5.1	5.0
Eurozone manufacturing and services PMIs	24/01	10:00 pm	-	-
European Central Bank, Dec, Refi rate, %	25/01	1:45 am	0.0	0.0

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We expect Q4 Chinese GDP growth to ease to 6.4% yoy, in line with market expectations. Growth over the calendar year is expected to slow to 6.6%, the lowest rate since 1990. Chinese retail sales growth may rebound **slightly to 8.2% yoy** in December, due to base effects. But car sales remain a drag. We expect industrial production growth to ease to 5.2% yoy because the official December manufacturing PMI decreased into contractionary territory for the first time since July 2016. Fixed asset investment growth might have edged higher to 6% year to date in December because of a rebound in the construction PMI.

The Bank of Japan is widely expected to maintain current policy settings. With limited inflation in wages and prices, we do not predict any policy tightening in the foreseeable future.

January readings for Australian manufacturing and services sentiment are released on Thursday. The CBA Composite PMI eased from 53.9 to 52.9 in December. Both the manufacturing and services PMIs posted falls. The PMIs are still pointing to expansion, but at a decelerating rate.

Also released on Thursday is the December Australian labour market report. The labour market has so far remained solid despite some softening in other economic data. We have forecast a lift in jobs of 20,000 and a slight fall in the unemployment rate to 5.0% on a drop in the participation rate to 65.6%. Such a result would be considered a decent outcome. A decent print for December will likely push back a little against market pricing for the RBA which is now implying a 50% chance of a rate cut in 2019.

Both Eurozone services (51 exp, 51.2 prior) and manufacturing markit PMIs (51 exp, 51.4 prior) are expected to cool in January consistent with our expectation that the Eurozone economy continued to weaken in January because of headwinds from the softer global economy. High frequency indicators such as the IFO index also suggest the slowdown continues.

No changes are expected in the European Central bank policy decision, with the Refi rate held at 0.0%, and marginal lending facility at 0.25%. Recall that the ECB finished its bond buying program in December, but the Eurozone economy has shown signs of weakening. A dovish speech by ECB President Draghi suggests the ECB is in no hurry to begin tightening monetary policy.

Key Forecasts

ASB NZ economic forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
	<< actual	forecast >>					
GDP real - Q%	0.3	0.5	0.8				
GDP real - A%	2.6	2.4	2.6	2.5	3.3	3.0	2.9
GDP real - AA%	3.0	2.8	2.7	2.5	3.0	3.1	2.9
CPI - Q%	0.9	0.0	0.4	0.3			
CPI - A%	1.9	1.8	1.7	1.6	1.8	1.8	2.1
HLFS employment growth - Q%	1.1	0.1	0.5	0.4			
HLFS employment growth - A%	2.8	2.4	2.4	2.2	1.7	1.6	1.4
Unemployment rate - %sa	3.9	4.2	4.1	4.1	3.9	3.8	3.7
Annual current account balance as % of GDP	-3.6	-3.9	-3.8	-3.9	-3.9	-3.7	-3.8

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	Sep-18	Dec-18	Mar-19	Jun-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	1.9	2.0	2.1	2.1	2.1	2.5	3.0
NZ 2-year swap rate	2.0	2.0	2.3	2.4	2.7	3.0	3.2
NZ 10-year Bond	2.7	2.4	2.9	3.0	3.3	3.4	3.4

ASB foreign exchange forecasts	Sep-18	Dec-18	Mar-19	Jun-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.66	0.67	0.66	0.67	0.68	0.70	0.66
NZD/AUD	0.92	0.95	0.90	0.91	0.91	0.90	0.90
NZD/JPY	75	74	74	74	73	75	74
NZD/EUR	0.57	0.59	0.58	0.57	0.55	0.55	0.54
NZD/GBP	0.51	0.53	0.53	0.53	0.53	0.54	0.51
NZD TWI	72.1	73.5	72.0	72.4	72.3	72.9	70.2

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