

Economic Weekly

22 July 2019

NZ inflation as expected, labour data next up

Annual NZ CPI inflation lifted to 1.7% in Q2, as widely expected. While annual inflation from some core measures firmed slightly, we do not see this as a barrier to the Reserve Bank of New Zealand (RBNZ) cutting the OCR to 1.25% at the August meeting. **The final key data release ahead of the RBNZ's August 7th Monetary Policy meeting is the release of Q2 labour market data** (released the day before). This week is set to be relatively quiet, with key global events including the UK Conservative Party leadership announcement (Wednesday morning), the European Central Bank policy announcement (Thursday night) and US Q2 GDP (Saturday morning). In NZ, the June Trade Balance is due for release this week.

Key events and views

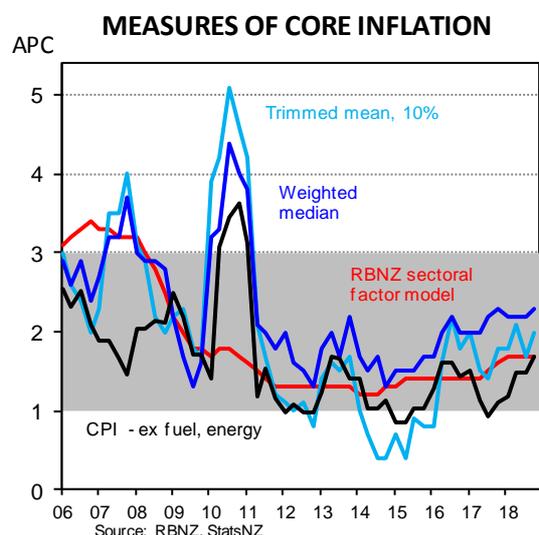
Foreign exchange	NZD cross outperformance to continue.
Interest rates	NZ and global interest rates lower on expectations of more policy stimulus.
Domestic events	June Trade Balance.
International events	UK Conservative Party leadership announcement, ECB policy announcement, US Q2 GDP.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: Core inflation measures up, but for how much longer?

Q2 CPI inflation was in line with expectations, with a lift in fuel prices pushing annual CPI inflation up to 1.7%, still within the 1-2% range it has resided for the last two years.

Annual CPI inflation from some core measures ticked higher in the June 2019 quarter and remained clustered around 2%. From this perspective, the RBNZ could claim some success in keeping annual CPI inflation well within the 1-3% target range.

However, annual core inflation from the RBNZ's sectoral factor model held at 1.7%, the 38th consecutive quarter below 2%. With **economic growth softening over the past year, the growing risk is that core inflation measures are unlikely to remain close to target going forward. Risks to the overall CPI inflation outlook are skewed to the downside, with the OCR set to move lower still.** We expect a further 50bps of OCR cuts over 2019.



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6766	0.6718	0.6593	0.6754	FLAT/DOWN	0.6700	0.6850	UP
NZD/AUD	0.9602	0.9552	0.9511	0.9167	FLAT	0.9500	0.9680	UP
NZD/JPY	72.89	72.57	70.58	75.79	FLAT/UP	71.70	73.70	UP
NZD/EUR	0.6032	70.58	0.5836	0.5790	FLAT/UP	0.5950	0.6130	FLAT
NZD/GBP	0.5410	0.5346	0.5191	0.5182	FLAT/UP	0.5300	0.5500	FLAT/UP
TWI	74.1	73.4	72.1	72.83	FLAT/UP	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 was the strongest performing G10 currency last week. At first blush, this outperformance was a little hard to reconcile given a dearth of local news/events. The only notable piece of data – Q2 CPI – came in exactly as we, the market, and the RBNZ expected.

Currency markets are basically a game of ‘who-has-the-easiest-monetary-policy’ at present. And, against that background, last week’s gains in the NZD become easier to reconcile. Monetary easing expectations continued to ramp up in Europe, propelling NZD/EUR to three month highs. Brexit uncertainty and the Bank of England’s policy about turn lifted NZD/GBP to 7 month highs. And the US market’s will they-won’t they speculation about a 50bps Fed rate cut in July saw NZD/USD dragged up to almost 0.6800.

Near-term outlook

We suspect upward pressure on NZD crosses to remain a feature of currency markets this week. Thursday night’s ECB meeting will be the highlight of the week. We don’t expect any policy change but the risk is tilted in the direction of more dovish rhetoric as the ECB steers the market towards more easing later in the year (we expect a 10bp cut in the deposit rate in September). **NZD/EUR should remain supported as a result.**

In the UK, the Conservative Party is expected to announce its new leader on Tuesday UK time. Even with a ‘no-deal Brexit’ largely ruled out, it’s hard to see much GBP upside while negotiations continue. **NZD/GBP volatility, within a gradual upward trend, looks set to continue.** We don’t expect a 50bps cut from the Fed in July. But, like nearly everyone else, we do expect a 25bps cut in July, with a further 50bps of cuts delivered over the rest of the year. **The USD should remain on the back-foot as a result.**

Medium-term outlook

We expect the NZD to track in a sideways range over the rest of the year. NZ monetary policy looks set to move relatively in-sync with some of our key trading partners, essentially nullifying relative interest rate expectations as a key driver of currency markets. We expect the RBNZ, RBA and US Fed to all cut policy interest rates over the coming months. **Further ahead, we expect the NZD to firm against most crosses from late 2019 onwards.** The NZD/USD will be supported by NZ’s high terms of trade while the USD remains under downward pressure from the US Federal Reserve’s easing cycle. We expect NZD/AUD to remain close to 0.95 over 2019 and to subsequently firm.

ASB foreign exchange forecasts

(end of quarter)

	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
	<< 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

<u>Wholesale interest rates</u>	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.50	1.50	1.50	1.75	UNCH	UP
90-day bank bill	1.53	1.58	1.58	1.92	UNCH/DOWN	UP
2-year swap	1.33	1.37	1.29	2.14	UNCH/DOWN	UP
5-year swap	1.41	1.49	1.36	2.52	UNCH/DOWN	UP
10-year swap	1.77	1.87	1.72	2.99	UNCH/DOWN	UP
10-year govt bond yield	1.57	1.66	1.51	2.79	UNCH/DOWN	UP
Curve Slope (2s10s swaps)	0.44	0.50	0.43	0.85	UNCH	UNCH/UP

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

Market Recap

Both global and NZ yields retraced some of the previous week's climb, with the curve flattening. Catalysts were global, with US interest rates easing on expectations of more policy stimulus. In a speech last week, Fed Chair Powell stuck to the script, reiterating he was "carefully monitoring" downside risks to US growth and that the Fed would "act as appropriate to sustain the expansion". Dovish comments by 2019 Fed voters Evans, Williams and Clarida kept the option of the front-loading of Fed cuts alive, but the rally (i.e. fall) in short-term yields faded as the New York Fed backtracked. Media reports were critical of the Fed's communication with the markets. Last week's Q2 NZ CPI inflation prints were in line with consensus, with little market reaction. The RBA Minutes were dovish in tone, but Australian labour market data was solid enough to signal there is no imminent need for another rate cut. Heightened political tensions between the UK and Iran provided support to safe-haven bonds. US (2.06%), Australian (1.35%) and NZ 10-year (1.56%) government bond yields ended the week towards the lower part of recent ranges.

Near-term NZD interest rate outlook

Current market pricing has around 85% odds of a 25bp OCR cut priced in for August and more than 40bps of cuts by November before the OCR troughs at around 1% in mid-2020. **We have maintained our downward bias for NZ interest rates, given our lower OCR view.** There are only a few local data prints ahead of the RBNZ August MPS (Aug 7), including the ANZ business outlook (31 July) and Q2 labour market data (Aug 6). There is also a scattering of offshore events this week, including Thursday's speech by RBA Governor Lowe. We expect global rates to wax and wane ahead of the key Fed decision (Aug 1, 30bp cuts priced in), and with no Fed speeches before then, Q2 GDP (mkt: 1.8% qoq annualised) could provide some volatility. The ECB is not expected to change policy settings this week, although we expect a dovish assessment signaling future policy easing. The winner of the Conservative Party leadership contest between Boris Johnson and Jeremy Hunt is due to be announced on 23rd July (UK time). We expect longer-term NZ yields to remain range-bound, but sensitive to movements in US Treasury yields.

Medium-term outlook

Our bias is for the curve to initially steepen and then to progressively flatten as policy easing this year precedes mild policy tightening. We expect 25bp cuts in August and November, with the OCR to remain at 1%, until a gradual RBNZ tightening cycle commences from early 2022. Slowing global growth is expected to result in more policy stimulus offshore. We expect 100bps of interest rate cuts by the Fed (July, September, December, and March 2020), 25bps of cuts by the RBA (November), with policy easing by the ECB and People's Bank of China. Inflation looks set to remain low and interest rate normalisation from global central banks a long way off, capping long-term interest rates.

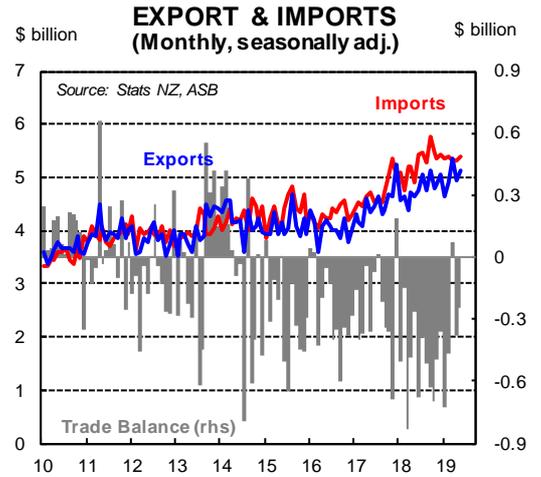
ASB interest rate forecasts

(end of quarter)	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
	<< actual		>> forecast >>					
NZ OCR	1.75	1.50	1.25	1.00	1.00	1.00	1.25	1.75
NZ 90-day bank bill	1.9	1.7	1.5	1.3	1.3	1.3	1.6	2.0
NZ 2-year swap rate	1.6	1.4	1.3	1.2	1.2	1.2	1.6	2.0
NZ 5-year swap rate	1.8	1.4	1.4	1.4	1.4	1.5	1.9	2.3
NZ 10-year swap rate	2.2	1.8	1.8	1.8	1.8	1.9	2.1	2.3
NZ 10-year Bond	1.8	1.6	1.6	1.6	1.6	1.7	1.9	2.1

Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
Merchandise trade balance, June, \$m	24/07	10:45 am	264	-	250

We expect a **modest trade surplus of circa \$250m in June**. Looking over the month, dairy export values are likely to soften as the weak end to the production season is reflected in weaker export volumes, although strong meat export values are likely to provide some offset. 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 narrow towards \$5.0 billion**.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
RBA Assistant Governor Kent speech, Sydney	23/07	10:30 am	-	-
Australia CBA PMIs, July	24/07	11:00 am	-	-
RBA Governor Lowe speech, Sydney	25/07	3:00 pm	-	-
ECB Interest Rate Announcement, %	25/07	11:45 pm	0.0	0.0
US GDP, Q2, saar	27/07	12:30 am	1.8	1.5

*Originally published by CBA Global Markets Research on Friday 19th July at 1.43pm

The Reserve Bank of Australia's (RBA) Assistant Governor Kent will deliver a speech titled "*The Committed Liquidity Facility*" at The Bloomberg Address in Sydney. This is unlikely to address monetary policy.

The last **PMI survey in Australia** showed the service sector was on a stronger footing in June, with business activity expanding at the fastest rate so far this year. The manufacturing PMI has also shown a rebound over Q2.

RBA Governor Lowe is due to speak at The Anika Foundation Luncheon in Sydney. The topic of the speech is "*Inflation Targeting and Economic Welfare*". There has been some debate about whether the RBA should lower its inflation target from its current 2-3%, on average, over the medium term. This target is higher than other central banks around the world and with inflation globally low, this will be a very topical speech.

We expect **no policy change from the European Central Bank when they meet on Thursday.** But we forecast the ECB will cut the deposit rate by 10bp to -0.50% in September. However, the risk is that the ECB loosens monetary policy this week. Eurozone core inflation is low, high frequency business indicators have weakened significantly, and risks to Eurozone economic growth from the slowing world economy have increased.

We expect a downward correction to inventories, net exports and government spending to slow Q2 **US GDP growth** from the 3.1% seasonally adjusted annual rate (saar) in Q1 2019 to 1.5%saar in Q2 2019. But we expect the strength of the US economy to be consumer spending.

Key Forecasts

ASB NZ economic forecasts

	Mar-19 << actual	Jun-19 forecast >>	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
GDP real - Q%	0.6	0.7	0.7				
GDP real - A%	2.5	2.3	2.6	2.7	2.8	2.4	2.3
GDP real - AA%	2.7	2.5	2.5	2.5	2.6	2.5	2.3
CPI - Q%	0.1	0.6	0.7	0.2			
CPI - A%	1.5	1.7	1.5	1.5	1.9	1.7	1.8
HLFS employment growth - Q%	-0.2	0.5	0.4				
HLFS employment growth - A%	1.5	1.4	0.8	1.2	1.8	1.5	1.4
Unemployment rate - %sa	4.2	4.3	4.4	4.4	4.4	4.3	4.1
Annual current account balance as % of GDP	-3.6	-3.4	-3.5	-3.6	-3.6	-3.4	-3.3

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

(end of quarter)	Mar-19 << actual	Jun-19 forecast >>	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
NZ OCR	1.75	1.50	1.25	1.00	1.00	1.00	1.25
NZ 90-day bank bill	1.9	1.7	1.5	1.3	1.3	1.3	1.6
NZ 2-year swap rate	1.6	1.4	1.3	1.2	1.2	1.2	1.6
NZ 5-year swap rate	1.8	1.4	1.4	1.4	1.4	1.5	1.9
NZ 10-year swap rate	2.2	1.8	1.8	1.8	1.8	1.9	2.1
NZ 10-year Bond	1.8	1.6	1.6	1.6	1.6	1.7	1.9

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