

Economic Weekly

23 October 2018

Dairy production bonanza likely to erode prices

The fine weather enjoyed by most over the long weekend has also supported a strong start to the dairy season, with this season's milk production likely to break previous records. On Page 2 we discuss the implications of bumper milk production on dairy prices. The week ahead is set to be relatively quiet, with just trade data out in NZ. Key events offshore include the Bank of Canada and European Central Bank monetary policy announcements.

Key events and views

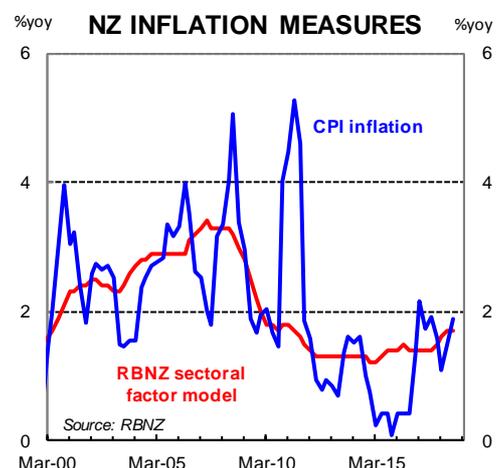
Key Insights	Dairy production giveth, dairy production taketh away.
Foreign exchange	NZD/EUR strengthened last week on mounting concerns around Italy's fiscal position.
Interest rates	NZ interest rates start the week a fraction lower.
Domestic events	NZ to post a trade deficit in September with imports higher on rising oil prices.
International events	Bank of Canada rate announcement, ECB policy announcement, US GDP.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: Core inflation lifting, for now

Inflation leapt higher in Q3, with annual CPI inflation lifting to 1.9% largely on the back of stronger petrol prices. Indeed, CPI inflation excluding petrol was just 1.2% yoy in Q3 – down from 1.8% this time a year ago. But it appears the lift in petrol prices is masking further global deflationary pressure on NZ consumer prices, as **tradable prices excluding vehicle fuels have fallen 1.3% from a year ago**.

Meanwhile, **domestic inflation pressures are finally starting to slowly build**, with non-tradable annual inflation rising to 2.6% – more than the RBNZ expected. With opposing forces from global and domestic inflation sources, the underlying inflation picture is complex. This is why the RBNZ prefers its own measure of core inflation – the sectoral factor model – which estimates that **annual core inflation remained steady at 1.7% in Q3, and up from a low of 1.4% a year ago**.

Evidence of building core domestic inflation, along with an expectation of a lift in wage inflation over the coming year, suggests a rising inflation outlook and **reinforces the view the next move in the OCR is likely to be a hike**. But equally, the outlook for weaker economic demand over the coming year raises questions on how long stronger domestic inflation will be sustained.



Production giveth, production taketh away

- Dairy production has started the 2018/19 season with a hiss and a roar.
- Indeed, production is on track for a new record high this season and will boost export volumes accordingly over coming months.
- However, with this extra dairy supply we have lowered our 2018/19 milk price forecast to \$6.25/kg.

Production giveth

The 2018/19 season has started with a hiss and a roar. Indeed, favourable weather has helped NZ production to date surge more than 5% ahead of the same point last season.

Some of the reason for the healthy production numbers in annual change terms is that last season's production was so weak. In particular, farmers did it tough with an overly wet spring and then drought over summer in some parts. This season so far the weather has been largely favourable, helping production start strongly.

Farmers have also been in a better position to take advantage of the favourable weather. Cashflows are positive and farmers are putting the dairy downturn behind them. Accordingly, farmers are spending more pasture maintenance (via fertiliser application) and on animal health. This spending has translated into more production per cow.

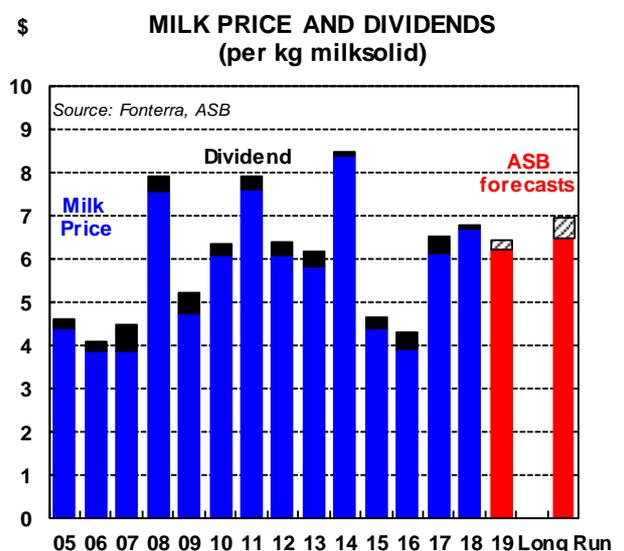
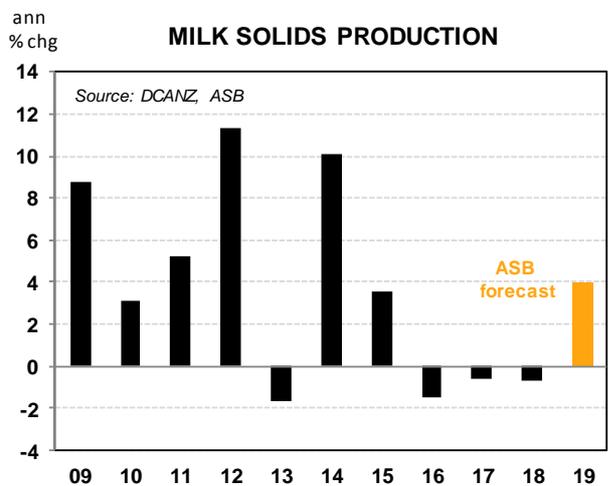
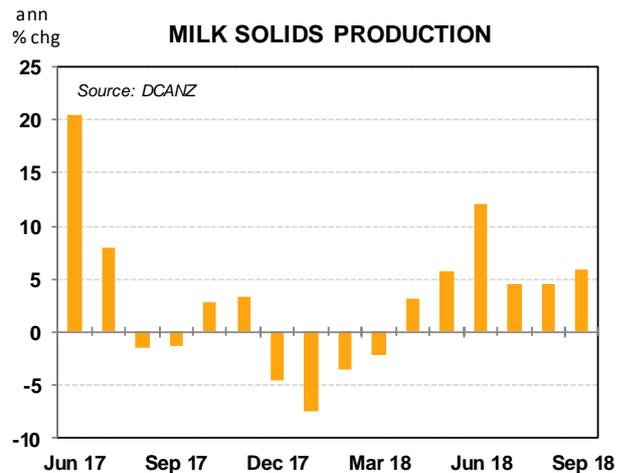
With all this in mind, we have doubled our 2018/19 production growth forecast from 2% to 4%. Indeed, after three seasons of declining production, production is on track to set a new record high.

Strong dairy production over recent months has also boosted GDP. Indeed, agricultural production jumped 4.2% over Q2, with dairy production making a large contribution to the pickup. Moreover, we expect dairy export volumes to grow steadily over the coming year, after posting declines in three out of the last four quarters.

But production also taketh away

But extra milk also means a lower milk price forecast. Last week, we also trimmed our milk price forecast by 25 cents to \$6.25/kg.

In net income terms, the higher production is not enough to offset the lower milk price. All up, we estimate farmer incomes are around \$240m lower as a result of these forecast changes.



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6557	0.6566	0.6691	0.6990	FLAT/DOWN	0.6350	0.6620	UP
NZD/AUD	0.9260	0.9213	0.9175	0.8907	FLAT	0.9200	0.9320	FLAT
NZD/JPY	73.97	73.51	75.42	79.08	FLAT	72.9	75.1	FLAT/UP
NZD/EUR	0.5719	0.5672	0.5680	0.5914	FLAT/UP	0.5640	0.5810	FLAT
NZD/GBP	0.5056	0.4994	0.5041	0.5331	FLAT/UP	0.4990	0.5140	DOWN
TWI	72.2	71.8	72.3	73.67	FLAT	70.0	73.0	FLAT

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

NZD Recap

The **NZD/USD** remained off its recent lows last week, but there was a degree of volatility in currency crosses given the bouts of risk-off sentiment throughout the week. The stronger than expected Q3 NZ CPI release on Tuesday was a key NZD support last week. There was also a short-term dip in the NZD/AUD on Thursday when the Australian labour market data showed the unemployment rate had hit a new recent low. However, outside of short-term data driven movements, global concerns continued to be the key driver of currency movements last week. For example, the NZD/USD largely drifted lower over the remainder of the week on a reduced global risk appetite. Concerns around Italy's fiscal stability weighed on the euro over the latter half of the week. Recent speculation that some Conservative party members are looking at overthrowing British Prime Minister, Theresa May, has seen the GBP fall with the NZD/GBP back near 0.51 after starting the week around 0.496. Rising European political risk, amid ongoing trade tensions, supported the USD over the weekend with the USD index rising over 6% last week.

Near-term outlook

With few market-moving data releases this week, we expect other global factors to dominate currency movements.

Ongoing US-China trade concerns, increasing US Treasury yields and concerns surrounding Italy's fiscal position are likely to continue to support a general risk-off tone. Given this, we expect the USD to remain supported this week against the NZD and AUD. However, with the Italian Government so far looking unlikely to make any changes to its fiscal budget, there is scope for some upside in the NZD/EUR this week. There is also a chance that we see some short-term volatility in the EUR following the ECB's rate announcement overnight on Thursday. Although the ECB is unlikely to change policy settings or guidance, any perceived change in tone by the Bank could spark volatility. Finally, the Q3 US GDP release overnight on Friday will also be a highlight this week.

Medium-term outlook

We have a stronger 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 (although it has recently dipped below this range). 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 is expected to remain in a 90-91 Australian cent zone through to the end of next year. 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. Low inflation is expected to keep the BOJ on hold, with the NZD/JPY modestly strengthening over the forecast period.

ASB foreign exchange forecasts (end of quarter)	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
				<< actual	forecast >>				
NZD/USD	0.71	0.72	0.67	0.66	0.65	0.66	0.68	0.70	0.66
NZD/AUD	0.91	0.94	0.92	0.92	0.90	0.90	0.91	0.90	0.90
NZD/JPY	80	77	74	75	73	74	73	75	74
NZD/EUR	0.59	0.59	0.58	0.57	0.58	0.58	0.55	0.55	0.54
NZD/GBP	0.53	0.51	0.52	0.51	0.52	0.53	0.53	0.54	0.51
NZD TWI	74.3	74.3	72.5	72.1	71.4	71.9	72.3	72.8	70.2

Interest Rate Market

<u>Wholesale interest rates</u>	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	1.90	1.91	1.94	FLAT	UP
2-year swap	2.03	2.04	2.03	2.17	FLAT	UP
5-year swap	2.39	2.41	2.41	2.68	FLAT/DOWN	UP
10-year swap	2.90	2.92	2.93	3.21	FLAT/DOWN	UP
10-year govt bond yield	2.66	2.70	2.67	2.96	FLAT/DOWN	UP
Curve Slope (2s10s swaps)	0.87	0.88	0.90	1.04	FLAT	FLAT/DOWN

* Current as at 9.30am today; week ago as at Tuesday 5pm

Market Recap

NZ swap yields start the week a fraction lower, with the curve marginally flatter. Local yields spiked higher following the stronger Q3 +0.9% qoq (+1.9% yoy) CPI print, but this was largely unwound after the RBNZ estimate of core inflation was shown to be stable at 1.7% yoy. The major global equity indices were little changed compared to a week ago, but weaker than expected Chinese Q3 GDP and the low Chinese yuan triggered the pledge of more policy support by the Chinese government. This, and the prospect of the Australian Coalition going into minority government helped push Australian yields lower. Oil prices fell as the Saudi Arabian government pledged that the world's biggest oil exporter would not withhold oil supplies to counter any punishment over the killing of regime critic Jamal Khashoggi. By contrast, US swap yields were modestly higher across the curve. The Fed Minutes was interpreted as being more hawkish, with the path of interest rates to depend on the evolution of the economic outlook and were likely to continue to move up, irrespective of where US rates were relative to their neutral levels. Comments by various Fed speakers signalled further rate hikes lay ahead. Italian yields surged and spreads with German 10-year bonds widened to April 2013 highs following European Union warnings over the proposed government spending in the Italian Budget.

Near-term NZD interest rate outlook

We have a broadly neutral bias for domestic interest rates this week. In a light week for the domestic calendar, local yields will take direction from offshore. **The global risk profile is negatively skewed and we remain concerned over global growth prospects and various geopolitical and trade risks, which could trigger further curve flattening and bolster the demand for safe haven assets.** The impasse between the Italian Government and the European Commission over fiscal policy is yet to be resolved and while UK PM May believes that 95% of Brexit deal between the UK and European Union is done, considerable hurdles lie ahead. **For now, we note that NZ assets are interpreted as being in the 'safe-haven' camp,** with solid demand evident in last week's 2037 Government bond tender. Market odds are just under 90% in favour of a hike by the Bank of Canada this week. No change is expected from this week's policy decision by the ECB, with the signal key interest rates will be on hold until mid-2019, with asset purchases to be halted at the end of 2019. Q3 US GDP is expected to growth at a still-solid 3% annualised clip, keeping market odds tilted towards a December Fed rate hike and higher US yields.

Medium-term outlook

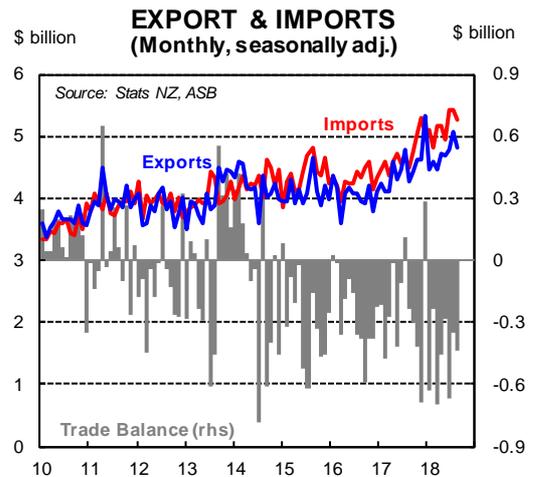
Given the cautious RBNZ assessment over the pace of NZ growth and due to our low CPI inflation outlook we expect the OCR to remain on hold until February 2020. If growth momentum slows and inflationary pressure fails to materialise, the OCR could be lowered to a new record low, but we still view the hurdle to OCR cuts as being high. We expect a historically-low OCR endpoint of just **2.75% this cycle** (from August 2021 onwards). **Modest RBNZ tightening and low global yields should limit the climb in longer-term NZD yields.**

ASB interest rate forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)				<< actual	forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50	2.75
NZ 90-day bank bill	1.88	2.0	2.0	1.9	1.9	2.0	2.3	2.7	3.0
NZ 2-year swap rate	2.21	2.2	2.1	2.0	2.1	2.2	2.5	3.0	3.2
NZ 10-year Bond	2.75	2.7	2.9	2.7	3.0	3.1	3.3	3.5	3.6

Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
Trade Balance, Sep, \$m	25/10	10.45 am	-1,484	-1,365	-1,300

We expect a \$1,300m trade deficit over September. This deficit follows on from the record deficit recorded last month. In part, recent deficits owe to rising oil prices. Indeed, we anticipate that import values will be strong, reflecting the 9% lift oil prices in NZD terms over the month. Meanwhile, export values will remain modest following the normal pattern of low agricultural production and export volumes at this point of the year. Looking at the annual balance, we expect the deficit to widen to \$4.9 billion.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
RBA Dep Gov Debelle at ISDA Annual Australian Conference	23/10	11:35 am	-	-
RBA Dep Gov Debelle at Sibos 2018 Conference, Sydney	23/10	4:00 pm	-	-
Australia CBA PMI surveys	24/10	11:00 am	-	-
Bank of Canada Interest Rate Announcement, %	25/10	3:00 am	1.75	1.75
ECB Interest Rate Announcement, %	26/10	12:45 am	0.0	0.0
Australia National Accounts, 2017/18	26/10	-	-	-
US GDP, Q3, saar	27/10	1:30 am	3.4	3.0

*Originally published by CBA Global Markets Research on Friday 19th October 2018 at 13.16pm.

The **Reserve Bank of Australia's Deputy Governor Debelle** is due to speak at the 2018 ISDA Annual Australian Conference in Sydney. Given the audience, the focus of the remarks are likely to be concentrated on the RBA's work on LIBOR benchmark rates rather than specific commentary around monetary policy and economic conditions.

Debelle is also due to appear on a panel at the Sibos 2018 Conference in Sydney. The theme of the conference is "Enabling the digital economy" and the panel topic is "FX market changes and the potential impact on correspondent banking" and will explore the FX Global Code that Debelle has been involved with. No monetary policy comments are likely.

Australia's CBA PMI surveys cover manufacturing and services, or close to 75% of the Australian economy. The flash PMIs access 80-85% of survey results.

The detailed release of **Australia's National Accounts** often contains large historical revisions to previous data. This could impact the next round of GDP data due 5 December. In the past there have been significant revisions to the savings ratio. The release also contains data on the capital stock.

The **Bank of Canada (BoC) is expected to raise the overnight rate** by 25bps to 1.75% at Thursday's meeting (80% priced-in by Canadian interest rate futures). Canada's economy is operating close to capacity and downside risks to the economy have been reduced following the new United States-Mexico-Canada Agreement (USMCA).

The **European Central Bank (ECB)** is widely expected to make no monetary policy changes at Thursday's meeting. Interest rates on the main refinancing operations, the marginal lending facility and the deposit facility will stay at 0.00%, 0.25% and -0.40%, respectively. The ECB will also signal again that it expects to keep key interest rates at their present levels "at least through the summer of 2019" and stop its asset purchases end-December 2018. It will be interesting to see if ECB President Draghi is more constructive on the Eurozone's inflation outlook during the post-meeting press conference.

The New York and Atlanta Fed's **Q3 US GDP** trackers average around 3% seasonally adjusted annualised rate. Growth in personal consumption spending was strong in Q3, particularly non-durable goods. But business investment seems to have stalled in Q3. And we estimate net exports will also detract modestly from GDP growth.

Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Previous	Forecast	
							Mkt	ASB
Tue 23 Oct	11:30	AU	ANZ Roy Morgan Cons Conf	Oct	Index	119.5	~	~
	11:35	AU	Remarks by RBA's Debelle in Sydney					
	16:00	AU	RBA's Bullock speaks on panel in Sydney					
	17:30	AU	RBA's Debelle speaks on panel in Sydney					
	18:30	JN	Nationwide department sales	Sep	y%ch	-0.2	~	~
	19:00	JN	Machine tool orders	Sep F	y%ch	2.8	~	~
Wed 24 Oct	11:00	AU	CBA Australia Flash PMI, Mfg	Oct	Index	54.0		
	11:00	AU	CBA Australia Flash PMI,	Oct	Index	52.2		
	13:00	AU	Skilled vacancies	Sep	m%ch	0.6	~	~
	18:00	JN	Leading index CI	Aug F	Index	104.4	~	~
Thu 25 Oct	10:45	NZ	Trade balance	Sep	NZD	-1,484	-1,365	-1,300
	12:50	JN	PPI services	Sep	y%ch	1.3	~	~
Fri 26 Oct	13:30	AU	Annual National Accounts 2017-18					
Sat 27 Oct	14:30	CH	Industrial Profits YoY	Sep	y%ch	9.2	~	~

*P = Preliminary

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Previous	Forecast	
							Mkt	ASB
Tue 23 Oct	14:30	US	Fed's Kashkari speaks at Early Childhood Development Event					
	15:00	US	Richmond Fed Manuf. Index	Oct	Index	29.0	25.0	~
	15:00	EC	Consumer confidence	Oct A	~	-2.9	~	~
	16:20	UK	Carney speaks at a Conference in Toronto					
Wed 24 Oct	09:00	EC	Markit Eurozone manuf. PMI	Oct P	Index	53.2	~	~
	14:45	US	Markit US manuf. PMI	Oct P	Index	55.6	55.5	~
	15:00	CA	Bank of Canada rate decision	Oct	%	1.50	1.75	1.75
	15:00	US	New home sales	Sep	000	629.0	628.0	~
	18:00	US	Atlanta Fed's Bostic speaks at Energy Summit in Baton Rouge					
	18:10	US	Fed's Mester speaks at Forecasters Club in New York					
	19:00	US	U.S. Federal Reserve Releases Beige Book					
Thu 25 Oct	12:45	EC	ECB Main refinancing rate	Oct	%	0.0	~	0.0
	13:30	US	Wholesale inventories	Sep P	m%ch	1.0	~	~
	13:30	US	Durable goods orders	Sep P	%	4.4	-0.8	~
	15:00	US	Pending home sales	Sep	m%ch	-1.8	-0.5	~
	16:00	US	Kansas City Fed manuf. activity	Oct	~	13.0	~	~
Fri 26 Oct	02:00	US	Fed's Mester speaks to Money Marketeters in New York					
	09:00	EC	ECB survey of professional forecasters					
	13:30	US	GDP annualized		q%ch	4.2	3.2	3.0
	15:00	US	Uni. of Michigan sentiment	Oct F	Index	99.0	98.6	~

Key Forecasts

ASB NZ economic forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
			<< actual	forecast >>					
GDP real - Q%	0.6	0.5	1.0	0.6	0.4				
GDP real - A%	2.9	2.6	2.8	2.8	2.5	2.7	3.1	3.1	2.9
GDP real - AA%	2.8	2.7	2.7	2.8	2.7	2.7	2.8	3.2	2.9
CPI - Q%	0.1	0.5	0.4	0.9	0.6				
CPI - A%	1.6	1.1	1.5	1.9	2.4	2.4	1.6	1.6	1.9
HLFS employment growth - Q%	0.4	0.6	0.5	0.4	0.3				
HLFS employment growth - A%	3.7	3.1	3.7	1.9	1.9	1.7	1.8	1.9	1.5
Unemployment rate - %sa	4.5	4.4	4.5	4.6	4.7	4.7	4.3	4.1	4.1
Annual current account balance as % of	-2.9	-3.0	-3.3	-3.2	-2.9	-2.2	-1.5	-1.6	-1.8

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	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)			<< actual	forecast >>					
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50	2.75
NZ 90-day bank bill	1.88	2.0	2.0	1.9	1.9	2.0	2.3	2.7	3.0
NZ 2-year swap rate	2.21	2.2	2.1	2.0	2.1	2.2	2.5	3.0	3.2
NZ 10-year Bond	2.75	2.7	2.9	2.7	3.0	3.1	3.3	3.5	3.6

ASB foreign exchange forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)			<< actual	forecast >>					
NZD/USD	0.71	0.72	0.67	0.66	0.65	0.66	0.68	0.70	0.66
NZD/AUD	0.91	0.94	0.92	0.92	0.90	0.90	0.91	0.90	0.90
NZD/JPY	80	77	74	75	73	74	73	75	74
NZD/EUR	0.59	0.59	0.58	0.57	0.58	0.58	0.55	0.55	0.54
NZD/GBP	0.53	0.51	0.52	0.51	0.52	0.53	0.53	0.54	0.51
NZD TWI	74.3	74.3	72.5	72.1	71.4	71.9	72.3	72.8	70.2

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