Economic Weekly

25 March 2019

Singing from the same song sheet

Last week provided mixed news for both the local and global economy. Firstly, Q4 GDP printed a touch better than expected, although at 2.3% annual growth economic activity is still sluggish. Moreover, indicators to date suggest that this sluggishness has continued into 2019. In contrast, the dairy auction earlier in the week was strong enough to warrant us to upgrade our 2018/19 milk price forecast by 35 cents.

Offshore, the Federal Reserve made a dovish interest rate announcement. That announcement, along with ongoing concerns about the global economy, sent global interest rate yields into a tailspin. NZ rates followed the moves lower, with 10-year Government bond yields dipping below 2% for the first time on record. **This week the RBNZ gets to chime in with its thoughts - we expect it will sing from the same song sheet as its global brethren in issuing a cautious statement.**

Key events and views

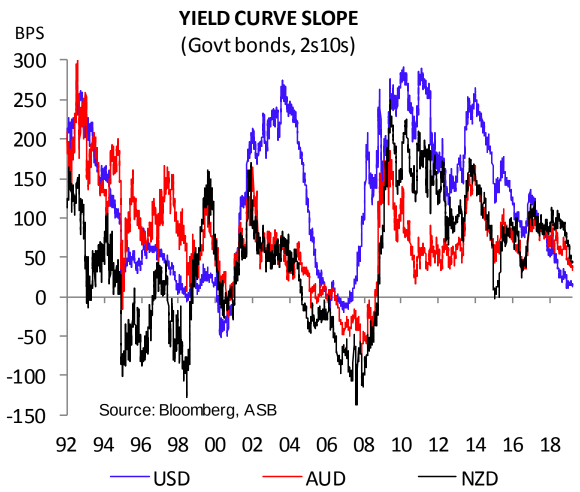
Foreign exchange	NZD rose against the USD following the Fed's dovish interest rate announcement.
Interest rates	Local and global yields fell last week, with many NZD yields at record lows.
Domestic events	Trade Balance, RBNZ Interest Rate announcement, Building Consents.
International events	RBA Assistant Governor Ellis speech, US PCE deflator, EU CPI.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: Falling flat

Over the weekend, a key US yield curve inverted as the 3-month Treasury yield exceeded the 10-year yield – for the first time in 12 years. Whilst still in positive territory, the much-watched spread between US 2-year and 10-year Treasury yields has also narrowed, sitting at just 12 bps (historical average: 122 bps).

Both New Zealand and Australian curves have flattened over the last few months, with long-term NZD yields touching record lows beyond the 4-year tenor, and with 10-year NZ bond yields currently yielding just 1.89%, a record low.

Inverting yield curves are typically a recessionary indicator. Prior to the Global Financial Crisis, yield curves inverted globally, preceding the slowdown. We have been warned.



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Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6872	0.6865	0.6775	0.7225	FLAT	0.6750	0.7000	UP
NZD/AUD	0.9709	0.9650	0.9548	0.9366	FLAT	0.9580	0.9820	FLAT
NZD/JPY	75.55	76.57	75.01	75.70	FLAT	74.10	77.10	UP
NZD/EUR	0.6084	0.6056	0.5974	0.5856	FLAT	0.5960	0.6210	FLAT
NZD/GBP	0.5199	0.5163	0.5197	0.5117	FLAT	0.5100	0.5310	UP
TWI	74.7	74.3	73.4	74.28	FLAT	73.5	75.5	UP

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

NZD Recap

The NZD/USD lifted over the week, spurred by the **weak USD** following **a cautious Federal Reserve statement** on Thursday morning. The Federal Reserve reiterated its 'patient' stance, revised lower its forecasts for US GDP growth and also lowered its guidance on the Fed Funds rate. The NZD received additional support on Wednesday and Thursday through a further lift in dairy prices (up 4% last week and up 20% over the year to date) and Q4 GDP rising in line with the economist median forecast (the market was likely positioned for a weaker GDP result). However, the USD weakness proved fleeting, with the USD rebounding Friday night and the NZD/USD falling back below 0.6900. Meanwhile, the **NZD outperformed the AUD** over the past week, breaking through 0.9700. The NZD was buoyed by strong NZ economic data (as above), while the AUD was weighed by commodity price declines. **Brexit uncertainty continues to weigh on GBP and drive bouts of elevated volatility.**

Near-term outlook

NZD direction will be led by the RBNZ OCR announcement on Wednesday, with scope for the RBNZ Governor to acknowledge that risks have shifted further to the downside. Meanwhile, the NZ-Australian 1-year interest rate spread (overnight index swap rates) points **to further NZD/AUD upside**. Despite the change in tone from the Federal Reserve and our view that the Fed tightening cycle is finished, we continue to see **limited USD downside** over the next 6 months, with the USD supported by relatively strong US GDP growth compared to other major economies.

GBP volatility will likely ease this week after the EU granted the U.K. a two-week unconditional time extension on the Brexit decision. U.K. Prime Minster Theresa May, has until 12 April to either (i) get her deal through; (ii) leave without a deal; (iii) or request a much longer time extension**.**

Medium-term outlook

We expect the NZD/USD to gradually strengthen given NZ's high Terms of Trade and continued investor interest in New Zealand assets. We expect the USD will hold some of its strength despite the market partially pricing in potential future Fed rate cuts. We have lifted our NZD/AUD forecasts and now expect the NZD/AUD to remain close to 0.96 over the next few years. We revised our AUD forecasts lower to reflect Australia's housing adjustment and the risk of slower growth in Australian household consumption. We have delayed the timing the EUR appreciation as Europe's economy has softened and we expect the ECB will now wait until the end of 2020 before raising interest rates.

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	0.68	0.68	0.70	0.72	0.74
NZD/AUD	0.92	0.95	0.96	0.96	0.96	0.96	0.97
NZD/JPY	75	74	75	76	77	78	80
NZD/EUR	0.57	0.59	0.60	0.60	0.59	0.59	0.60
NZD/GBP	0.51	0.53	0.55	0.54	0.54	0.55	0.57
NZD TWI	72.1	73.5	74.1	73.9	74.8	75.0	76.6

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	1.88	1.89	1.96	FLAT	UP
2-year swap	1.78	1.84	1.88	2.23	FLAT	UP
5-year swap	1.87	1.97	2.05	2.67	FLAT	UP
10-year swap	2.25	2.37	2.47	3.11	FLAT	UP
10-year govt bond yield	1.91	2.08	2.18	2.81	FLAT	UP
Curve Slope (2s10s swaps)	0.47	0.53	0.59	0.88	FLAT	DOWN

** Current as at 10am today; week ago as at Monday 5pm*

Market Recap

Local and global yields fell last week, with curves under flattening pressure. Increasing nervousness over the global outlook, the dovish Fed assessment (no 2019 hikes according to the March 'dot plots'), ongoing Brexit drama and weakening global data were catalysts that pushed longer-term yields lower. Spreads between US 10-year (2.44%) and 3-month Treasury yields turned negative for the first time since 2007, with 2-year Treasury yields only 12bp below 10-year counterparts. Australian 3-year bond yields fell below the RBA 1.50% cash rate for the first time in 2½ years, with Australian 10-year bond yields at record lows (1.76%). **Falls in NZD yields were more modest, likely supported by the solid +0.6% qoq NZ Q4 GDP print. Nevertheless, NZD swap yields beyond the 4-year tenor still hit record lows last week as did NZ 10-year Government bond yields (1.89%).** There was also strong demand evident for last week's tender of the NZ 2037 Government bond. The UK and European Union agreed to a 2-week extension to the Brexit date (April 12) that could be extended till at least May 22. Over the weekend, media reports of a UK leadership challenge were denied by senior Ministers. UK 10-year yields hovered around 2½ year lows and along with Eurozone yields, remained close to the bottom of recent trading ranges.

Near-term NZD interest rate outlook

We have a neutral bias for NZD interest rates. Our core macro view is that the OCR will not be cut, but with more than 20bps of cuts priced in by next March, we acknowledge the risk profile. This week we expect the tone of this week's RBNZ policy assessment to be dovish, likely acknowledging that the risk profile has shifted further downwards. Friday's speech by RBNZ Governor Orr ahead of the new NZ monetary policy framework coming into effect in April, including the move away from a single voter (the Governor) to a Monetary Policy Committee, is unlikely to have much of an impact on NZD rates. US core inflation is expected to remain close to 2%, likely keeping the Fed on the side lines and there are a number of speeches by Fed members that will likely emphasise the need to take a "patient" approach to rate settings. **We expect longer-term yields to hover around historical lows**. Concerns over slowing global growth should continue to dampen yields, particularly with the deadlock between the US and China on trade unlikely to be resolved soon. Forthcoming Brexit headlines may trigger volatility in global yields.

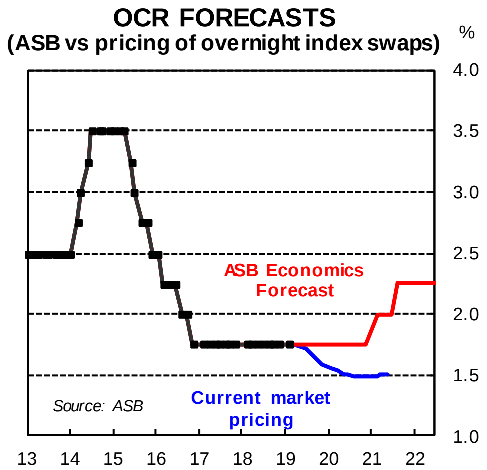
Medium-term outlook

We expect the OCR to remain on hold until February 2021, but acknowledge the risk of a 2019 cut if domestic growth and inflation disappoints or global prospects dim further. The Fed should remain "patient" and hold policy rates at 2.25-2.50%, with the Reserve Bank of Australia and European Central Bank expected to delay policy tightening. **A low OCR endpoint of just 2.25% is expected this cycle** (from late 2021), with proposed bank capital requirements expected to increase the wedge between borrowing rates and the OCR. NZD long-term yields are expected to drift higher, but mild RBNZ tightening and low NZ inflation should cap NZ yields at historically-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	2.00	2.25
NZ 90-day bank bill	1.91	1.97	1.9	2.0	2.0	2.3	2.5
NZ 2-year swap rate*	2.04	1.97	1.9	2.0	2.2	2.6	2.7
NZ 10-year Bond*	2.65	2.38	2.2	2.3	2.5	2.7	2.8

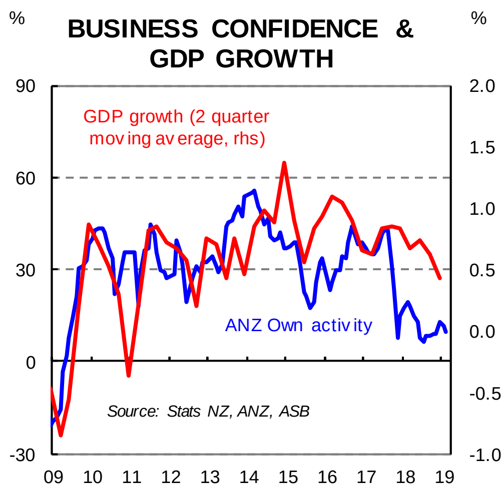
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
Trade Balance, Feb, $m	26/03	10:45 am	-914	-	0
RBNZ March OCR Review	27/03	2:00 pm	1.75%	1.75%	1.75%
ANZ Business Outlook, headline business confidence,	28/03	1:00 pm	-31	-	-
Building Consents, Feb, %	29/03	10:45 am	16.5	-	-



We expect a **flat trade balance (i.e. zero) in February**. Looking over the month, we expect a small fall in dairy export values, while we expect meat export values to rise in line with rebounding meat export volumes. At the same time, we expect softer import values over February as last month's strength was (in part) due to one-off items. Looking at the annual balance, **we expect the annual trade deficit to widen to $6.5 billion**.

A lot has gone on since the February Monetary Policy Statement was delivered just six weeks ago. Concerns over the health of the global economy have grown, global central banks have become more dovish, the tenor of domestic and global data has waned and the domestic mood is sombre following the terrorist attacks in Christchurch. At this time there is the clear need for government policy institutions to stay on message to provide continuity and reassurance**. As such, we expect the RBNZ to hold the Official Cash Rate at its 1.75% record low and pledge to maintain the OCR at expansionary levels for a considerable period (likely till 2021)**. While the RBNZ may acknowledge that risks have shifted further to the downside, the outlook remains reasonable. There is time for the RBNZ to wait and see how forthcoming data and events will unfold before moving the OCR. Our core view is that the RBNZ will hold the cash rate at 1.75% until early 2021, with the balance of risks tilting towards a lower OCR.



ANZ monthly business confidence and firms' own activity expectations fell in February, dashing hopes that business confidence would improve over early 2019. Furthermore, this weakness was led by the services sector, which is a key driver of NZ economic growth. The continued low level of business confidence in February suggests GDP growth may not pick up in Q1 2019 as we are expecting.

Residential dwelling consents have lifted strongly over the past few years and nationwide consents are at their highest levels since the mid-1970s. We believe house-building activity is likely to be close to a peak as the construction industry struggles with capacity constraints. Nonetheless, **we expect residential construction activity to remain at high levels over 2019 i**n order for housing supply to make up the shortfall which has emerged in recent years.

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
RBA Asst. Gov. Ellis speech	26/03	9:30 am	-	-
Australia Pvt. Sector Credit Growth, Feb, %mom	29/03	1:30 pm	0.2	0.2
Eurozone CPI, March, Headline, %yoy	29/03	10:00 pm	1.5	1.5
US PCE Deflator, January, Headline, %yoy	30/03	1:30 pm	1.4	1.4

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Reserve Bank of Australia Assistant Governor Ellis is slated to speak at the HIA March Industry Outlook Breakfast on Tuesday. There may be a housing market focus. Although, with the RBA having spoken a lot about housing recently, it's hard to think of what new information it could share. The central bank believes that the current housing downturn is being driven by the demand side, with the recent tightening in lending standards having a smaller impact. They find that the negative wealth effects for falling dwelling prices are small. Income growth is what matters most for consumption. But the longer the housing downturn goes on for, the more likely that falling house prices will weigh on consumption.

Australia's private sector credit growth has slowed over the past year. The downturn was driven by a decline in investor credit growth although more recently owner-occupier credit growth has been falling too. Personal credit growth has fallen further into negative territory with negative wealth effects from falling house prices contributing. Business credit growth has lifted which is a positive sign for business investment. We are expecting another soft 0.2% outcome for February.

We estimate a steep 5% decrease in **US** fuel prices will push the **headline Personal Consumption and Expenditure (PCE) deflator** down to 1.4% yoy. However, the already-released core CPI suggests the core PCE deflator remained at 1.9% yoy, close to the Federal Reserve's 2% yoy target.

In the **Eurozone**, the focus is on the preliminary **March CPI** report. Headline and core CPI inflation will likely remain muted around 1.5% yoy and 1.0% yoy in March, respectively. Softer economic activity and easing inflation expectations continue to contain price pressures. The European Central bank projects headline and core CPI inflation of 1.2% for 2019.

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	0.6	0.6				
GDP real - A%	2.6	2.3	2.4	2.2	3.2	3.0	2.9
GDP real - AA%	3.1	2.8	2.6	2.4	2.8	3.2	3.0
CPI - Q%	0.9	0.1	0.1	0.6			
CPI - A%	1.9	1.9	1.5	1.7	2.0	1.8	1.8
HLFS employment growth - Q%	1.1	0.1	0.7	0.4			
HLFS employment growth - A%	2.8	2.3	2.4	2.2	1.7	1.6	1.5
Unemployment rate - %sa	4.0	4.3	4.2	4.3	4.2	4.1	4.1
Annual current account balance as % of GDP	-3.6	-3.7	-3.5	-3.6	-3.7	-3.6	-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

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NZD/AUD	0.92	0.95	0.96	0.96	0.96	0.96	0.97
NZD/JPY	75	74	75	76	77	78	80
NZD/EUR	0.57	0.59	0.60	0.60	0.59	0.59	0.60
NZD/GBP	0.51	0.53	0.55	0.54	0.54	0.55	0.57
NZD TWI	72.1	73.5	74.1	73.9	74.8	75.0	76.6

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