Economic Weekly

27 May 2019

Record Lowe's

New Zealand interest rates touched record lows last week. Catalysts were global, with global equities down as trade tensions between the US and China ratcheted up. RBA Governor Philip Lowe stated that, "at our meeting in two weeks' time, we will consider the case for lower interest rates." Our CBA colleagues now expect the RBA to cut the 1.50% cash rate by 50bps over 2019 (June and August). The US Federal Reserve is also expected to start cutting the 2.25-2.5% Federal Funds rate from later this year. We still expect a further cut to the 1.50% OCR later this year.

This week we will be looking for signs of a lift in domestic business confidence in the May Business Outlook. We don't envisage that the RBNZ will announce any changes to the loan-to-value restrictions at Wednesday's Financial Stability Report**. Budget 2019 is expected to be prudent with the Government operating well within its self-imposed fiscal parameters**, albeit with a smaller margin of fiscal headroom. Markets will remain sensitive to global trade headlines.

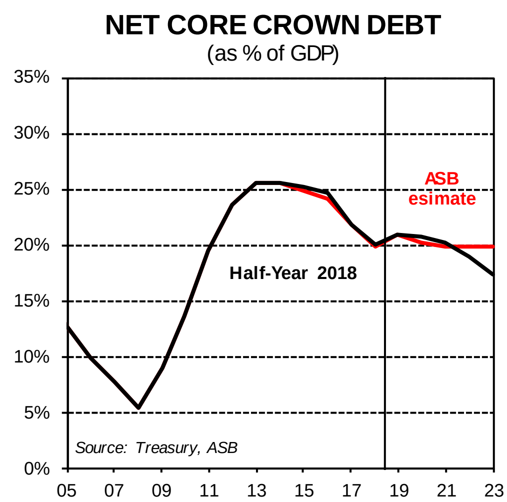
Key events and views

Chart of the Week: Moving target

We support the Minister of Finance's announcement last week that the Government plans to shift its debt target from a cap to a range. Indeed, moving to a more flexible 15%-25% of GDP net debt target from 2021/22 **still would leave NZ's public finances the envy of most OECD economies.**

Moreover, **the use of a range instead of a cap makes practical sense.** The range would allow government debt to fluctuate above and below the midpoint of the target range in line with the natural ebb and flow of the economy. And from an economic significance point of view, net government debt at a few percent either side of 20% of GDP is neither here nor there.

However, **the move should not be seen as a free lunch for politicians with policy agendas**. This and future governments still need to ensure that the onus is on maintaining the quality and impact of any proposed spending and investment initiatives.



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6553	0.6535	0.6642	0.6920	FLAT	0.6450	0.6650	UP
NZD/AUD	0.9456	0.9441	0.9455	0.9147	FLAT	0.9360	0.9560	UP
NZD/JPY	71.65	72.02	74.15	75.79	FLAT	70.70	72.60	UP
NZD/EUR	0.5846	0.5859	0.5963	0.5909	FLAT	0.5750	0.5950	UP
NZD/GBP	0.5151	0.5132	0.5147	0.5176	FLAT	0.5050	0.5250	UP
TWI	72.4	72.1	72.6	72.60	FLAT	71.00	74.00	UP

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

NZD Recap

The **NZD** edged lower over the first half of the week, led by a weaker **AUD** and soft global investor sentiment as US-China trade tensions and global growth concerns lingered. The **AUD** fell on Tuesday (taking the NZD/USD with it) after the Reserve Bank of Australia (RBA) moved to an explicit easing bias. ASB now expects the RBA to cut its 1.50% cash rate by 50bps over 2019 (June and August). The NZD was dampened by lower milk prices at the latest Global Dairy Trade auction and a weaker-than-expected forecast milk price range from Fonterra for both the 2018/19 and the 2019/20 seasons. Profit-taking and weaker US data saw the NZD/USD and AUD/USD lift later in the week. The **GBP** remained heavy throughout most of the week, weighed by Brexit uncertainty. UK Prime Minister May bowed to growing pressure to resign, announcing she would step down as leader of the 7th of June and remain as acting PM until a new replacement had been appointed. The GBP lifted on the news.

Near-term outlook

The **USD w**ill remain supported this week (on safe-haven investment flows), and the NZD/USD is likely to remain under pressure amid elevated trade tensions and global growth concerns. The Reserve Bank of NZ (RBNZ) releases its Financial Stability Report (Wednesday) and the NZ Government releases its Budget (Thursday). While both releases are likely to be closely scrutinised, consequences for NZD are limited. However, **NZD** could lift briefly on Wednesday, as we expect monthly ANZ business confidence to lift in May following the decision by the Government to rule out a capital gains tax. We expect the GBP will ultimately be weighed by political uncertainty as the risk of a disorderly hard Brexit has increased as the new Conservative leader may favour a no deal/hard Brexit.

Medium-term outlook

We have **recently updated our FX forecasts** reflecting our change in central bank forecasts, with the RBNZ and RBA cutting cash rates over 2019, and the Federal Reserve likely to be cutting the Fed funds rate from late 2019. The **NZD** is expected to soften in the near term, weighed by a lower OCR, weaker global growth and elevated trade tensions. However, we expect the NZD to remain supported over the medium term, firming against most crosses from late 2019 onwards. The **NZD/USD** will be supported by NZ's high Terms of Trade and a weaker USD led by interest rate cuts from the FOMC over 2020. We expect the NZD/AUD to remain close to 0.94 over 2019 and to subsequently firm.

ASB foreign exchange forecasts	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.67	0.68	0.65	0.64	0.68	0.69	0.72	0.73
NZD/AUD	0.95	0.96	0.94	0.94	0.94	0.95	0.96	0.97
NZD/JPY	74	75	72	71	74	75	78	79
NZD/EUR	0.59	0.60	0.58	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.53	0.52	0.52	0.50	0.53	0.53	0.55	0.56
NZD TWI	73.5	73.9	71.3	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	1.50	1.50	1.75	1.75	UNCH/DOWN	UP
90-day bank bill	1.71	1.71	1.78	1.99	UNCH/DOWN	UP
2-year swap	1.49	1.56	1.64	2.20	UNCH/DOWN	UP
5-year swap	1.60	1.68	1.78	2.66	UNCH/DOWN	UP
10-year swap	1.98	2.08	2.21	3.16	UNCH/DOWN	UP
10-year govt bond yield	1.73	1.81	1.90	2.75	UNCH	UP
Curve Slope (2s10s swaps)	0.49	0.52	0.57	0.96	UNCH	UNCH/UP

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

Market Recap

Global and NZD yields continued to grind lower, with curves under flattening pressure. Yields on the 1- to 10-year part of the NZ swap curve fell to record lows, with yields out to (and including) the 10-year tenor below 2%. NZ Government bond yields were also lower (10Y 1.72%), with solid demand from last week's tender. Australian yields fell and pricing for a June RBA rate cut moved above 90% after RBA Governor Lowe stated "at our meeting in two weeks' time, we will consider the case for lower interest rates." **Our CBA colleagues have shifted their RBA call, and now expect 25bp cuts to the 1.50% cash rate in June and August. Weaker US data and concerns over trade weighed on global yields.** The Trump administration was reportedly considering further sanctions on Chinese technology firms and hiking tariffs, while the Chinese government is reportedly considering counter-measures. US 10-year Treasury yields (2.31%) touched October 2017 lows but firmed at the end of the week on profit taking. The Fed minutes signalled no hurry to move US rates, but markets think otherwise. **We have changed our Fed call and now expect 100bps of cuts from late 2019. It is back to square one for Brexit**. Theresa May announced she will step down as party leader on June 7, and will remain as UK Prime Minister until a new successor is found.

Near-term NZD interest rate outlook

We have kept our modest downward bias on NZ yields over the next few months given our RBA and RBNZ views. An improvement in domestic business confidence from the ANZ survey could see yields tick higher. We expect little reaction from the RBNZ Financial Stability Report. **We expect a fiscally-responsible NZ Budget, which should cap NZD yields.** The weaker NZ economic outlook will likely show a slightly less impressive set of fiscal accounts, but modest revisions are expected, with little change to the NZ Government bond tender. **Global long-term yields are expected to remain sensitive to trade headlines and signals on global growth and could dampen further if concerns over global growth escalate.** UK political and Brexit headlines, US inflation data, repercussions from last week's European Elections, the Bank of Canada rates decision could contribute to volatility this week.

Medium-term outlook

Moves by the RBNZ will depend on the tenor of domestic data, the NZD, global scene and actions of other central banks. **We have pencilled in a 25bp OCR cut in August.** The OCR is then expected to remain at 1.25% until early 2022, before gradually drifting towards its 2.25% cyclical peak by late 2023. **Global central banks are expected to trim policy rates, and we expect 50bps of cuts from the 1.50% RBA cash rate over 2019.** In response to low inflation and to provide 'insurance', **the Federal Open Market Committee is expected to cut the 2.25-2.5% Federal Funds rate by around 100bps from late 2019**. **Global long-term interest rates are expected to remain historically-low.** NZD long-term yields are biased to drift higher, before eventually settling at around 2.5-3.0%, a historically-low endpoint.

ASB interest rate forecasts	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>					
NZ OCR	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.50
NZ 90-day bank bill	1.97	1.9	1.7	1.5	1.5	1.5	1.5	1.8
NZ 2-year swap rate*	1.97	1.6	1.6	1.5	1.5	1.5	1.6	1.9
NZ 10-year Bond*	2.38	1.8	1.8	1.8	1.8	1.8	2.1	2.4

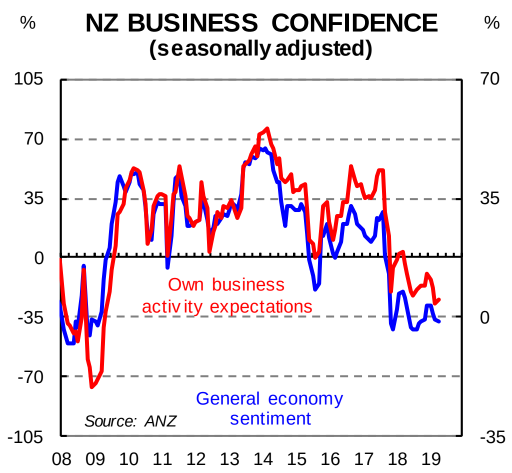
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
RBNZ Financial Stability Report	29/05	9:00 am	-	-	-
ANZ Business Outlook, Own Activity, May, net %	29/05	10:45 am	7.1	-	
Building Consents, residential, April, mom %	30/05	1:00 pm	-6.9	-	-
Budget Operating Balance (OBEGAL) 2018/19 f/c, % GDP	30/05	2:00 pm	1.9	-	0.8

The **RBNZ's Financial Stability Report** (FSR) releases are often a platform for changes to the RBNZ's loan-to-value ratio restrictions (LVRs). Despite the soft Auckland housing market, we **don't expect any changes to the LVR restrictions to be announced,** given the RBNZ last relaxed the restrictions at the start of the year and it also cut the OCR in May. Outside of Auckland and Canterbury the housing market is reasonably robust and credit growth has stabilised, but there seems little likelihood of the RBNZ tightening the restrictions in the current juncture.

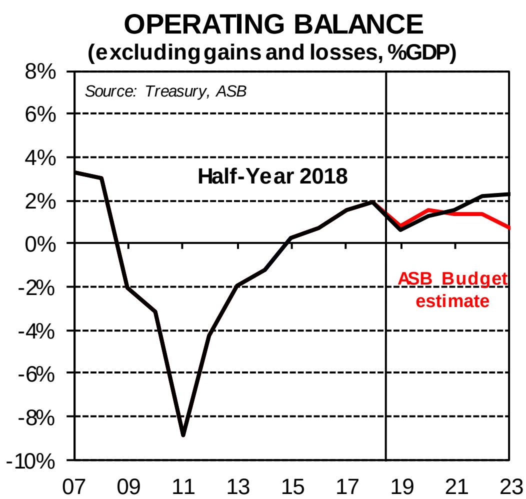
Housing and agriculture risks will remain at the forefront of the RBNZ's financial stability watch-list, though we would expect the RBNZ's view is that the risks have continued to reduce. Auckland dwelling prices are gradually easing and now look less stretched relative to incomes. Despite the solid outlook for producer incomes, agriculture lending growth has remained muted, particularly for dairy. The RBNZ's description of the financial system will be of more interest than usual. Given the RBNZ's assessment that locally-incorporated banks need to substantially increase their capital holdings, **will the financial system still be viewed as "sound"?**

ANZ monthly business confidence and firms' own activity expectations remained weak in the early months of 2019. Uncertainty around the Tax Working Group recommendations may have contributed to weaker confidence in the March and April surveys, and we may see a small lift in confidence in the May survey.



Residential building consents eased back in March following a number of strong months. We expect residential construction activity to remain at high levels over 2019, so that housing supply can make up the shortfall which has emerged in recent years. Meanwhile, there are no signs of a slowdown in commercial construction issuance despite weak business confidence levels seen over the past year.

We expect a second prudent Budget from the Minister of Finance, Grant Robertson. Mr Robertson continues to point out that this Government will operate within its self-imposed fiscal parameters this term. As a result, we expect Budget 2019 to show small operating surpluses, a largely flat net debt profile, mixed in with modest spending and investment increases where fiscal headroom permits.



However, **the slowing economy may have crimped that fiscal headroom somewhat compared to the 2018 Half-Year Update**. Indeed, we anticipate that the Treasury will revise down its economic growth forecasts over much of the forecast horizon. Since the 2018 Half-Year Update, we have revised down our own annual growth forecasts by an average of 0.5 percentage points through to 2022.

Budget 2019 will also reveal more of the Government's thinking and policy priorities under its new Wellbeing Budget framework. Specifically, the Wellbeing Budget document will contain a discussion of the wellbeing approach and outlook plus how the framework guided the setting of policy priorities and the subsequent spending and investments.

Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Australia Capital Expenditure Survey, Q1, %qoq	30/05	1:30 pm	0.5	-0.7
Australia Building Approvals, April, %mom	30/05	1:30 pm	0.0	0.0
Bank of Canada Interest Rate Announcement, %	30/05	2:00 am	1.75	1.75
Australia Private Sector Credit, April, %mom	31/05	1:30 pm	0.3	0.3
US PCE Deflator, April, %yoy	01/06	12:30 am	0.6	1.7

**Originally published by CBA Global Markets Research on Friday 24th May at 2:13 pm.*

We expect **Australia's** actual **volume of capex spending** to fall by 0.7% in Q1 after a solid 2.0% lift last quarter. Such an outcome would see the annual rate of growth dip to 0.3%. The 1st estimate of 2019/20 spending plans came in at $92.1bn three months ago. This was a strong number and the result implied a solid lift in mining capex and a smaller lift on the non-mining side. We consider a 2nd estimate that comes in larger than $98.5 as an upgrade to the 1st estimate and a good result. Less than $98.5bn would be a downgrade.

Australian building approvals have been even more volatile than usual lately (up 19.1% in February and down 15.5% in March). The trend series, however, has been running flat over the past few months. As such, we have pencilled in a flat outcome over April.

Total **credit growth in Australia** continues to edge lower. The slowdown has been driven by weakening housing credit growth and an acceleration in the decline of personal credit stock. Business credit growth remains decent, which will support the ongoing lift in non-mining capex.

The **Bank of Canada (BoC) is expected to leave the target overnight rate at 1.75%** and reiterate its neutral bias. In April, the BoC adopted a more explicit neutral bias. The central bank removed the sentence that there was "increased uncertainty about the timing of future rate increases" and instead noted "we will continue to evaluate the appropriate degree of monetary policy accommodation as new data arrive." Our base case scenario remains for the BoC to keep rates at 1.75% over our forecast horizon.

We estimate that the 7% increase in **US** gasoline prices will have lifted headline **Personal Consumption Expenditure** (PCE) **inflation** to 1.7%yoy in April. Already-released data suggest that US core PCE will tick higher to 1.7%yoy. However, this is below the Fed's 2% target and will likely see the Fed reaffirm their "patient" stance as a result.

Key Forecasts

ASB NZ economic forecasts	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
	<< actual	forecast >>						
GDP real - Q%	0.6	0.4	0.9					
GDP real - A%	2.3	2.2	2.2	2.7	2.9	3.1	2.4	2.4
GDP real - AA%	2.8	2.6	2.3	2.4	2.5	2.7	2.6	2.4
CPI - Q%	0.1	0.1	0.7	0.7				
CPI - A%	1.9	1.5	1.8	1.6	1.8	1.9	1.7	1.8
HLFS employment growth - Q%	0.0	-0.2	0.4					
HLFS employment growth - A%	2.3	1.5	1.3	0.8	1.2	1.8	1.6	1.4
Unemployment rate - %sa	4.3	4.2	4.3	4.3	4.3	4.3	4.2	4.1
Annual current account balance as % of GDP	-3.7	-3.3	-2.9	-2.7	-2.3	-2.2	-2.0	-1.7

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-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>					
NZ OCR	1.75	1.75	1.50	1.25	1.25	1.25	1.25	1.50
NZ 90-day bank bill	1.97	1.9	1.7	1.5	1.5	1.5	1.5	1.8
NZ 2-year swap rate*	1.97	1.6	1.6	1.5	1.5	1.5	1.6	1.9
NZ 10-year Bond*	2.38	1.8	1.8	1.8	1.8	1.8	2.1	2.4

ASB foreign exchange forecasts	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22
(end of quarter)		<< actual	forecast >>					
NZD/USD	0.67	0.68	0.65	0.64	0.68	0.69	0.72	0.73
NZD/AUD	0.95	0.96	0.94	0.94	0.94	0.95	0.96	0.97
NZD/JPY	74	75	72	71	74	75	78	79
NZD/EUR	0.59	0.60	0.58	0.57	0.58	0.58	0.59	0.59
NZD/GBP	0.53	0.52	0.52	0.50	0.53	0.53	0.55	0.56
NZD TWI	73.5	73.9	71.3	70.2	72.7	73.1	75.1	75.8

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