Economic Weekly

31 August 2020

Who borrows wins

For all the pointy-headed chatter about RBNZ quantitative easing, negative policy rates, direct financing of banks and so on, we're cognisant the average punter is probably wondering what it all might mean for them, should it all go ahead. Last week, we provided our take on a couple of the upshots.

First, our forecasts for term deposit rates and mortgage rates have been slashed. We think that an RBNZ scheme to lower the OCR below zero and lend directly to banks, if introduced, would heap downward pressure onto term deposit rates. This is especially so now that the banks' minimum core funding ratio has been lowered to 50% from 75%. Cheaper bank funding costs (TDs account for around 60% of bank funding) would flow through to lower mortgage and business lending rates. They're already at rock-bottom levels, but we see further downside. Our Senior Wealth Economist released his latest forecasts this morning. In short, we think term deposit rates could fall below 1% with mortgage rates for some terms below 2%.

Second, the promise of extremely low interest rates for years to come will continue to boost asset prices. Our previous forecast for a 6% fall in NZ house prices (itself one of the least pessimistic around) was upgraded last week to 'just' a 3% fall. Global equity markets also remain on a tear as investors factor in a permanently lower discount rate. Of note, the NZX 50 hit a fresh record high on Friday.

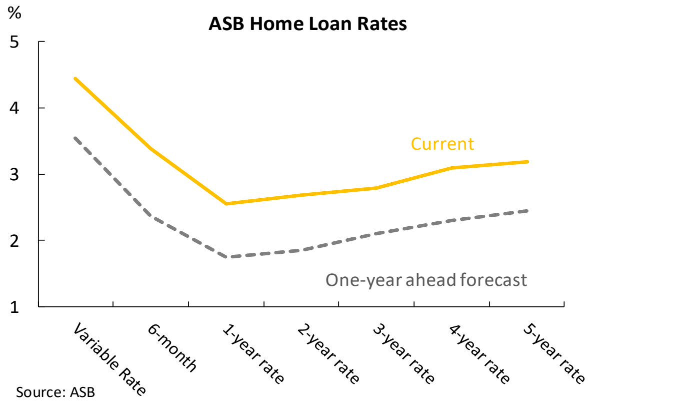
It's worth remembering that all of this is exactly what the Reserve Bank is trying to engineer as it tries to reflate the economy. Boosting asset prices, encouraging debt accumulation, and the associated increase in inequality are unfortunate side-effects of the way easy monetary policy works. We can at least take comfort that we're not alone. The US Federal Reserve's commitment last week to allow inflation and employment to run hotter for longer, by keeping interest rates lower for longer than it might have in past cycles, promises to underpin all of these trends for some time to come. Where it all ends is anyone's guess. At least us Aucklanders get to leave the house this week.

mike.jones@asb.co.nz

Recent key economics

ASB Economic forecasts and monitoring:
ASB COVID-19 Chart pack
Home Economics
Financial market trends:
Corporate Hedging Toolbox
Policy response:
RBNZ August MPS Review
Assessing the RBNZ's bag 'o' tricks
For COVID-19 research, see here

Chart of the week



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.6736	0.6530	0.6703	0.6299	FLAT/UP	0.6580	0.6880
NZD/AUD	0.9150	0.9114	0.9287	0.9375	FLAT	0.9000	0.9300
NZD/JPY	71.02	69.12	69.90	67.01	FLAT/UP	69.30	72.80
NZD/EUR	0.5656	0.5536	0.5635	0.5702	FLAT/UP	0.5520	0.5810
NZD/GBP	0.5045	0.4989	0.5105	0.5169	FLAT/UP	0.4920	0.5180
TWI	72.4	70.8	72.6	70.46	FLAT/UP	N/A	N/A

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

NZD Recap

The NZD is up against all the major crosses over the week, although gains against the AUD were slight. The lift comes against a backdrop of relatively buoyant global investor sentiment which also saw equities lift and interest rates climb higher. Global investor sentiment has been buoyed by the combination of massive policy stimulus, strong US economic data, diffusing trade tensions, and the hopes that a vaccine for COVID-19 will be developed.

The Federal Reserve announced a major shift in policy direction, saying it will switch to "average inflation targeting". This more flexible and symmetrical approach will allow inflation to run "moderately" above the Fed's 2% goal "for some time" following periods when it has run below that objective (like it has done at present) so as to support the labour market and broader economy. The USD initially slumped after the announcement, with the NZD/USD rally continuing through the weekend.

Outlook

The direction of global risk sentiment is expected to be a key barometer for future NZD direction. We expect US economic data to remain positive this week, supported by the decline in rates of new US COVID-19 infections. Continued positive global investor sentiment is likely to continue to weigh on the USD and support both the NZD/USD and AUD/USD. The NZD may receive some additional support early in the week from foreign buying ahead of the 1 September settlement of the $NZ4bn New Zealand government bond. New Zealand's Debt Management Office indicated foreign investors (excluding Australia) bought 48% of the bonds. Wednesday is shaping up to be a potentially volatile day, particularly for the NZD/AUD, with the GlobalDairyTrade auction taking place Tuesday night/Wednesday morning, NZ Q2 Terms of Trade released at 10.45 am and – most importantly – Australian Q2 GDP released at 1:45pm NZT.

We have recently updated our medium-term FX forecasts to reflect a weaker USD view, reflecting an expectation that the US current account deficit will widen, and the US Terms of Trade will decrease. However, NZD-specific factors are expected to limit NZD upside, particularly as the RBNZ is about to embark on a much more aggressive monetary easing campaign than many of its offshore peers. Although the RBNZ appears keen to cut the OCR into negative territory, the RBA remains reluctant, and we expect a widening interest rates differential will continue to weigh on the NZD/AUD

jane.turner@asb.co.nz

ASB foreign exchange forecasts	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Mar-22	Mar-23
(end of quarter)	<< actual	forecast >>					
NZD/USD	0.64	0.66	0.67	0.67	0.66	0.66	0.66
NZD/AUD	0.93	0.90	0.89	0.88	0.86	0.85	0.86
NZD/JPY	69	70	71	70	69	69	69
NZD/EUR	0.57	0.54	0.54	0.54	0.53	0.52	0.53
NZD/GBP	0.52	0.50	0.50	0.49	0.49	0.49	0.49
NZD/CNY	4.5	4.6	4.6	4.6	4.5	4.4	4.4
NZD TWI	71.4	69.6	70.0	69.5	68.0	67.5	67.7

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	0.25	0.25	0.25	1.00	UNCH/DOWN	UP
90-day bank bill	0.28	0.28	0.30	1.19	UNCH/DOWN	UP
2-year swap	0.08	0.09	0.19	1.01	UNCH/DOWN	UP
5-year swap	0.20	0.14	0.28	0.98	UNCH/DOWN	UP
10-year swap	0.61	0.49	0.63	1.27	UNCH/DOWN	UP
10-year govt bond yield	0.62	0.58	0.75	1.07	UNCH/DOWN	UP
Curve Slope (2s10s swaps)	0.54	0.40	0.44	0.26	UNCH	DOWN

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

Market Recap

NZ short-term yields start the week little changed and around record lows, with longer-term NZ yields joining the global march higher. Triggering the drift up in longer-term yields was the unveiling of the US Federal Reserve's monetary policy strategy, including a more flexible inflation targeting regime. Markets have perceived the changes as cementing in low US policy rates for a prolonged period, whereas the willingness of the Fed to tolerate higher Inflation pushed long-term global yields higher, with US10-year Treasury yields touching 2-month highs (0.75%) towards the end of last week. Also helping to push global yields higher were surging equity markets, with the MSCI global index touching a record high at the end of last week.

Strong demand has helped to limit increases for NZ Government bonds, with a marked narrowing in swap spreads and with NZ longer-term yields below US and Australian counterparts. The syndication of the 2027 NZ Government bond attracted close to $18bn in bids, with $4bn issued, with NZ yields also dampened by $1,316m in RBNZ government bond purchases (the highest in 3 months).

Near-term interest rate outlook

The prospect of a negative OCR should maintain downward pressure on short-term NZ yields. This week's data – including partial inputs for NZ GDP, Q2 Australian GDP (our CBA colleagues expect a 6% Q2 contraction) and August Non-farm Payrolls (mkt: 1,275k) is unlikely to significantly impact yields. Tomorrow's RBA decision is not expected to signal a shift in policy direction, with little impact on NZ yields.

NZ longer-term yields will take their cues from global catalysts, with the direction of global equities an important barometer. The $1.35bn in NZ government bond purchases signalled from the RBNZ this week will outpace the $950m in weekly tenders. Cumulative RBNZ purchases ($27.2bn to date) are well under the $100bn LSAP cap and comfortably below Crown indemnity thresholds, providing plenty of scope for the RBNZ to front-load asset purchases over the next few months, helping to flatten the NZ yield curve and depress NZ yields.

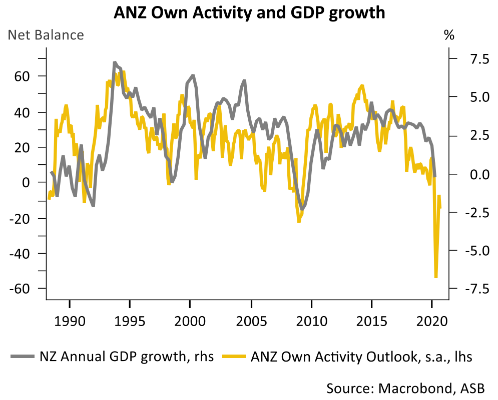
The growing NZ Government Bond market (around $105bn of NZ bonds on issue) could prompt its inclusion in global bond funds, bolstering the demand for NZ Government bonds. Index provider FTSE Russell announced last week NZ government bonds fit their market size for index inclusion, with a final announcement expected on 24 September.

Medium-term outlook

Providing operational hurdles are cleared and the RBNZ sticks to its forward guidance, we expect to see the RBNZ cut the OCR to -0.50% by early 2021 (most likely April) and for a Funding for Lending Programme to be introduced at this time. Prior to then we expect the RBNZ to front-load asset purchases and employ forward guidance to dampen yields. Low global inflation and subdued global growth prospects should keep NZ yields low and the curve reasonably flat despite high public debt issuance. mark.smith4@asb.co.nz

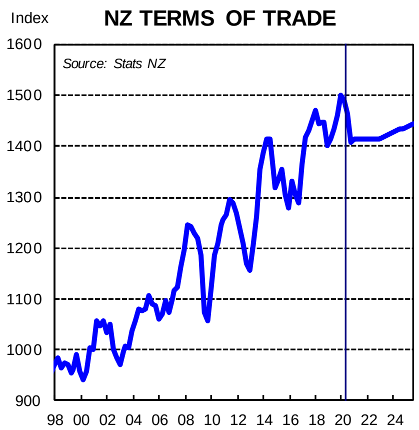
Domestic events

Data	Date	Time (NZT)	Market	ASB
ANZ Business Outlook, own activity next 12 mths, Aug (f)	31/8	1:00pm	-	down
NZ Building Consents, Residential, July, %mom	01/09	10:45am	-	-
Terms of Trade, % qoq, Q2	02/09	10.45 am	-	-1.7
Building Work Put In Place, Q2, % qoq	4/09	10:45am	-	-30



We expect business confidence to fall in August, as a result of the unexpected re-emergence of COVID-19 in NZ. Prior to the latest virus outbreak, **business confidence had started to edge lower from early-July highs. The preliminary August data were** released on Monday August 10th and included responses up to the 8th of August. NZ learnt of the latest COVID outbreak the next day. The results collected over the second half of August should capture most of the response to the outbreak, although some survey responses may still have been filled in prior to the outbreak knowledge (i.e. those filled in online between the 9th and 11th or those mailed in). ANZ may choose to report the results split between those received before the outbreak and those received after.

Residential building consent numbers were flat in June after staging a strong recovery in May - residential building consents issuance has largely recovered its lockdown-induced slump. The key question going forward is how long NZ's housing construction demand will hold up. We have been surprised by the resilience of the NZ economy, with economic and housing demand stronger than expected during the middle of the year as NZ largely returned to business as normal under Level 1. While the re-emergence of COVID may dent confidence somewhat, we have revised our construction forecasts to reflect housing construction demand holding up over the second half of the year.



We expect data to show that NZ's goods Terms of Trade (ToT) fell 1.7% in the June quarter, adding to the previous quarter's 0.7% decline. Nonetheless, NZ's Terms of Trade remain elevated at very high levels. Over Q2 we forecast NZ export prices fell 1.5%, while import prices lifted 0.3%. Already-released monthly trade data suggest export prices received for many of NZ's key exports fell over Q2, including dairy, meat and forestry. Meanwhile, we expect import prices largely stabilised, particularly as oil prices made some recovery over Q2.

We have assumed the volume of building work put in place fell 30% over Q2, as a result of the COVID-19 outbreak and the Alert Level restrictions on activity. Under Alert Level 4 only essential construction activity could take place. Concrete sales fell 23% over Q2, which suggests our assumption may be too severe – its possible more activity was able to be completed during Alert Level 3 and 2 than we had assumed. We had assumed that social distancing requirements would be a material constraint on construction productivity.

Major International Events for the week ahead*

Data	Date	Time (NZT)	ASB
Australia Private Sector Credit, July, %mom	31/08	1:30 pm	-0.2
Australia Current Account Surplus, Q2, AUD$bn	01/09	1:30 pm	13.4
RBA Interest Rate Announcement, %	01/09	4:30 pm	0.25
Eurozone CPI, August, %yoy	01/09	9:00 pm	-
Australia GDP, Q2, %qoq	02/09	1:30 pm	-0.6
US ISM Manufacturing Index, August, points	02/09	2:00 am	-
Australia Trade Balance, July, AUD$bn	03/09	1:30 pm	3.8
US Non-farm Payrolls, August, Unemployment Rate, %	04/09	12:30 am	9.9

**Originally published by CBA Global Markets Research on Friday 28 August at 3:26 pm*

Australia's private sector credit is likely to fall 0.2% in July. Looking ahead we expect credit growth to trend broadly sideways in 2020/21. Housing credit is expected to remain positive. But business credit is likely to fall as the business sector adopts a deleveraging mindset and investment falls, which can be expected during a big economic downturn.

Australia's current account is likely to record a fifth consecutive quarterly surplus in Q2. We are forecasting a $A13.4bn current account surplus (around 2.8% of GDP) driven by another large trade surplus in the quarter. Both exports and imports have fallen in the quarter with services trade hit hard by border closures. But the fall has been larger for imports.

We do not expect the Reserve Bank of Australia (RBA) to take any policy action at its September meeting; we see the cash rate remaining at 0.25% for the next three years at least. The main shift from the RBA has been in forecasting a slower recovery in 2021. We will be watching closely to see how its view on the economic outlook changes as Q2 becomes clearer ahead of GDP.

We expect **Australia's GDP** to show a large contraction over Q2. Coronavirus restrictions were in place to varying degrees during the quarter and have had a huge impact on private sector activity. Household spending, business investment and dwelling investment will show solid falls in the quarter. There may be some offset from stronger public sector spending. We also expect a solid 1.2ppt contribution from net exports in the quarter.

Australia's ABS preliminary merchandise trade report for July indicated that goods imports surged by 11% and exports eased by 6%. Sharp recoveries for petroleum (+15%) and road vehicles (+49%) drove imports higher over July. The value of goods exported in July declined as exports of iron ore cooled from the record high values of June. We expect the trade balance to ease to $A3.8bn in July as exports ease and imports strengthen.

Headline Eurozone CPI inflation quickened in July at an annual pace of 0.4%. The ECB's base case scenario is for headline CPI inflation to average 0.3% in 2020 because of the significant increase in economic slack and the indirect effects of the steep fall in oil prices.

Already-released **US** regional surveys were mixed in August. But, on balance, the surveys suggest a modest improvement in the **ISM manufacturing index** in August. In July, employment was the only sub-category that remained below 50pts. Another below-50 reading in August will suggest that confidence remains subdued in the manufacturing sector.

We expect the **US labour market** recovered further in August. The decennial US Census is currently underway and temporary hiring may have further supported the labour market. We expect another 1.5mn jobs were added in August and the unemployment rate likely dipped to 9.9%. But we expect wages were flat over the month because labour market slack remains very elevated.

Key Forecasts

ASB NZ economic forecasts	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Mar-22	Mar-23
	forecast >>						
GDP real - Q%	-13.8	11.3	0.9	0.4	0.1		
GDP real - A%	-14.1	-5.1	-4.7	-2.8	12.9	0.8	3.2
GDP real - AA%	-2.5	-4.4	-6.0	-6.6	-0.4	3.8	2.3
CPI - Q%	-0.5	0.9	0.0	0.1	0.2		
CPI - A%	1.5	1.7	1.2	0.6	1.2	1.1	1.5
HLFS employment growth - Q%	-0.4	-2.6	-1.0	-0.1	0.2		
HLFS employment growth - A%	1.1	-1.8	-3.0	-4.1	-3.5	1.9	1.8
Unemployment rate - %sa	4.0	6.4	7.1	7.4	7.5	6.8	6.7
Annual current account balance as % of GDP	-2.5	-2.4	-2.5	-3.1	-3.3	-3.3	-3.5

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	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Mar-22	Mar-23
(end of quarter)	<< actual	forecast >>					
NZ OCR	0.25	0.25	0.25	0.25	-0.50	-0.50	-0.25
NZ 90-day bank bill	0.30	0.25	0.15	0.00	-0.50	-0.50	-0.20
NZ 2-year swap rate	0.21	0.10	0.00	-0.15	-0.30	-0.30	0.00
NZ 5-year swap rate	0.35	0.15	0.10	0.00	-0.15	-0.15	0.15
NZ 10-year swap rate	0.74	0.50	0.30	0.10	-0.10	0.10	0.50
NZ 10-year Bond	0.91	0.55	0.45	0.25	0.00	0.20	0.55

ASB foreign exchange forecasts	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21	Mar-22	Mar-23
(end of quarter)	<< actual	forecast >>					
NZD/USD	0.64	0.66	0.67	0.67	0.66	0.66	0.66
NZD/AUD	0.93	0.90	0.89	0.88	0.86	0.85	0.86
NZD/JPY	69	70	71	70	69	69	69
NZD/EUR	0.57	0.54	0.54	0.54	0.53	0.52	0.53
NZD/GBP	0.52	0.50	0.50	0.49	0.49	0.49	0.49
NZD/CNY	4.5	4.6	4.6	4.6	4.5	4.4	4.4
NZD TWI	71.4	69.6	70.0	69.5	68.0	67.5	67.7

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Economist	Mike Jones	mike.jones@asb.co.nz	(649) 301 5661
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Publication & Data Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

www.asb.co.nz/economics

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