Economic Update

Q1 GDP Review

18 June 2015

Weak Q1 GDP should get the RBNZ over the line

- GDP lifts 0.2%, well below market and RBNZ expectations of 0.6%, but in line with ASB's forecast.
- Falls in milk production, mining and communications offset by tourist-related strength.
- While the weak result is likely to be temporary it should push the RBNZ over the line to cut the OCR again in July.

Summary and implications

Q1 GDP was much weaker than the market expected, printing at just 0.2% compared to a median expectation of 0.6%. However, we were bang on the result with our 0.2% forecast, which was very much out on a limb compared to the consensus. As a result, there was not much in the detail which surprised us.

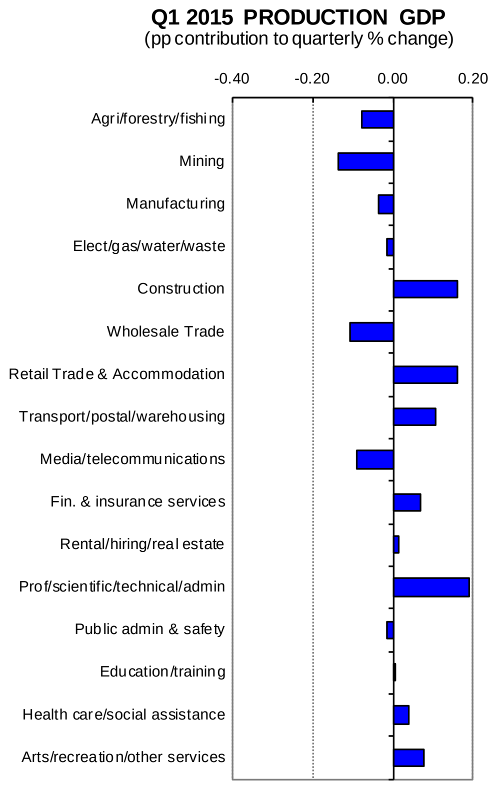
Much of the weakness in Q1 is temporary but it is still a significant surprise to the RBNZ and market participants. The RBNZ signalled another rate cut, and said the timing of which was data dependent. **We now expect this rate cut to come in July** rather than September (September was signalled in the June MPS). The GDP result will swing more forecasters and market participants into focusing on a July cut, increasingly making that move the path of least regret for the RBNZ.

GDP lifts 0.2% in Q1; growth follows very strong momentum over 2014.

Key figures

0.2% qoq (ASB 0.2%, market and RBNZ f/c 0.6%)

+2.6% yoy, +3.2 aapc.



We still see underlying GDP growth of 0.7%, although there are some downside risks.

Comment

Q1 GDP was significantly below market expectations (0.6%), although in line with our own expectations of 0.2% growth. Much of the weakness in Q1 is temporary. We still see underlying growth of 0.7%, although there are some downside risks to the outlook. Growth should remain supported by low interest rates, rising disposable labour incomes and investment demand. However, slowing construction activity and lower dairy incomes are key threats to the outlook. One of the key areas we will monitor closely going forward is the level of business confidence and investment intentions.

Milk, mining and communications are key drags on activity.

Areas of weakness in Q1 were largely as expected, and most are unlikely to be sustained:

- Milk production declined in Q1 due to drought, but production appears to have recovered since.
- Wholesale trade declined sharply as signalled in a prior release.
- Mining declined sharply as oil and gas exploration and extraction fell, likely in response to lower oil prices.
- Communications declined due to seasonality, as expected. Stats NZ have now acknowledged this seasonality and this component will be seasonally adjusted in future.

Tourism-related strength provides offset to weaker components.

Offsetting these declines was tourism-related strength. Against a back drop of a steady upward trend in tourist arrivals, the timing of Chinese New Year and the Cricket World Cup added additional momentum to this sector. Retail spending, air travel, sports and gambling all lifted strongly as a result of increased visitor numbers. To some extent, the strength from these components will be temporary also.

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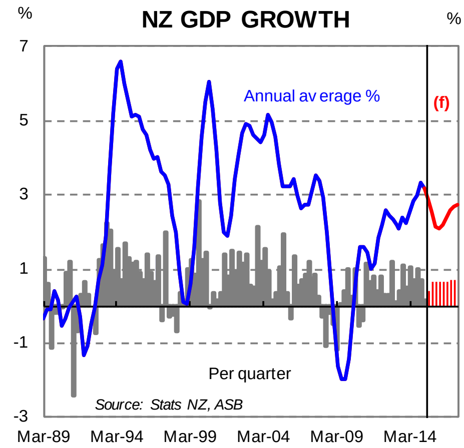
Services sector now the key driver of annual growth.

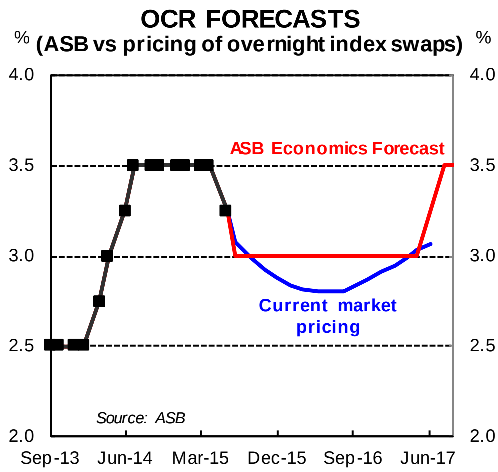
Services growth was strong, underpinned by visitor spending and increased business-related services (including scientific, architectural and engineering activity). Over the past year, growth has broadened and is finding more support from services rather than goods and production.



Implications

We expect the RBNZ will cut the OCR again in July.

The GDP result is a significant near-term surprise for the RBNZ, which had pencilled in 0.6% growth in the June MPS. While most of the areas of weakness are unlikely to be sustained, we still expect the weaker result should be enough cause for concern on its own – particularly given the RBNZ's relatively bullish medium-term growth forecasts. The RBNZ stated at the June MPS "*We expect further easing may be appropriate. This will depend on the emerging data*". As such, we now expect this follow up rate cut as soon as July. We can no longer see why the RBNZ will wait until September given its genuine concerns for demand given its weaker national income outlook due to the lower Terms of Trade.



Initial market reaction

Market participants also now more confident of a July cut.

The NZD/USD had lifted to trade near 0.70 this morning due to a weak USD after this morning's FOMC meeting. When the GDP data printed on the weak side of market expectations at 10.45am, the NZD dropped 0.8%, to trade back down near recent lows around 0.69. NZ swap rates also dipped up to 6 basis points in the wake of the GDP data. The GDP data are also strengthening convictions that the RBNZ will cut the OCR in July. In terms of market pricing, there is a 68% probability of a 25bp rate cut at the July meeting now implied in the OIS market.

Background to the data

Gross Domestic Product (GDP) is a measure of the output produced in an economy during a period. Total output is collated in value-added terms to avoid double counting of production. GDP is measured on a quarterly basis and released towards the end of the next quarter. It provides a reasonably comprehensive measure of activity within the economy but the long delay in compilation and release does tend to negate the importance of the actual data release. Three measures of GDP are possible: via income data, via expenditure data and via production data. The latter two are reported on a quarterly basis in New Zealand with the production series preferred as the more accurate measure of short-term change.

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