Economic Weekly

04 November 2019

RBNZ speech subject to market interpretation

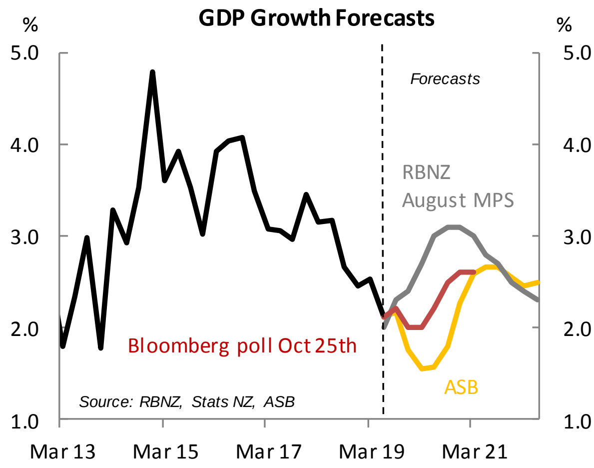
The NZ labour market data released on Wednesday is the key focus this week (ahead of the RBNZ's November OCR announcement next week) and we will be closely watching to see how much of the weakness in forward-looking indicators shows up in Q3 labour market conditions. Last week, a RBNZ speech warning "there is a danger that markets end up paying too much attention to our communications" prompted a reaction from markets, much to our surprise. **We continue to expect the RBNZ to cut the OCR 25bp at next week's announcement.**

Key events and views

Key Insights	RBNZ warns of over-interpreting central bank communication.
Foreign exchange	The short-term outlook remains tilted in favour of additional NZD appreciation.
Interest rates	Rates could move higher before they move lower if current positive risk sentiment persists.
Domestic events	Q3 labour market data on Wednesday is the key focus.
International events	RBA rate announcement (on Tues) and Statement of Monetary Policy (Fri).

Chart of the Week: Taking the hatchet to our growth forecasts

We have revised our GDP growth forecasts down significantly since our previously Quarterly Economic Forecasts produced just a quarter ago in August. **Continued weakness in business confidence surveys have become too much to ignore – over 2019 businesses have consistently reported weakening demand and declining profitability.** Investment activity has stalled over the past year as a result, and we fear that labour demand will be next with upcoming labour market reports likely to show some easing in labour market conditions. **Our suite of GDP growth indicators suggest an underlying pace of GDP growth of barely 0.4% per quarter over H2 2019, with risks skewed to the downside.** We have undertaken modelling work and found that the chance of NZ entering a recession is around 30% - far too high to ignore the potential growth implications. But don't just take our word for it – we may now be on the bearish side of consensus but the likely direction of revisions to the RBNZ's growth forecasts is fairly clear in our view (see chart). **A poll of economic forecasts published by Bloomberg on Oct 25th shows that the RBNZ's August Monetary Policy Statement (MPS) GDP growth forecasts are now looking quite optimistic.** We would be surprised if the RBNZ doesn't revise its growth forecasts closer to the consensus at the November MPS – hence we continue to expect the RBNZ will cut the OCR 25bp at its upcoming meeting – see Page 2 for further discussion.



ASB Economics (649) 301 5659 nick.tuffley@asb.co.nz

Key insights this week: The dark arts of central bank communication

On Monday last week at the CBA Global Markets conference in Sydney **RBNZ Assistant Governor Christian Hawkesby gave a speech entitled "Speaking, listening and understanding: The art of monetary policy communications"**. As the title suggests, the speech outlined the RBNZ's evolving methods of communications, and the benefits and limitations of transparency. It also gave some insights into the thinking behind the RBNZ's decision to cut the OCR by 50bp in August, albeit consistent with 'least room for regret' comments made by the Governor.

An irony of this speech is that it showed how different listeners interpret the same communication. Having listened to the speech in person and read the text later, my interpretation was that there were few implications for the market's view of what the RBNZ would do in the future. However, one local bank said the speech made it wonder if the RBNZ was now less committed to a 25bp OCR cut this month, and that if it was unhappy with the (then) deep pricing of a November cut then it needed to more explicit about fact. Coincidentally (or not) another bank delayed its expectation of an OCR cut from November until February. All up and for various reasons, market pricing of a November OCR cut moved from 22bp before the speech was released to 13bp by the end of the week – implying a 50:50 chance.

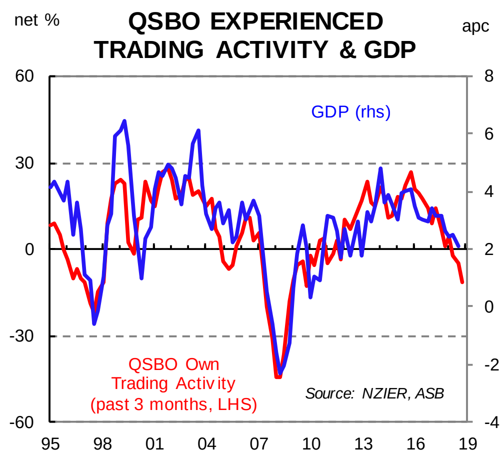
A key line from the official speech text is: "In this scenario there is a danger that markets end up paying too much attention to our communications for what we have said 'we will do', leaving no one left to analyse the incoming economic data for what 'we should do'. As a central banker, I am far more interested in listening to what 'we should do'."

At the risk of sowing further confusion, **here is my interpretation of the comments**. The RBNZ signals a particular course of action with its statements and forecasts. But, if the subsequent flow of events suggests the RBNZ should instead adjust its outlook, then people need to focus on the implications of those events rather than stay fixated on what the RBNZ has implied in the past it will do. In other words, don't blindly follow what the RBNZ has said in the past it will do, be sure to update your view based on events. A different RBNZ decision may have become more appropriate instead of what has been previously signalled.

So what do we think it is appropriate for the RBNZ to do? Keep cutting the OCR, by 25bp this month and in February.

Why?

- Business confidence is overall weaker, particularly businesses' view of their own activity outlook, since the RBNZ last published its economic growth forecasts;
- Our growth forecasts have been pulled down considerably since the August MPS and are substantially weaker than the RBNZ's, and other forecasters have similarly slashed their forecasts;
- Although Q3 headline inflation was marginally higher than RBNZ expectations, some of the causes were increases in government charges and a surprisingly sharp lift in domestic airfares;
- The RBNZ has yet to factor in the economic impact of its increased bank capital requirements, which even by its own calculations will impact on bank customer interest rates by 20-40bp.



Much of the RBNZ's upcoming decision will depend on the extent to which it revises down its own growth outlook. The more it does, the slower the build-up in inflation pressure, and the greater the need for more stimulus

Of course, there are the labour market data releases to get through this week, which could alter the balance of risks. But, given the wobbliness of the surveys, the RBNZ is likely to be careful in placing too much weight on them.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6442	0.6369	0.6320	0.6652	UP	0.6340	0.6460	FLAT
NZD/AUD	0.9311	0.9340	0.9357	0.9243	FLAT	0.9240	0.9400	FLAT
NZD/JPY	69.69	69.20	67.47	74.95	UP	68.90	70.00	UP
NZD/EUR	0.5767	0.5735	0.5757	0.5835	FLAT	0.5680	0.5830	UP
NZD/GBP	0.4981	0.4959	0.5119	0.5120	FLAT	0.4915	0.5010	FLAT
TWI	71.0	70.5	70.5	72.73	FLAT/UP	N/A	N/A	FLAT/UP

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

NZD Recap

The NZD/USD ended last week a bit over 1% higher. Both domestic and global factors combined to send the currency higher.

Globally, investors' more constructive attitude towards the global economy managed to make it through the week unscathed, despite a huge volume of event risk. Friday's strong read on the US labour market and growing optimism about the completion of 'phase 1' of a US-China trade deal were key in this regard. US equity indices scaled fresh highs and the VIX index (a proxy for risk aversion) fell to the lowest level since July.

Domestically, further gains in local interest rates offered support to the NZD. The NZ yield curve has lifted 20-30bps since the start of October as markets have pegged back the amount of easing the RBNZ might have to roll out over the next 6 months. We think the process has run a bit far (see article above).

Near-term outlook

The short-term outlook remains tilted in favour of additional NZD appreciation in our view. First, speculative positioning remains extremely short NZ dollars. The further the currency runs to the topside the bigger the risk that this position will need to be unwound, adding fuel to the rally.

Second, NZD fundamentals have improved. The 'fair-value' range implied by our short-term valuation model has lifted to 0.6600-0.7000. All three of the model's variables have contributed to the higher range. Global risk appetite is more positive, NZ-US interest rate differentials have become less negative, and NZ commodity prices are up around 3% in the past two months. Technically, there is still 0.6460 resistance to overcome. But assuming this succumbs, we could see a move back into the 0.6500s this week.

Medium-term outlook

Our forecasts have the NZD/USD essentially trending sideways for the best part of the next nine months, to a low of 0.6200 in March 2020. This slow and low forecast profile reflects the drag from the NZ growth slowdown and associated RBNZ interest rate cuts, and the subdued global backdrop. From late 2020, we expect the currency to begin trending higher again as fiscal and monetary stimulus eventually drive a recovery in the NZ economy, and NZ's Terms of Trade remain elevated.

mike.jones@asb.co.nz

ASB foreign exchange forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.67	0.63	0.63	0.62	0.67	0.68	0.68
NZD/AUD	0.96	0.93	0.94	0.94	0.94	0.94	0.94
NZD/JPY	72	68	66	64	70	71	71
NZD/EUR	0.59	0.57	0.57	0.57	0.59	0.60	0.60
NZD/GBP	0.53	0.51	0.49	0.46	0.51	0.52	0.52
NZD TWI	73.2	70.2	69.1	67.9	71.5	72.0	72.0

ASB

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.00	1.00	1.00	1.75	UNCH/DOWN	UP
90-day bank bill	1.12	1.06	1.05	1.94	UNCH/DOWN	UP
2-year swap	1.04	0.93	0.82	2.05	UNCH/DOWN	UP
5-year swap	1.12	1.01	0.83	2.38	UNCH/DOWN	UP
10-year swap	1.39	1.33	1.12	2.87	UNCH/DOWN	UP
10-year govt bond yield	1.27	1.20	1.00	2.59	UNCH/DOWN	UP
Curve Slope (2s10s swaps)	0.35	0.40	0.29	0.82	UNCH/UP	UNCH/UP

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

Market Recap

As we suspected, Australasian yields on interest rate swaps nudged higher over the past week, with more modest rises for longer tenors. With the Australasian data-flow generally mixed, the unwinding of long positions, mortgage-related pressures and the change in OCR call by another NZ bank triggered the move. Australian Q3 CPI was low, with little immediate market reaction**. US yields were initially weaker but then firmed as China and the US continued to work towards a trade deal.** President Trump signalled the first phase of the US/China trade deal could be signed this month (most likely in the US), while Chinese state media noted a "consensus on principles" had been reached following “serious and constructive” talks. Stronger than expected US Non-farm Payrolls data and some signs of improvement in Chinese manufacturing sentiment also supported yields. Imminent risks of a hard Brexit receded after the UK Parliament voted for an early general election on December 12. The US Federal Open Market Committee cut rates by 25bps to 1.50%-1.75%, but the signal was that the bar to further cuts had been raised, with Jerome Powell noting the cut was insurance against growing risks and (again) indicating the Fed may pause from here. The Bank of Canada held rates at 1.75%, but a dovish policy assessment prompted more sizeable falls for Canadian yields.

Near-term NZD interest rate outlook

We have retained a mild downward bias given our conviction that slowing global growth will likely require more policy support and lower interest rates. **However, rates could move higher before they move lower if current positive risk sentiment persists. Further positive signs on trade could be the catalyst and there is the possibility that central banks copy the FOMC and decide to wait on the sidelines for the time being**. We expect the Reserve Bank of Australia (RBA) to hold the 0.75% cash rate this week (less than 10% odds of a cut). **Despite this, the NZ short-term growth outlook looks subpar and we believe the RBNZ will till take out additional insurance next week and cut the OCR by 25bps (to 0.75%).** Current NZ market pricing – just 14bps of an OCR cut in November and a terminal OCR in the vicinity of 0.70% - looks a little light. Expectations for Wednesday’s NZ labour market data – a modest climb in the Q3 unemployment rate (to 4%) and a wage-settlement induced lift in (still modest) wage inflation – if correct are unlikely to move market pricing, but the historical volatility in the employment data suggests a surprise may occur.

Medium-term outlook

Our forecast is for the curve to initially steepen and then to flatten as policy easing precedes mild policy tightening. We expect 50bps of OCR cuts (-25bps Nov 19, -25bps Feb 20), with the OCR to plateau at 0.5% this cycle. This will be followed by mild and gradual OCR hikes from 2022, with an OCR endpoint of just 2%. We also expect a further 25bp cut by the RBA in February (0.5% floor). The Fed is expected to cut the 1.75%-2% Federal Funds rate by 100bps by mid-2020 (Oct 19, Dec 19, Mar 20, Jun 20). **Low inflation, low global growth and a negatively skewed risk profile should cap NZ and global long-term interest rates at historically-low levels.** mark.smith4@asb.co.nz

ASB interest rate forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.50	1.00	0.75	0.50	0.50	0.75	1.25
NZ 90-day bank bill	1.7	1.2	1.0	0.9	0.8	1.0	1.5
NZ 2-year swap rate	1.4	0.9	0.8	0.7	0.7	1.0	1.4
NZ 5-year swap rate	1.4	0.9	0.9	0.8	0.9	1.3	1.7
NZ 10-year swap rate	1.8	1.2	1.2	1.1	1.2	1.6	2.0
NZ 10-year Bond	1.6	1.1	1.0	0.9	1.0	1.4	1.8

Domestic events

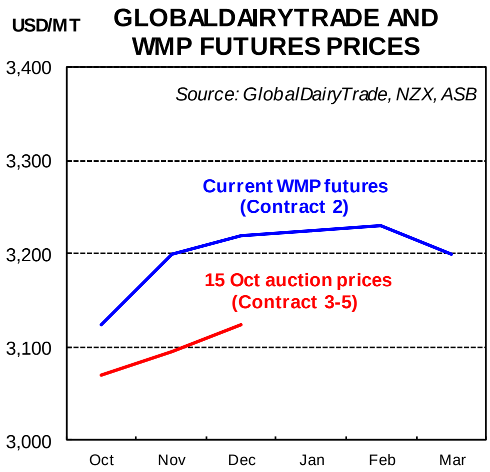
Data	Date	Time (NZT)	Market	ASB
GlobalDairyTrade auction, whole milk powder, % chg	05/11	Overnight	-	+1.0
Unemployment rate, Q3, %	06/11	10:45 am	4.1	4.1
LCI – pvt sector salary & wage rates, %qoq	06/11	10:45am	0.6	0.6
Electronic Card Transactions, Retail, Sep, %mom	11/11	10:45am	-	0.3

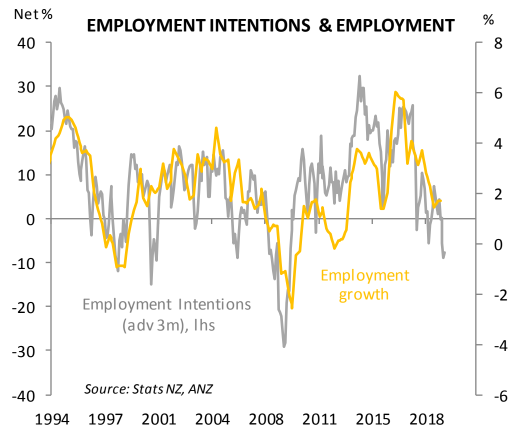
We expect whole milk powder (WMP) prices to lift 1.0% at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago WMP prices were unchanged. At this stage, the futures market is pointing to a similar lift in prices. NZ production growth is slowing and it's likely that is leading prices higher.

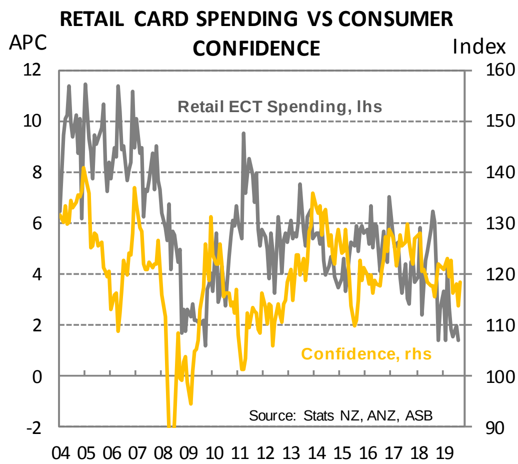
The big question for **Q3 NZ labour market data** is how much of the recent weakness in the forward indicators will show up in the official statistics. The HLFS can be a tad unpredictable. **We're looking for a modest 0.3% lift in employment and a small rise in the unemployment rate to 4.1%. We'd caution, though, that the risks are tilted towards a weaker result.**

We expect the recent pick-up in wage growth to continue in the third quarter. Annual growth in the key private sector Labour Cost Index (LCI) wage measure is expected to lift from 2.2% yoy to 2.3%, in part reflecting the impact of teacher and care-worker pay settlements in July.

Card spending picked up in the September quarter, with durable, hospitality and consumable spending showing more vigour. We expect a more sluggish start to spending in the December quarter, in part due to some pullback from some recent strength. The late night screening of the Rugby World Cup is likely to dampen hospitality spending, while higher fuel spending should weigh on discretionary spending**. The 75bps of OCR cuts since May has provided a boost to the housing market and is likely to support broader consumer spending over the coming months.**







Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
Australia Retail Trade, September, %mom	04/11	1:30 pm	0.4	0.4
RBA Interest Rate Announcement, %	05/11	4:30 pm	No chg	No chg
Australia Trade Balance, September, A$bn	07/11	1:30 pm	5.05	5.00
BoE Interest Rate Announcement, %	08/11	1:00 am	No chg	No chg
Australia Statement of Monetary Policy (SMP)	08/11	1:30 pm	-	-
China Trade Balance, October, US$bn	08/11	-	40.2	37

**Originally published by CBA Global Markets Research on Friday 1st November at 1.08pm*

Australian retail trade has been soft despite tax rebates and lower interest rates. The August release did show tentative signs of some pickup in spending on discretionary items such as clothing and footwear and recreational goods, as well as at department stores. We expect a 0.4% lift in retail trade in September, the same as in August. We also expect a 0.2% lift in volumes in Q3. A further pickup in consumer spending should occur as tax rebates continue to flow, cash rate cuts continue and the wealth effect of the turnaround in the housing market.

We expect the Reserve Bank of Australia (RBA) to leave the cash rate on hold at 0.75% in November. This follows a cash rate cut in October. We continue to expect a final interest rate cut in February 2020 but November appears too soon. The RBA will prefer to wait and see the impact of its three rate cuts to date. The latest labour market report was also on the positive side and the Q3 2019 CPI release was in line with expectations, providing no near-term catalyst for the RBA to ease at this meeting.

Australia's external performance has been incredibly strong in recent months. The trade balance for August was $A5.9bn and we expect another sizeable, albeit smaller surplus of $A5.0bn for September. Commodity prices have retreated on demand concerns out of China but volume growth could help offset this as LNG exports continue to lift.

We do not expect any material changes to the RBA's near-term forecasts in its Statement on Monetary Policy later this week. In August, the RBA tweaked forecasts including a downgrade to the labour market and inflation projections and near-term GDP projections. The RBA currently expects GDP growth to lift to 2.4%pa in December 2019 (1.4%pa as at June), partly helped by base effects as weaker GDP numbers recorded in Q3 2018 and Q4 2018 are removed from the annual calculation. Downside risks to GDP do remain due to the persistent weakness in household spending and as the downturn in the dwelling investment cycle is larger than originally expected. On inflation, the Q3 2019 CPI was in line with RBA expectations so there it's unlikely there will be any changes to the bank's inflation forecasts. The unemployment rate estimate was lifted in the August statement to 5.25%. Since then the unemployment rate has hovered between 5.2% and 5.3%. The technical assumptions used in the August SMP roughly hold today so should not alter the forecasts.

The Bank of England is widely expected to leave the Bank Rate at 0.75% and maintain the stock of its asset purchases at £445bn. The BoE will likely highlight again that assuming a smooth Brexit and some recovery in global growth, "gradual" and "limited" increases in interest rates would be appropriate. The BoE is unlikely to make material changes to its macroeconomic projections. UK economic and inflation dynamics are tracking the BoE's August forecasts.

We expect **China's exports and imports** to contract 5%yoy and 8%yoy in October, respectively. Both the net exports orders and import PMI sub-indices dipped further into contractionary territory in October. The outlook for global trade remains dim despite increasing chances of a "phase one" trade deal between China and the US. We expect the trade balance to print a US$37bn surplus.

Key Forecasts

ASB NZ economic forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
	<< actual	forecast >>					
GDP real - Q%	0.5	0.4	0.2				
GDP real - A%	2.1	2.2	1.8	1.6	2.6	2.5	2.5
GDP real - AA%	2.4	2.3	2.1	1.9	2.1	2.6	2.5
CPI - Q%	0.6	0.7	0.3				
CPI - A%	1.7	1.5	1.7	2.1	1.7	1.8	1.8
HLFS employment growth - Q%	0.7	0.3	0.2				
HLFS employment growth - A%	1.4	0.9	1.2	1.5	1.5	1.5	1.3
Unemployment rate - %sa	3.9	4.0	4.1	4.3	4.3	4.2	4.4
Annual current account balance as % of GDP	-3.4	-3.4	-3.3	-3.1	-2.7	-2.9	-2.9

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-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZ OCR	1.50	1.00	0.75	0.50	0.50	0.75	1.25
NZ 90-day bank bill	1.7	1.2	1.0	0.9	0.8	1.0	1.5
NZ 2-year swap rate	1.4	0.9	0.8	0.7	0.7	1.0	1.4
NZ 5-year swap rate	1.4	0.9	0.9	0.8	0.9	1.3	1.7
NZ 10-year swap rate	1.8	1.2	1.2	1.1	1.2	1.6	2.0
NZ 10-year Bond	1.6	1.1	1.0	0.9	1.0	1.4	1.8

ASB foreign exchange forecasts	Jun-19	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
(end of quarter)		<< actual	forecast >>				
NZD/USD	0.67	0.63	0.63	0.62	0.67	0.68	0.68
NZD/AUD	0.96	0.93	0.94	0.94	0.94	0.94	0.94
NZD/JPY	72	68	66	64	70	71	71
NZD/EUR	0.59	0.57	0.57	0.57	0.59	0.60	0.60
NZD/GBP	0.53	0.51	0.49	0.46	0.51	0.52	0.52
NZD TWI	73.2	70.2	69.1	67.9	71.5	72.0	72.0

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 Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
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

@ASBMarkets