Quarterly Economic Outlook

Blowin' in the wind

ANZ

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ISSN 2624-1439

Publication date: 18 April 2019

New Zealand economic outlook

The New Zealand economy has been evolving broadly as expected, but softening near-term indicators have led us to downgrade the near-term outlook. Economic tailwinds are blowing a little more softly than they once were, and that's being reflected in waning capacity pressures. We have brought our OCR cut call forward, with a 25bp cut pencilled in for August (previously November), and two follow-up moves in November and February. With the RBNZ now expected to come to the party a little earlier than we previously thought, it shouldn't be long before the economy gets the stimulus it needs to push economic activity back into inflation-building territory.

International outlook

Evidence of a global growth slowdown continues to accumulate. Weaker growth has been broad-based across New Zealand's trading partners. Underlying inflation is muted, and risks to global growth and inflation are to the downside. However, there are early signs that the recent easing in financial conditions is getting some traction. Overall, international developments have reduced a key tailwind for the New Zealand economy. While commodity prices have held up well so far, risks are looking a bit one-sided with global demand fragile.

Primary sector outlook

Global uncertainty and slowing economic activity are not expected to impact primary sector returns in the short term but this remains a key risk in the longer term. The risk of significant trade disruptions appears to be reducing as talks between China and the United States progress, and the Brexit deadline has been pushed out to October.

Financial markets outlook

The RBNZ surprised markets with a shift towards an explicit easing bias at its March meeting. Market pricing shifted aggressively, with 50bps of cuts priced in by the end of 2019. Long-end yields have pre-empted a cut but we expect there will be another move lower once the first cut is delivered and markets open up to the possibility of a third. The Fed's stance will likely cap any further upward moves in the long end, while there may be a brief repricing at the short end of the New Zealand curve following the RBNZ's May meeting. We believe there is room for the NZD to move lower as the RBNZ is unlikely to cut just once. Buoyant commodity prices, alongside positive market risk sentiment, will provide support, but domestic challenges remain. We expect the NZD/USD to reach 0.64 by the end of this year.

Calendar Years	2016	2017	2018(f)	2019(f)	2020(f)	2021(f)
New Zealand Economy						
Real GDP (annual average % change)	3.9	3.1	2.8	2.2	2.5	2.9
Real GDP (annual % change)	3.5	3.4	2.3	2.3	2.6	3.0
Unemployment Rate (Dec quarter)	5.2	4.5	4.3	4.3	4.2	4.1
CPI Inflation (annual %)	1.3	1.6	1.9	1.5	1.9	2.0
Terms of Trade (OTI basis; annual %)	6.7	7.9	-4.7	2.4	0.8	0.8
Current Account Balance (% of GDP)	-2.2	-2.9	-3.7	-3.8	-4.0	-4.1
NZ Financial Markets (end of Dec quarter)						
TWI	76.1	73.0	71.5	67.7	63.5	--
NZD/USD	0.69	0.71	0.67	0.64	0.63	--
NZD/AUD	0.96	0.91	0.95	0.91	0.84	--
Official Cash Rate	1.75	1.75	1.75	1.25	1.00	--
10-year Bond Rate	3.33	2.72	2.37	2.60	2.60	--

Source: Statistics NZ, Bloomberg, ANZ Research

New Zealand economic outlook

Summary

The New Zealand economy has been evolving broadly in line with our expectations (as outlined in recent editions of our ANZ Quarterly Economic Outlook). Quarterly growth of 0.6% in Q4 was in line with our forecast. However, softening near-term indicators have led us to downgrade the near-term outlook a smidgen, which together with downward revisions to historical GDP sees annual growth decelerate to just 2% by Q2 this year. Economic tailwinds are blowing a little more softly than they once were, and that's being reflected in waning capacity pressures. We have brought our OCR cut call forward, with a 25bp cut pencilled in for August (previously November), and two follow-up moves in November and February. With the RBNZ now expected to come to the party a little earlier than we previously thought, it shouldn't be long before the economy gets the stimulus it needs to push economic activity back into inflation-building territory.

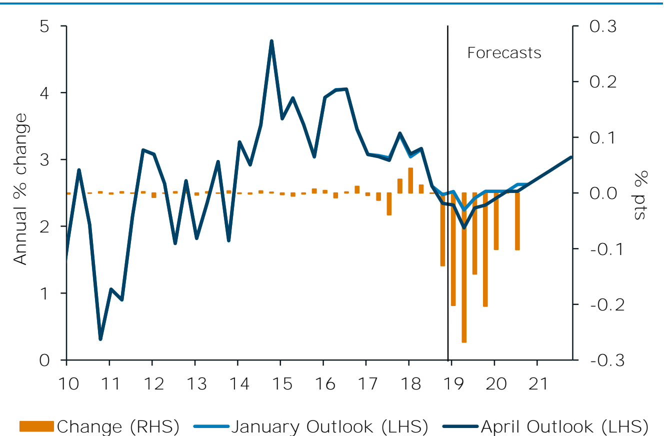
Blowin' in the wind

The New Zealand economy has been shedding momentum for a while now, and near-term indicators suggest this process is continuing into the first half of this year. However, now that the RBNZ has taken heed a little sooner than we expected, a little extra monetary stimulus shouldn't be far away (we've brought forward our first cut call from November to August). With economic tailwinds blowing a little more softly than before and headwinds picking up, a lower OCR is required to provide the necessary offset that will nudge growth back up above trend and get non-tradable inflation to where it needs to be.

But as noted above, we expect the growth slowdown has a little further to run in the near term. In fact, we've downgraded our near-term outlook, with annual growth forecast to slow from 2.3% at the end of 2018 to 2.0% by the middle of this year. This is based on quarterly growth of 0.5% and 0.6% in Q1 and Q2 respectively. Downward revisions to historical GDP since our January update have lowered the starting point for annual growth, and this accounts for around half the downgrade to the outlook (figure 1).

Starting in the second half of the year, annual growth is forecast to accelerate gradually, lifting above trend and reaching 3.0% by the end of 2021 (we've added on an extra forecast year since our last update). On a per capita basis, growth is expected to remain subdued for a little while yet, but lift gradually from sub-1% annual growth currently to just below 2% by 2021.

Figure 1: Production GDP growth



Source: Statistics NZ, ANZ Research

This pick-up in growth will be hard won. The fact remains – we're late in the cycle and the low-hanging fruit was picked long ago. And there are pockets of the economy where an OCR cut will have less of a stimulatory impact than if it been delivered earlier in the cycle. For example, lower interest rates can be expected to boost house prices, but with prices already very high relative to incomes and the impacts of government policy weighing, we don't foresee a breakout to double-digit house price growth any time soon.

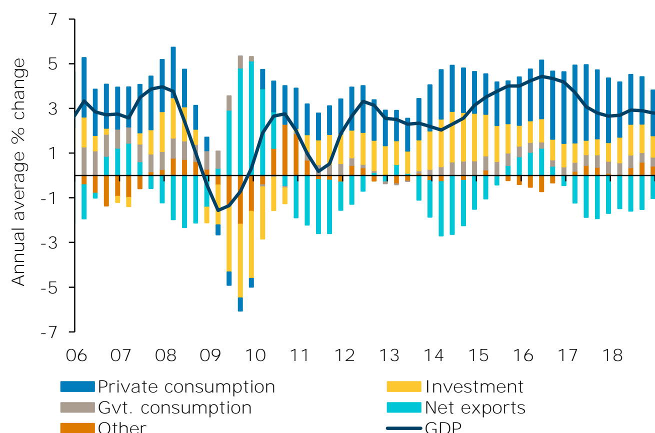
And history tells us that it's difficult for the New Zealand economy to grow above trend when the most cyclical component (housing) isn't shooting for the moon. So while modest house price inflation is probably a good thing from a financial stability standpoint, it does imply a lower-than-otherwise pass-through to real activity and accordingly inflation pressures. Nonetheless, we think OCR cuts will nudge economic growth up to where it needs to be, albeit gradually and with risks skewed to the downside.

Better be home soon

This economic cycle has been driven largely by domestic factors, with migration-led population growth accounting for around two thirds of GDP growth for the past three years or so. We expect domestic factors to continue driving growth going forward, albeit in a lower gear than previously.

Households are generally in good stead. Low interest rates, gradually rising real wages, and higher transfer payments through the Families Package have been supporting household financial positions. Add an additional 300,000 people to the economy (give or take) through migration these past few years and it's no wonder that private consumption growth has been leading broader macroeconomic growth (figure 2).

Figure 2: Contributions to expenditure GDP growth



Source: Statistics NZ, ANZ Research

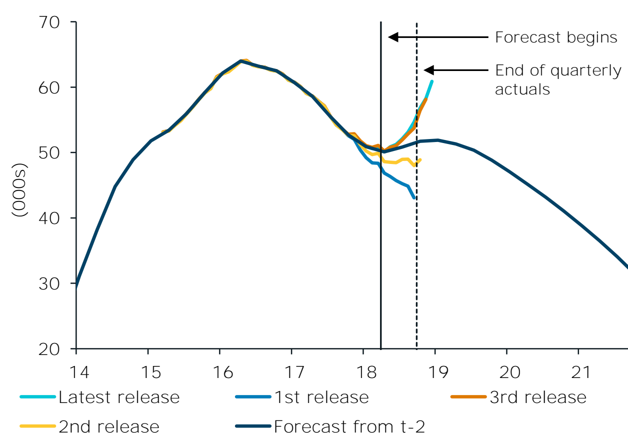
Figure 3: Household saving rate

Source: Statistics NZ, ANZ Research

However, we expect growth in private consumption will ease slightly over the next couple of years before gradually ticking up and stabilising into 2021. There are a number of forces at play:

- **The housing market has cooled.** And with house prices high relative to incomes, affordability is a constraint that is not going away in a hurry. We suspect Government policies such as the banning of foreign buyers and extending the bright-line test on capital gains are also contributing to a softer housing market. But now that a capital gains tax has been taken off the table, any associated uncertainties (that may have been weighing on decisions) are set to recede. In addition, mortgage rates have come down, and forecast OCR cuts mean downward pressure should remain. Lower interest rates are expected to give the housing market a boost, but we're not talking the kind of boost that would drive house price inflation back up to levels seen earlier in the cycle. That means homeowners won't be building equity at the same pace as they have in the past. Further, lower interest rates will do little to alleviate some of the capacity constraints (such as labour availability) in residential building, so any boost to residential investment and associated durables consumption is expected to be small.
- **Household debt levels are high**, reflecting what's been going on in the housing market these past few years. And while low interest rates mean this is manageable from a debt-servicing perspective, we still expect households will be looking to gradually rebuild their saving buffers over the next couple of years (figure 3). All else equal, this limits the scope for a credit-fuelled spend-up.
- **Slowing population growth** is expected to put a dampener on growth in consumption spending. Looking through the highly volatile nature of the new outcomes-based migration data and its susceptibility to drastic revisions, we are assuming the migration cycle remains in gradual easing mode, largely as a result of those who came to New Zealand on temporary visas in recent years continuing to cycle out. However, this forecast is officially on notice (as net inflows have been reported to be trending upwards of late) so we'll be watching closely to see how the revisions evolve over time. Unfortunately, since the removal of departure cards and the implementation of the new methodology, getting a pulse on the migration cycle in anything resembling real time has been challenging. In an attempt to look though the noise, we have opted to forecast migration arrivals and departures with a two quarter lag, hopefully avoiding the bulk of revisions (figure 4).

Figure 4: Annual net migration releases and forecast.



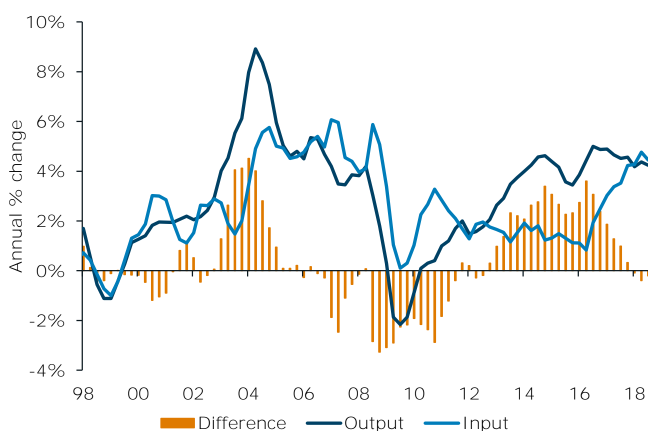
Source: Statistics NZ, ANZ Research

New Zealand economic outlook

- Providing some offset to the above, **ongoing tightness in the labour market** is expected to keep real (inflation adjusted) wage growth trending upwards. The unemployment rate is expected to drift slightly lower towards 4% once more (remaining below the level consistent with our estimate of full employment) and employment growth is expected to remain modest (slowing slightly alongside slower growth in the working-age population).

The outlook for investment is a mixed bag. On the construction side, the going is looking tough. Growth in input prices (which excludes both capital and labour) for both residential and non-residential building construction is now outpacing that of output prices (figure 5), implying margins are coming under pressure. Firms are reporting difficulty passing on higher costs (for labour as well as materials) and profitability expectations are dire.

Figure 5: Building construction producer price indexes



Source: Statistics NZ

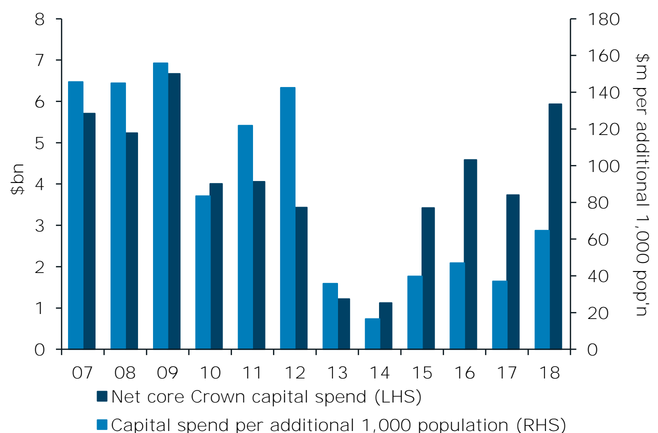
That said, construction activity is expected to remain at a high level. But with capacity constraints acute, costs on the rise, and cash-flow pressures building, growth will struggle to accelerate.

We expect growth in residential investment to track broadly sideways at around 2-3% y/y, which is well down from the double-digit growth seen over 2016. While we see limited upside to this outlook, we will be watching supply-side developments associated with the KiwiBuild program very closely. The way we see it, given capacity constraints are acute, more KiwiBuild homes will generally mean fewer homes built by the private sector. However, residential investment activity could get a bump if constraints around land availability, credit, labour, red tape, and/or materials are alleviated. And in the event of a private-sector slowdown (and hence a freeing up of available resources for building), KiwiBuild could pick up the slack and put a floor under the deceleration.

Growth in other investment such as plant and machinery has slowed over the past year. One explanation is that businesses are cautious, and indeed our own ANZ Business Outlook survey corroborates this view. Soft investment is a little worrisome from a medium-term perspective, as it implies a lower stock of productive capital and therefore slower future GDP growth than otherwise. While we expect investment in plant and machinery to recover gradually, investment intentions aren't sending a strong signal here. This is one component of the economy that could use a little nudge from lower interest rates.

Government spending (investment and consumption) is expected to support growth in the near term. However, the spending profile is relatively front loaded, meaning the boost to GDP growth won't last long. Overall, there is little scope for the Government to up the fiscal stimulus ante without throwing out the window their strategy to reduce net core Crown debt to 20% of GDP within five years of taking office. However, there is still an infrastructure deficit to address (figure 6), and one would hope that if economic conditions deteriorated too much, the Government would step up to the plate and look for the type of capital spending that would lean against the wind in the near term and boost sustainable growth (by lifting the productive capacity of the economy) in the medium term.

Figure 6: Core Crown capital spending per capita



Source: The Treasury, Statistics NZ

Net exports have been making a positive contribution to quarterly growth recently. On the goods side, dairy has had a decent season, with milksolids production expected to finish 2.75% up on last year (see page 10). Delayed slaughter means there's a bit of strength in the pipeline for meat exports. And forestry and horticulture are doing well. However, beyond the current season a return to more normal (and slightly less favourable) weather conditions may see growth in primary exports slow.

New Zealand economic outlook

Prices for New Zealand's key export commodities have proven remarkably resilient in the face of slowing global growth. For dairy, a lot of the explanation lies with tightening global supply. While off its peak, the terms of trade remains at a high level, supporting national incomes and keeping the NZD buoyed.

Goods imports have been holding at a high level as strong domestic demand (along with a supported NZD) has been sucking in imports, and preventing the trade balance sustaining large surpluses. Recent NZD weakness and further depreciation (see page 12) should support import-competing firms, but we think strong imports will nonetheless continue to keep net exports growth in check – after all, the key drivers of growth are largely domestic currently, and a relatively subdued global growth outlook suggests this is unlikely to change.

On the services side, we've seen strong growth in imports as New Zealanders take advantage of relatively cheap international flights. While reports of weak demand for domestic leisure air travel are an ominous sign for discretionary consumption, we suspect the relatively cheap cost of international travel provides at least a partial explanation here. Exports of services (tourism and education) remain at a high level, but upside is limited given accommodation constraints.

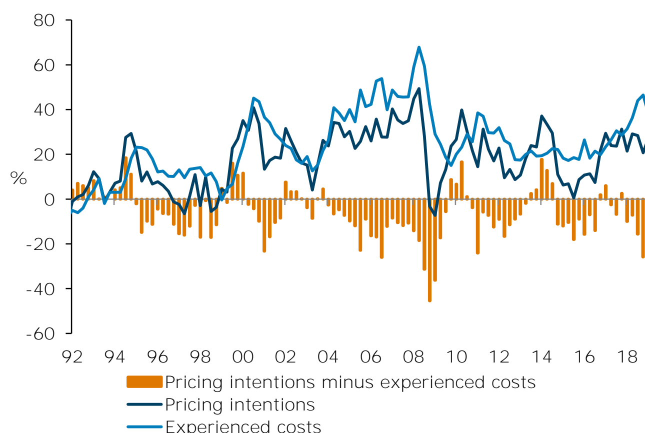
Putting it all together, we estimate the output gap is currently sitting close to zero and will be back in negative territory by the time growth finishes slowing. However, the gradual acceleration in GDP growth over 2020 and 2021 is expected to nudge the output gap back into the black. But that will require a little additional stimulus – a total of three 25bp OCR cuts should do the trick.

Three little birds

The RBNZ's March OCR Review stated "the more likely direction of our next OCR move is down". While we were expecting the Bank to play this tune, they have started the party a little earlier than we thought they might. But for good reasons: growth momentum has slowed a little more sharply than we anticipated, disappointing recent RBNZ forecasts by a decent margin; near-term activity indicators are soft; capacity indicators are beginning to trend down; non-tradable inflation is still shy of where it needs to be; and global central banks have turned markedly more dovish.

In light of all the above, we've brought our OCR cut call forward, with a 25bp cut pencilled in for August (previously November), and two follow-up moves in November and February. We see risks to this call as broadly balanced. Some indicators, such as the QSBO's experienced domestic trading activity, suggest growth will be weaker than the 0.5% q/q we've pencilled for Q1. And that wouldn't bode well for the likely direction of capacity pressures, particularly given cost pressures have tentatively turned a corner (figure 7).

Figure 7. Experienced costs vs pricing intentions



Source: NZIER

Conversely, some of the global data has exhibited something of a rebound recently, such as China's PMI (and solid Q1 GDP) and US non-farm payrolls (see page 8). It is possible that the RBNZ will want to see where the dust settles on the global outlook before pulling the interest rate lever.

And indeed, we think the RBNZ still has some time up its sleeve. The NZD TWI has fallen from 74.9 to below 73 since the RBNZ's dovish Review in late March. And given current market pricing, the Bank should be able to keep the NZD under downward pressure at the May MPS so long as it firms up its dovish tilt – some stronger forward guidance and a downward-sloping OCR track ought to do it. However, even if the slowdown in global growth has found a floor, we don't see this as a game changer for the RBNZ. The economy is still in need of a pick-me-up to prevent inflation from drifting south in the medium term.

Price tag ft. RBNZ

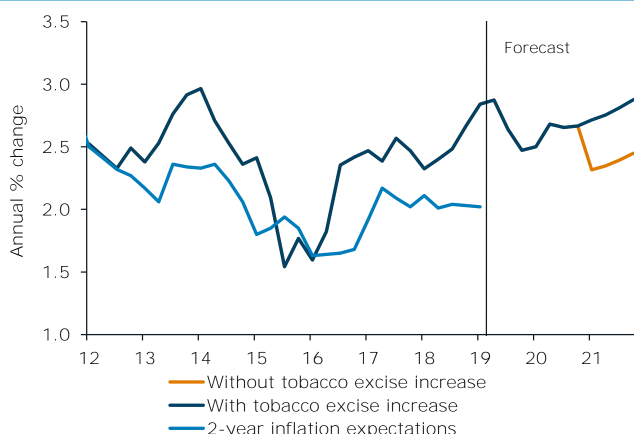
In the near term, in contrast, annual non-tradable inflation is expected to pick up slightly and even flirt with the elusive 3% line by Q2 this year (largely on account of previous capacity and price pressures). However, as we head into the second half of 2019, the recent and further easing in capacity pressures will become more evident in non-tradable inflation outturns. OCR cuts are expected to provide the necessary stimulus to drive non-tradable inflation gradually towards target over the medium term. Overall, annual headline inflation is expected to remain soft (near 1.5%) for the remainder of the year before gradually ticking up to 2% by 2021.

New Zealand economic outlook

There are risks to our inflation forecast in both directions, but the skew has moved more towards the downside of late. The risk that low inflation is a structural phenomenon has not changed, while the cyclical (activity and capacity) risks have shifted to the downside. Further, we have previously noted that the gap between pricing intentions and experienced costs represents an upside risk to inflation, but recent data show this gap is now shrinking.

Now that we've extended our forecasts out a year, a new downside risk stands out for 2021. Annual headline inflation has been receiving a shot in the arm for a number of years now from the 10% annual rise in tobacco excise duties – a policy that is legislated to continue until January 2020. However, we've had no indication from the Government on whether it plans to keep this going. Our forecasts assume it does, with tobacco prices jumping another 10% or so in Q1 2021. The risk here is that without this annual boost, non-tradable inflation takes a step down in Q1 2021, and that inflation expectations follow suit. Figure 8 shows what happens to annual non-tradable inflation when tobacco inflation is 2% in Q1 2021, opposed to 10%.

Figure 8. Non-tradable inflation with and without higher tobacco excise



Source: Statistics NZ, ANZ Research

Walk on the wild side

Risks to this outlook are skewed towards softer outturns.

- Should the RBNZ proceed with its proposal to increase bank's capital requirements by such a large amount, difficulty obtaining credit (particularly for the relatively risky agricultural and business sectors) could become a significant headwind to growth. While the magnitude of the impact is highly uncertain, it seems very likely that credit conditions will tighten as a result. The question is how much the RBNZ can offset with the OCR. Higher credit costs should be easy enough to offset (assuming we don't hit the zero bound), but if credit availability becomes an issue, offsetting increases in the cost of credit will only go so far.
- Productivity growth has been weak, and our outlook incorporates a small improvement over time (as investment recovers alongside slowing population growth). However, if history is anything to go by, even with our expectation for a modest improvement here, we could be setting ourselves up for disappointment.
- Business survey data continues to paint a pretty soft picture, with cost pressures, margin squeeze, regulation, and difficulty finding skilled labour all weighing. Experienced trading activity presents downside risks to our near-term growth outlook, but other indicators such as the Light Traffic Index out of our ANZ Truckometer suite are more optimistic. That said, the ANZ Truckometer Light Traffic Index is pointing towards softer growth in Q2 and Q3 this year.
- While businesses sentiment remains in pessimistic territory, a buoyant household sector (with modest income growth and around average consumer sentiment) has continued to prop up demand. If households were to get spooked, and decided to rein in spending in order to rebuild savings buffers a little faster, economic growth would slow markedly. And with labour market data generally lagging, a sharp fall in consumer sentiment could be the canary in the coalmine.
- Then there's the lengthy list of global risks (see page 8), which, if they were to materialise, could be the catalyst that spooks households into pulling back on consumption and businesses into holding off on new investment.

However, not all risks are to the downside:

- Our expectation that lower interest rates will have a relatively muted (but still positive) impact on house price inflation and household spending could prove to be on the pessimistic side, particularly now a capital gains tax is off the table. The housing market, particularly in Auckland, has been known to get back on the horse again.
- At face value, upwards revisions to net migration suggest population growth could be stronger than we've pencilled in, which, all else equal, implies stronger headline GDP growth. But stronger population growth will boost both the supply and demand side of the economy, so there will be offsetting impacts for inflation.

Overall, we see risks to GDP as broadly balanced, while risks to medium-term inflation are skewed south. OCR cuts are needed – it's just a question of when they will eventuate, and what impact they will have.

International outlook

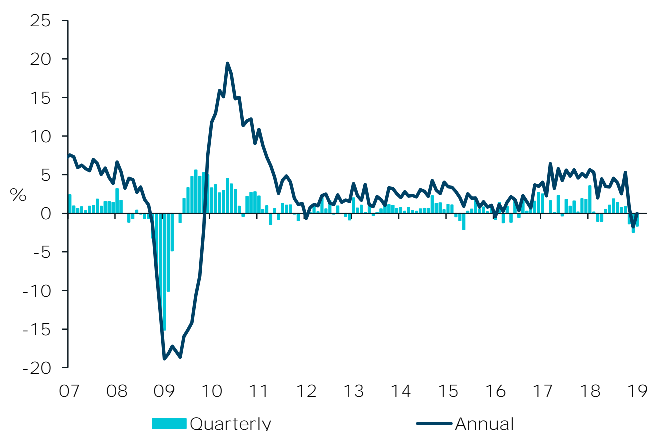
Summary

Evidence of a global growth slowdown continues to accumulate. Weaker growth has been broad-based across New Zealand's trading partners. Several key uncertainties appear to have weighed on activity: China-US trade negotiations, Brexit, and the effects of previous tightening in Chinese credit growth. Growth in China remains fragile, but increased stimulus will provide support. In Australia, the weak housing market and subdued wage growth has cooled household spending. Momentum has also eased in the US, with a weak start to the year for both consumer spending and investment. Euro area growth has decelerated, led by manufacturing, reflecting the slowdown in external demand. Labour markets have remained strong in many advanced economies, supporting stronger wage growth. However, underlying inflation is muted. Risks to global growth and inflation are to the downside, but there are early signs that the recent easing in financial conditions is getting some traction. International developments have reduced a key tailwind for the New Zealand economy. Commodity prices have held up well so far, but risks are looking a bit one-sided with global demand fragile.

We're all in this together

Evidence of a slowdown in global growth continues to accumulate, and risks of a sharper slowdown remain. Weaker growth has been broad-based across New Zealand's trading partners, and a strong rebound in activity is not expected in the near term. Global trade has slumped, with annual growth in trade volumes at its weakest since the global financial crisis (figure 1).

Figure 1. Global trade volumes



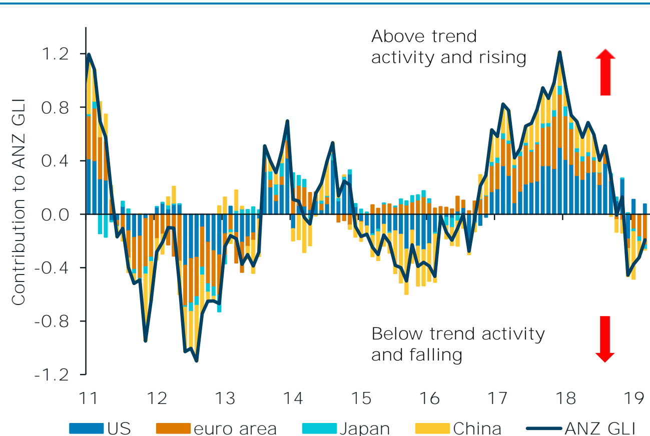
Source: Bloomberg, ANZ Research

Several uncertainties appear to have weighed on consumption and investment decisions: the China-US trade negotiations, Brexit, and the effects of previous tightening in Chinese credit growth.

Partly offsetting the deteriorating outlook, support has been provided by more stimulatory policy settings globally. Central banks have turned more cautious: the Fed is now firmly on hold, the ECB has rekindled its easing program, the PBOC has been easing policy, and the RBA has struck a more cautious, flexible tone. This has helped support a rebound in financial markets and the prices of risky assets.

Our forecast for world growth has declined slightly to 3.5% y/y in 2019, with a small pick-up to 3.7% next year. Recent data indicate some stabilisation in global growth, with tentative signs from leading indicators that activity is finding a floor (figure 2). Labour markets remain healthy (figure 3), and wage growth has been picking up. But despite this, underlying inflationary pressure remains subdued (figure 4).

Figure 2. ANZ Global Lead Index



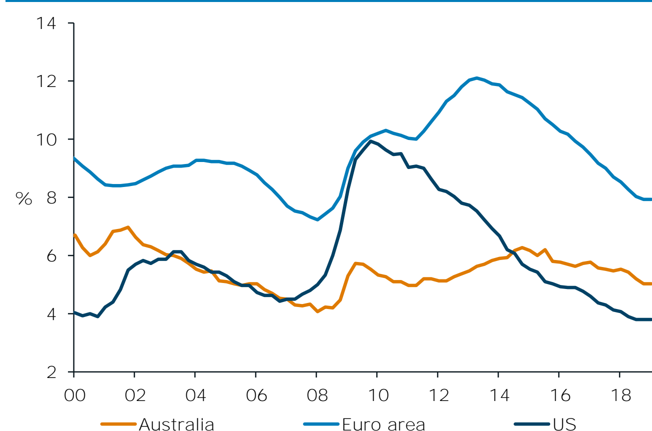
Source: Bloomberg, ANZ Research

China's economy grew 6.4% y/y in Q1, despite the recent string of softer monthly data earlier in the year. Industrial production activity and retail sales were stronger than expected, and China's high frequency economic indicators also suggest that any slowdown has found a floor (for now at least). In particular, leading indicators such as money supply data, PMI activity indicators, and producer price index (PPI) inflation showed signs of acceleration in March. However, downside risks to Chinese growth remain – with uncertainty still hanging over the China-US trade negotiations and slowing global momentum – but policy stimulus from both the Government and PBoC has reduced the risk of a sharper deceleration. Fiscal spending is expected to increase and tax rates are being cut in 2019. The PBoC will continue to implement targeted cuts in the reserve requirement ratio (RRR) to support the economy.

Growth in **Australia** has moderated over the past six months, with continued weakness in the housing market and weak real wage growth weighing on

consumer spending. The slower pace of growth in H2 2018 and into 2019 has seen less progress on reducing unemployment and boosting wages than expected. Looking forward, the economy is expected to grow around 2.5% y/y over the next couple of years. Fiscal policy will provide some support in the second half of 2019, with tax cuts and transfers boosting household incomes. The RBA is expected to remain on hold; labour market developments will be crucial. The unemployment rate is expected to remain flat in 2019 and move lower in 2020. But if unemployment moves higher, the RBA will likely ease.

Figure 3. Unemployment rates

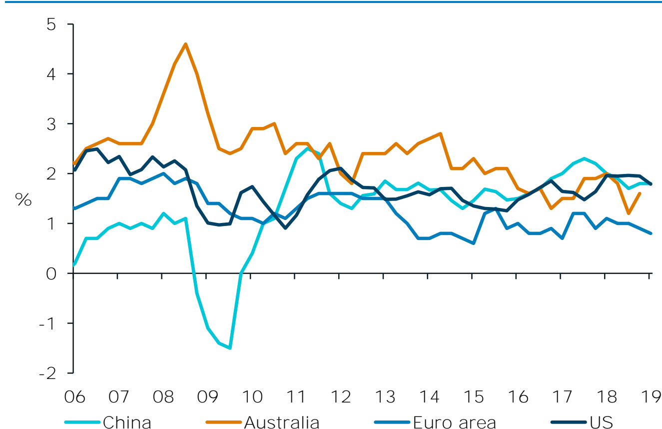


Source: Bloomberg, ANZ Research

The **US** economy expanded at a well above-trend pace in 2018, bumped up by a sizable fiscal boost. But there was a sharp loss of momentum toward the end of last year and the start of this year, with growth in consumer spending and investment slowing. That said, Q1 GDP may overstate the recent weakness, given the effect of the temporary government shutdown and seasonal adjustment issues. Over the coming two years we expect growth to decelerate towards potential (slightly below 2%) amid waning fiscal stimulus and a lagged response to the ending of the Fed's tightening cycle. With growth moderating and inflation subdued, we expect that the Fed is done with this tightening cycle. We're forecasting the fed funds rate to remain unchanged at 2.25-2.50% as the economy slows towards its potential growth rate.

In the **euro area**, growth has been particularly weak. Leading indicators of activity, such as PMIs, have fallen sharply, reflecting the slowdown in external demand. Extended monetary accommodation is needed in the face of weak demand. Inflation remains low, despite recent strength in wage growth. Core inflation has been stable around 1% for the past year. The ECB has provided more monetary policy support by pushing back its guidance on the expected timing of interest rate increases and announcing a new TLTRO III series.

Figure 4. Core inflation rates



Source: Bloomberg, RBA, ANZ Research

The tailwind from the global environment has rapidly reduced for the New Zealand economy. The risk of a sharper slowdown in global growth remains, although renewed global policy stimulus is likely to support growth over the medium term with financial conditions having eased. However, lower global interest rates will put upward pressure on the New Zealand dollar if the RBNZ does not follow the tune of global central banks. And that could dampen inflation and weigh on export earnings. New Zealand's commodity prices have held up well so far, but risks are looking a bit one-sided with global demand fragile.

Table 1: GDP Growth

Calendar Years (annual average % change)	1998-2007 average	2008-2016 average	2017	2018	2019(f)	2020(f)
United States	3.1	1.4	2.2	2.9	2.1	2.0
Australia	3.4	2.6	2.4	2.8	2.1	2.6
Japan	1.0	0.4	1.9	0.8	0.5	0.8
Euro area	2.4	0.4	2.4	1.9	1.1	1.7
China	10.0	8.4	6.8	6.6	6.4	6.1
World	4.3	3.3	4.0	3.9	3.5	3.7

Source: Bloomberg, ANZ Research

Primary sector outlook

Summary

Global uncertainty and slowing economic activity are not expected to impact primary sector returns in the short term but this remains a key risk in the longer term. The risk of significant trade disruptions appears to be reducing as talks between China and the United States progress, and the Brexit deadline has been pushed out to October.

It's no game

Brexit has the potential to disrupt exports of New Zealand's wine and lamb, as the UK is a key market for these products. However, this risk is now reduced by the increased likelihood of an orderly departure of the UK from the EU. At the same time, alternate markets for wine and lamb continue to develop.

Trade negotiations between China and the US are progressing, which is positive as the uncertainty this causes has been a drag on economic growth. A reduction in trade flows between China and the US may have provided some short-term support for New Zealand exports but the sooner this dispute is sorted the better, as slower global growth is not positive for an export-based economy such as ours.

China girl

Dairy returns are expected to remain firm in the coming months on the back of milk supply growing more slowly than usual across the main milk-producing regions.

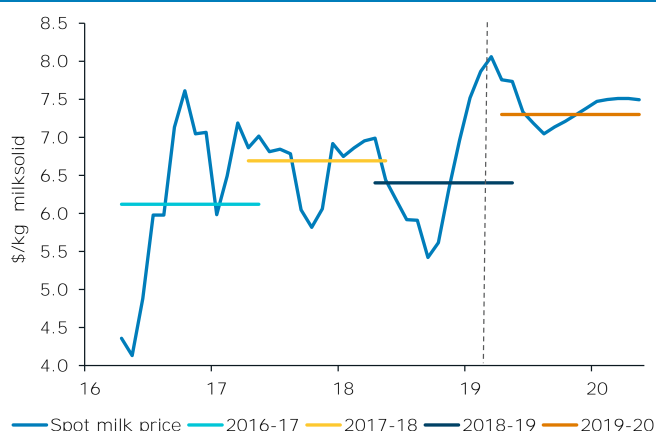
Demand for dairy products has been strong through the first quarter of 2019. NZ dairy exports were elevated during Q1 due to strong milk production in the first half of NZ's dairy production season. This extra supply coincided with strong global demand, allowing prices to respond in a positive manner.

Strong demand early in the calendar year is not unusual, as China, the world's largest dairy importer, tends to stock up at this time. The NZ-China Free Trade Agreement allows for a specific quantity of goods to enter the country each year at a reduced tariff rate. In the case of milk powders this provided a 10% advantage for the first 162,484t of milk powder that was imported in 2019.

The inventory build in China does mean there is more risk of price fluctuations as their urgency to secure additional product dissipates. But as New Zealand's milk production is falling faster than normal as we move towards the end of the production season, the risk of a substantial price correction is much reduced.

The upward trend in dairy commodity prices, combined with some softening of the NZD, means stronger milk prices are forecast for next season. We expect a milk price in the vicinity of $7.30/kg milksolid for the 2019/20 season. However, despite the high returns, expected dairy farmer confidence remains low.

Figure 1. Farmgate Milk Price



Source: NZX, GDT, ANZ Research

Sense of doubt

Dairy land values have stalled, with some indications that prices are starting to recede. Buyers are biding their time on making offers and the lack of international and 'investment' focused buyers has resulted in dairy farm sales in Canterbury stalling.

Despite strong milk prices, future returns remain uncertain as legislative changes are expected to add costs, but what is unknown is exactly how much. In this environment it is not surprising that we are seeing a decreased appetite for investment in dairy farms.

The sheep and beef sector is more buoyant. This sector is enjoying an extended period of strong returns with rising environmental compliance costs being less of a concern.

Lamb returns are exceptionally high for this time of the season. Normally farmgate returns fall at this time of the year when the bulk of lambs are being processed. This year, strong international prices, favourable exchange rates, and strong procurement pressure means farmgate returns for lamb and mutton remain high. Unfortunately the same can't be said for coarse wool, but this is less of a concern given the bulk of the income from lambs comes from the meat. Returns for fine wools are better than coarse wools, so the high-country farms that are more reliant on wool returns are still receiving reasonable incomes.

Primary sector outlook

Try some buy some

Beef returns have held at moderate levels despite more beef coming out of Australia earlier in the season. This is primarily due to the rapid rise in demand from China, which for beef sourced from NZ, Australia, and South America is providing a viable alternative market to the US. This has supported the price of beef being exported to the US.

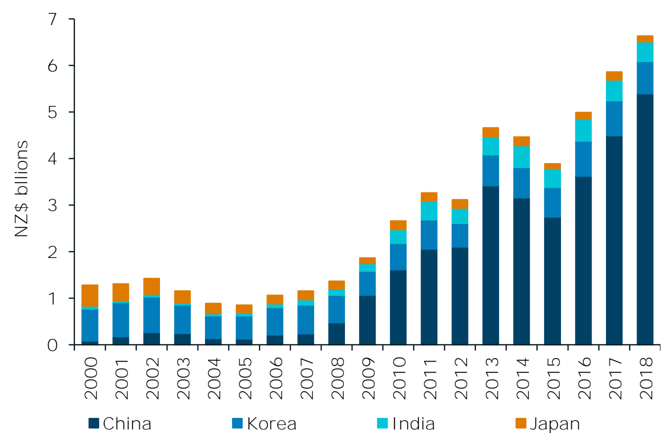
In addition, the volume of domestically raised beef being processed in the US is lower than expected. Processing numbers were expected to have lifted by now as the number of cattle on feed lots in the US has increased. However, the number of cattle ready for processing has been lower than expected and slaughter weights are down. This is providing support to the market at present and this support is expected to continue. As the number of cattle processed in the US lifts later in the year we will see further competition in the high-value Asian markets such as South Korea and Japan. Total processing volumes will be reduced due to the deaths from the flooding in the Mid-West. This is mainly expected to impact volumes in 2020 due to the high number of young calves that drowned.

The US is officially allowed to export beef to China, although access was only granted last year so a lot of processing facilities in the US are yet to be certified. The US-China trade war has stifled this trade for now, and it will take time for trade to flourish. Any improvement in the US-China relationships will bolster China's own domestic beef, pork and dairy production as these industries partially rely on imported feed: particularly soybeans, alfalfa hay for cattle and whey for pigs.

Knock on wood

Forestry returns are expected to remain high in the coming months. The volume of timber being felled remains elevated as the industry works its way through the higher volume of trees that were planted in the 1990s. Strong returns for logs are keeping felling rates high for now. The extra timber is being readily absorbed by international markets, which are dominated by demand from China. A slowing of economic activity in China could bring lower demand for logs, but thus far this has not happened. Ongoing government-backed infrastructure projects are expected to keep demand firm through the second quarter of this year.

Figure 2. Log export revenue



Source: Statistics NZ

Here today, gone tomorrow

The first ships have sailed laden with the new-season kiwifruit just picked. A record harvest is expected as additional plantings come on stream. Export returns from this sector will be bolstered by sales of more of the higher-value gold varieties. The number of gold fruit harvested this season is expected to outnumber green for the first time.

The volume of wine exported this year is expected to be down as the Marlborough sauvignon blanc harvest is shaping up to be poorer than expected. Exact quantities won't be known until the harvest is complete, but thus far volumes have been down but quality has been good.

The apple harvest is expected to be at record levels this season as new plantings mature. Finding sufficient labour for picking remains a challenge for the industry, with similar challenges faced by the kiwifruit industry.

Financial markets outlook

Summary

The RBNZ surprised markets with a shift towards an explicit easing bias at its March meeting. We have brought forward our expectations of the first OCR cut from November to August, with follow-up cuts pencilled in over the next year. Market pricing has shifted to aggressively price in a reduction to the OCR with 40bps priced in by the end of 2019. Long-end yields have pre-empted a cut but we expect there will be another move lower once the first cut is delivered and markets open up to the possibility of a third. The Fed's stance will likely cap any further upward moves in the long end of the curve, while there may be a brief repricing at the short end of the New Zealand curve as markets adjust expectations following the RBNZ's May meeting. Expectations of a cut to the OCR have begun to weigh on the NZD, but we believe there is room for the currency to move lower as the RBNZ is unlikely to cut just the once. Buoyant commodity prices, alongside positive market risk sentiment, will provide support, but domestic challenges remain. We expect the NZD/USD to reach 0.64 by the end of this year.

I want it that way

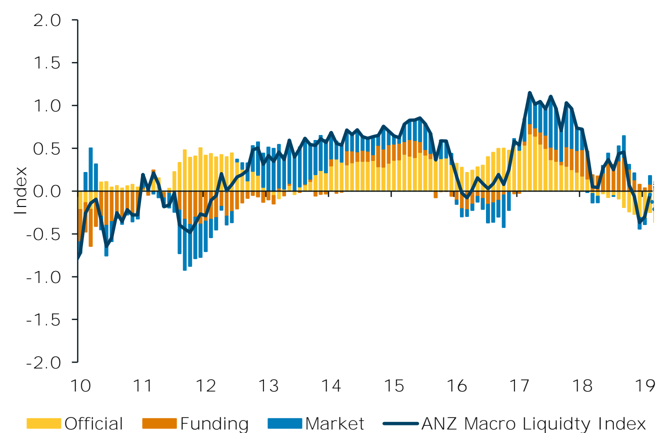
The New Year saw the central banking community call time on interest rate increases. In a surprising change in stance, the Federal Reserve, the ECB and the RBA led interest rate markets lower before the RBNZ joined the party at the end of the quarter. Concerns over global growth have been a primary reason for the change in central bank rhetoric, but domestic data have also started to soften in many countries.

The Federal Reserve has front-footed a dovish stance and has called time on its tightening cycle, including quantitative tightening. The Fed has (via its dot plots) removed the likelihood of a hike in US interest rates in 2019, and has eased concerns over tightening liquidity conditions by calling an end to its balance sheet reduction. The data pulse in the US has been mixed yet mildly positive, suggesting the Fed has timed its halt to hikes appropriately.

Markets have been quick to unwind future rate hike expectations, moving to price in some easing later this year. Unsurprisingly, US bond yields have rallied now that the Fed is on hold, from 2.7% in December to 2.6% currently. Going forward, we see US 10-year yields moving higher as US data improves, but this may be some time away as markets will look for a sustained improvement in data. We are currently forecasting US 10-year yields to move back to 3.0% over 2019.

With the US outlook shifting, the global liquidity cycle has improved from its contractionary position, reflecting a step back towards easy central bank monetary policy and liquidity conditions. The ECB has also stated that it will keep monetary policy accommodative this year. The euro area has seen its data deteriorate of late, leaving many questioning the region's growth prospects for this year. Alongside its dovish bias, the ECB announced it will embark on another series of quarterly targeted longer-term refinancing operations (TLTRO-III) in September this year.

Figure 1. ANZ Global Liquidity Index



Source: Bloomberg, Thomson Reuters Datastream, ANZ Research

China's data suggests that its recent economic downturn may have bottomed out. Recent PMI, trade and credit data suggests a momentum shift in the economy and while it remains early days, we remain optimistic that this rebound can be sustained, with domestic policy geared towards supporting growth.

A rebound in China's data has potential knock-on benefits for other economies as well. Australia and New Zealand will welcome recent improvements, since these economies remain reliant on China's demand for its exports. New Zealand's commodity prices have held up despite Chinese growth concerns and, should the data show a sustained upward trajectory, this will allay any fears of a drop in the future.

All up, the global markets outlook has improved since our previous ANZ Quarterly Economic Outlook but is likely to remain challenging in the near term. Uncertainties around Brexit will continue to weigh on the UK and Europe, and though US-China trade talks have made good progress, markets remain wary of downside scenarios.

NZ rates – When doves cry

A slowdown in global growth continues to weigh on the outlook for monetary policy in New Zealand. The RBNZ moved towards an explicit easing bias at their March

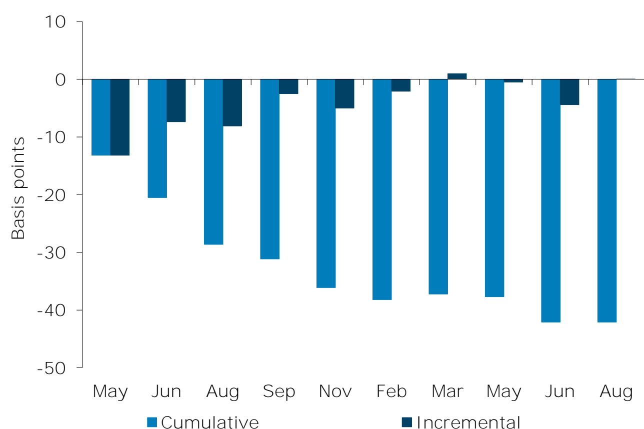
Financial markets outlook

OCR Review, stating that the next move in the OCR is more likely to be down. Despite already pricing a good chance of cuts, post-release moves were significant, with markets quick to price in a 45% chance of a 25bps cut to the OCR in May, a full cut by August and a 50% chance of a second cut by November this year.

Although markets are pricing in the chance of a cut in May, we expect the RBNZ to wait until August (with another in November and the last in February 2020). While the change in stance was sudden, we continue to believe it may take some time for developments to spur an actual cut from the RBNZ. A substantial easing in both interest rates and the exchange rate has already been delivered with the change in tone. We certainly expect the RBNZ to maintain its easing bias at future meetings, but an acknowledgement of a changing balance of risks is not a promise of imminent action. Satisfactory domestic data, coupled with recent improvements to the global picture, may provide a degree of breathing room before a cut is finally delivered in the latter half of the year as it becomes clear inflation pressure is waning.

Local yields have rallied to new lows this quarter. The New Zealand 10-year Government bond yield rallied to a low of 1.74% before retracing with offshore yields. We see the spread between the New Zealand and US 10-year bonds narrowing to -40bps by the end of 2020. The short end of the local curve sustained its rally as markets eye a rate cut in the near future. Our expectation is that the short end of the curve will continue to hold its ground at these low levels, with an eventual cut providing the longer end a chance to flatten further.

Figure 2: Market pricing for OCR



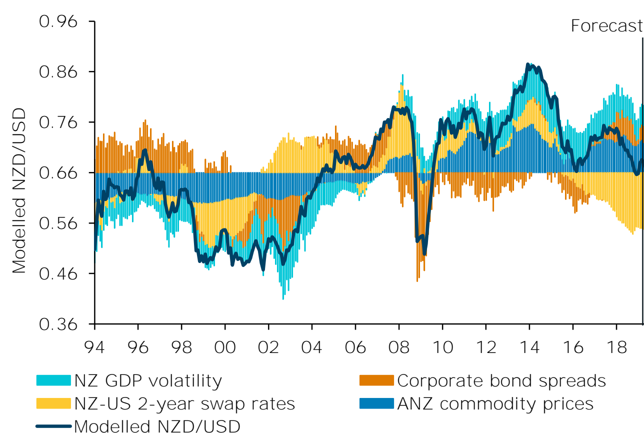
Source: Bloomberg, ANZ Research

NZD – Carry me home

The NZD has had a tumultuous time since the turn of the New Year, holding firm at dizzying heights against major crosses, before the RBNZ's change in stance saw a marked sell-off. A rebound in Chinese data coupled with news of progress in US-China trade talks had kept the NZD buoyed. But against the recent backdrop of a potential cut to the OCR, the NZD has struggled to sustain any upward momentum.

As shown in the figure below, the divergence in monetary policy settings between NZ and the US has been a primary driver for the NZD of late. Its influence was evident earlier in the year as global central banks became more dovish. Commodity prices remain supportive of the NZD but their influence can't outweigh NZ-US interest rate differentials. With US yields now higher than NZ, the NZD also lacks the carry component that has attracted many to the currency in the past.

Figure 3: What's moving the NZD



Source: Bloomberg, ANZ Research

Despite a recent improvement in data globally, we believe the outlook for global growth will remain subdued for some time. Domestic forward indicators also suggest that the New Zealand economy is past its prime and as the recent tick up in unemployment is followed by other signs that output growth and capacity pressures are waning, the NZD will become more vulnerable to downside pressures.

As is normal in currency markets, the expected decline in the NZD is likely to be anything but orderly, and opportunities will emerge for both buyers and sellers. Improvements in trade relations between the US and China will continue to support the NZD, alongside other factors positively impacting market risk sentiment. But a dovish domestic outlook will cap any upside moves.

Individual currency pairs

NZD/USD: On shaky ground. The NZD fell sharply as the RBNZ joined its central banking peers with a more dovish monetary policy outlook. USD moves will remain tied to the US data pulse following the Fed

Financial markets outlook

calling time on rate hikes. As such, we have revised our forecasts higher, and now expect the NZD/USD will reach 0.64 by the end of this year. That said, while the NZD will remain supported by positive changes towards risk, we expect any upside momentum to be dampened by the dovish domestic backdrop in the near term.

NZD/AUD: You first? This cross has traded a wide range since the beginning of the year. Early on, it appeared as though the RBA may succumb to cutting policy ahead of the RBNZ, but more recently the tables have turned. The current move lower could be sustained as data improves in Australia while the RBA maintains its neutral bias.

NZD/EUR: Data concerns. Europe's growth has lagged most major economies, and the currency has struggled to maintain any upward momentum as a result. That said, we expect the EUR to strengthen against the NZD as the RBNZ cuts the OCR in the coming months.

NZD/GBP: Kicking the can, again. Unsurprisingly, Brexit is the primary driver here. Uncertainty remains rife after numerous Brexit votes failed to pass in the House of Commons. That said, markets believe the chances of a 'hard' Brexit remains thin. This cross will be volatile as negotiations continue.

NZD/JPY: Sticking with sentiment. This pair continues to trade subject to risk sentiment. With global liquidity conditions easing lately, risk appetite remains supported. We expect to see this this cross continue to grind lower.

Table 1: Forecasts (end of quarter)

FX Rates	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20
NZD/USD	0.65	0.64	0.64	0.63	0.63	0.63	0.63
NZD/AUD	0.93	0.91	0.91	0.90	0.90	0.88	0.84
NZD/EUR	0.60	0.58	0.56	0.53	0.50	0.50	0.50
NZD/JPY	71.5	69.1	69.1	66.2	66.2	66.2	66.2
NZD/GBP	0.48	0.47	0.47	0.46	0.45	0.45	0.44
NZD/CNY	4.35	4.27	4.26	4.17	4.16	4.15	4.13
NZ$ TWI	70.2	68.6	67.7	65.6	64.8	64.4	63.5
Interest Rates	**Jun-19**	**Sep-19**	**Dec-19**	**Mar-20**	**Jun-20**	**Sep-20**	**Dec-20**
NZ OCR	1.75	1.50	1.25	1.00	1.00	1.00	1.00
NZ 90 day bill	1.83	1.58	1.33	1.16	1.16	1.16	1.16
NZ 2-yr swap	1.67	1.64	1.60	1.54	1.56	1.63	1.64
NZ 10-yr bond	2.05	2.35	2.60	2.50	2.50	2.60	2.60

Source: Bloomberg, ANZ Research

Key economic forecasts

Calendar Years	2015	2016	2017	2018(f)	2019(f)	2020(f)	2021(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.5	3.9	3.1	2.8	2.2	2.5	2.9
Private Consumption	3.6	5.3	4.8	3.3	3.3	2.4	2.7
Public Consumption	2.5	2.0	2.9	2.2	2.5	3.2	3.2
Residential investment	5.6	10.8	0.9	2.7	3.3	1.7	2.1
Other investment	3.2	2.1	4.4	4.3	2.8	3.7	3.9
Stockbuilding[1]	-0.3	0.1	-0.1	0.3	-0.3	0.0	0.0
Gross National Expenditure	3.0	4.6	4.0	3.6	2.5	3.0	3.2
Total Exports	7.4	2.1	1.8	3.0	2.6	2.4	2.7
Total Imports	4.0	3.3	6.9	5.6	1.8	3.1	3.2
Employment (annual %)	1.4	5.8	3.7	2.3	1.6	1.5	1.4
Unemployment Rate (sa; Dec qtr)	4.9	5.2	4.5	4.3	4.3	4.2	4.1
Labour Cost Index (annual %)	1.6	1.6	1.9	2.0	2.2	2.3	2.3
Terms of trade (OTI basis; annual %)	-3.1	6.7	7.9	-4.7	2.4	0.8	0.8
Current Account Balance ($bn)	-7.1	-5.7	-8.1	-10.8	-11.5	-12.8	-13.7
as % of GDP	-2.8	-2.2	-2.9	-3.7	-3.8	-4.0	-4.1
Prices (annual % change)							
CPI Inflation	0.1	1.3	1.6	1.9	1.5	1.9	2.0
Non-tradable Inflation	1.8	2.4	2.5	2.7	2.5	2.7	2.9
Tradable Inflation	-2.1	-0.1	0.5	0.9	0.1	0.7	0.8
REINZ House Price Index	14.8	14.5	3.5	3.3	3.5	3.0	2.0
NZ Financial Markets (end of December quarter)							
TWI	73.6	76.1	73.0	71.5	67.7	63.5	--
NZD/USD	0.68	0.69	0.71	0.67	0.64	0.63	--
NZD/AUD	0.94	0.96	0.91	0.95	0.91	0.84	--
NZD/CNY	4.43	4.81	4.62	4.62	4.26	4.13	--
NZD/EUR	0.63	0.66	0.59	0.59	0.56	0.50	--
NZD/JPY	82.1	81.1	80.0	73.7	69.1	66.2	--
NZD/GBP	0.46	0.56	0.53	0.53	0.47	0.44	--
Official Cash Rate	2.50	1.75	1.75	1.75	1.25	1.00	--
90-day bank bill rate	2.75	2.00	1.88	1.97	1.33	1.16	--
2-year swap rate	2.85	2.46	2.21	1.97	1.60	1.64	--
10-year government bond rate	3.57	3.33	2.72	2.37	2.60	2.60	--

[1] Percentage point contribution to growth

Forecasts finalised 18 April 2019

Source: Statistics NZ, REINZ, Bloomberg, Treasury, ANZ Research

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