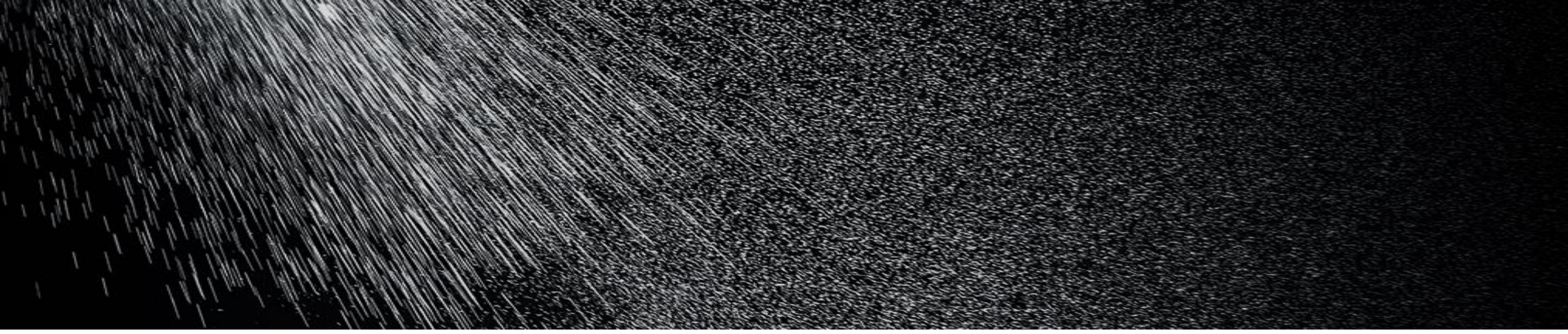
ANZ Research

July 2019

# Quarterly Economic Outlook

## A game of two halves



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## New Zealand economic outlook

The New Zealand economy has been gradually slowing as key economic tailwinds and headwinds duke it out, and it's still not entirely clear which will be on top by year-end. We expect the tailwinds will regain the upper hand, seeing growth bottom out shortly. While these two opponents are closely matched, help is undoubtedly on the way. The RBNZ has already cut the OCR, and we expect they'll do so again in August and November; the NZD remains around 2% below late-March levels; and Budget 2019 included a little extra fiscal stimulus. All up, we see annual growth slowing to 2% in Q2, before gradually lifting towards 3% in 2021. That's not going to drive a strong inflation pulse, but we expect it will be sufficient to keep core inflation elevated close to the target midpoint.

## International outlook

The synchronised slowdown in global growth has become more pronounced, with activity indicators weakening further in recent months. Businesses are deferring investment and industrial production activity has slowed. Uncertainties persist regarding trade, Brexit, and global growth and this is now spilling over to a broader slowdown. Inflation is still subdued and below target in many economies, despite tight labour markets and gradually rising wages. Additional policy stimulus is needed to support growth and inflation, with the risks to the outlook remaining to the downside.

## Primary sector outlook

Global demand and pricing generally remains robust for food-based commodities exported from New Zealand despite deteriorating global economies. But prices have declined for fibre exports. At present the food sector is benefitting from our exposure to the Asian markets whose economies are still growing rapidly, albeit at a slower rate than previously. Asia accounts for more than half of New Zealand's export returns.

## Financial markets outlook

A deterioration in the global data pulse has seen central banks become increasingly dovish, with some (such as the RBNZ) pre-empting a slowdown and embarking on a proactive easing cycle. The Federal Reserve's shift towards an easing bias at the June FOMC meeting set off a global hunt for yield. This saw US Treasury yields plummet, whilst New Zealand and Australian yields fell to record lows. The RBNZ's dovish bias extended beyond May's proactive cut and into its June OCR Review, leading us to bring forward our rate-cut expectations to August and November. Despite the RBNZ's dovish bias, the NZD has found support via a weaker USD. We expect the slowdown in global activity to weigh on the NZD, and expect the global easing cycle to continue to drag yields lower.

| Calendar Years | 2016 | 2017 | 2018 | 2019(f) | 2020(f) | 2021(f) |
|---|---|---|---|---|---|---|
| New Zealand Economy | | | | | | |
| Real GDP (annual average % change) | 3.9 | 3.1 | 2.9 | 2.2 | 2.5 | 2.9 |
| Real GDP (annual % change) | 3.5 | 3.4 | 2.5 | 2.2 | 2.6 | 3.0 |
| Unemployment Rate (Dec quarter) | 5.2 | 4.5 | 4.3 | 4.4 | 4.3 | 4.1 |
| CPI Inflation (annual %) | 1.3 | 1.6 | 1.9 | 1.2 | 1.8 | 2.0 |
| Terms of Trade (OTI basis; annual %) | 6.7 | 7.9 | -4.8 | 1.1 | 0.8 | 0.4 |
| Current Account Balance (% of GDP) | -2.2 | -2.9 | -3.8 | -3.8 | -4.0 | -4.1 |
| NZ Financial Markets (end of Dec quarter) | | | | | | |
| TWI | 76.1 | 73.0 | 71.5 | 66.7 | 66.9 | -- |
| NZD/USD | 0.69 | 0.71 | 0.67 | 0.61 | 0.65 | -- |
| NZD/AUD | 0.96 | 0.91 | 0.95 | 0.94 | 0.93 | -- |
| Official Cash Rate | 1.75 | 1.75 | 1.75 | 1.00 | 1.00 | -- |
| 10-year Bond Rate | 3.33 | 2.72 | 2.37 | 1.45 | 1.35 | -- |

Source: Statistics NZ, Bloomberg, ANZ Research

# New Zealand economic outlook

## Summary

The New Zealand economy has been gradually slowing as key economic tailwinds and headwinds duke it out, and it's still not entirely clear which will be on top by year-end. We expect the tailwinds will regain the upper hand, seeing growth bottom out shortly, but these two opponents are closely matched. Risks appear skewed towards the slowdown persisting a little longer, or being a little sharper in the near term than our expectation, but help is undoubtedly on the way. The RBNZ has already cut the OCR, and we expect they'll do so again in August and November; the NZD remains around 2% below late-March levels; and Budget 2019 included a little extra fiscal stimulus, which – if not a long-lasting impetus to growth – will at least provide a boost at this crucial turning point in the match. All up, we see annual growth slowing to 2% in Q2, before gradually lifting towards 3% in 2021. That's not going to drive a strong inflation pulse, but we expect it will be sufficient to keep core inflation elevated close to the target midpoint.

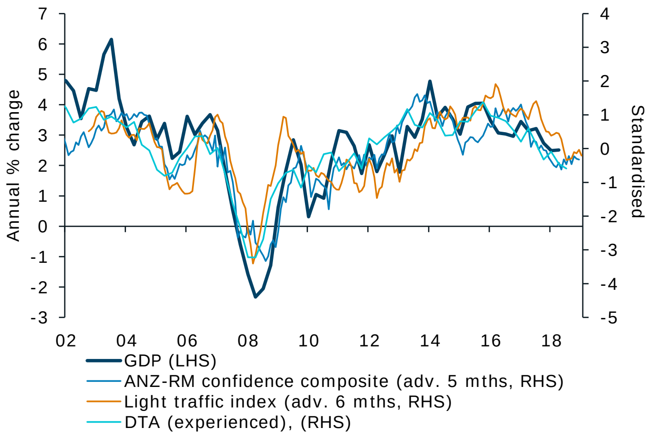
## Looking for the turnover

While headline GDP growth was stable at 0.6% q/q and 2.5% y/y in Q1, the details were undeniably soft – reflective of an economy that has continued to lose momentum from 2018. Growth among services industries, the powerhouse of the economy, was particularly weak at just 0.2% q/q. This was the lowest quarterly pace of growth since 2012, which is concerning given that the sector accounts for around two-thirds of the economy and is generally less volatile than the goods-producing and primary sectors.

Looking to the next GDP release, the data flow continue to support our view that economic momentum slowed into Q2, which we think will be more evident in the headline figures than it was in Q1. We expect the economy expanded at an anaemic pace of 0.4% q/q, which, absent revisions, will take annual growth to just 2%. And some indicators suggest there's downside risk to this forecast.

In particular, businesses have reported that their own activity contracted in Q2, to a degree that is consistent with annual growth slowing to below 2% in the near term. But other indicators, such as our Truckometer Indexes and our Confidence Composite Index, suggest (at least tentatively) that the slowdown is indeed finding a floor. But it's still a little early to gauge the degree, persistence, or, to be fair, even the existence of a turning point for momentum heading into the second half of the year. But since we have to take a punt, we'll back our indicators.

Figure 1. GDP growth and key forward-looking indicators

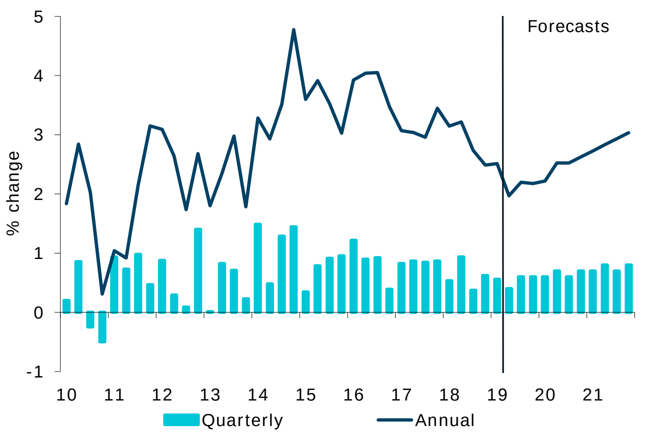



Source: Statistics NZ, NZIER, Roy Morgan, NZTA, ANZ Research

The final whistle may have been blown on the June quarter, but from a data-flow point of view the match statistics are yet to be released. We won't get Q2 GDP until mid-September. Doing the maths, growth of 0.8% q/q or lower in Q2 will see annual growth slow (provided GDP isn't revised too significantly). We think 0.8% is a pretty high bar for a surprise directional shift in annual growth, so it's all eyes on Q3 or beyond for the turning point.

We are picking the turnover will occur in Q3, with quarterly growth of 0.6% sufficient to put the trough in annual growth in the rear view mirror (figure 2), assuming Q2 pans out as we expect. But that's not to say the pick-up in growth won't be hard won. After all, key headwinds and tailwinds of growth are expected to remain pretty evenly matched for a while yet. We turn to these now.

Figure 2: Production GDP growth




Source: Statistics NZ, ANZ Research

## Kick off time

The match between key headwinds and tailwinds for control over the direction in GDP growth is always evolving, and complicated by the fact that some players have a habit of switching teams. But currently the headwinds of slowing migration-led population growth, near non-existent productivity growth, a wary business sector, and a softer housing market appear to be ahead on the scoreboard and not showing signs of letting up. However, the tailwinds of lower interest rates, a lower NZD, gradually lifting household incomes, and a little more government spending are providing a pretty solid defence. We don't think it will be too long before the tailwinds regain the upper hand, but it's going to be a close match. Importantly, if it looks like Team Tailwind's defence is inadequate and they're going to lose the game, they still have support from the benches in the form of ample fiscal headroom and further monetary stimulus.

### Households should remain loyal supporters

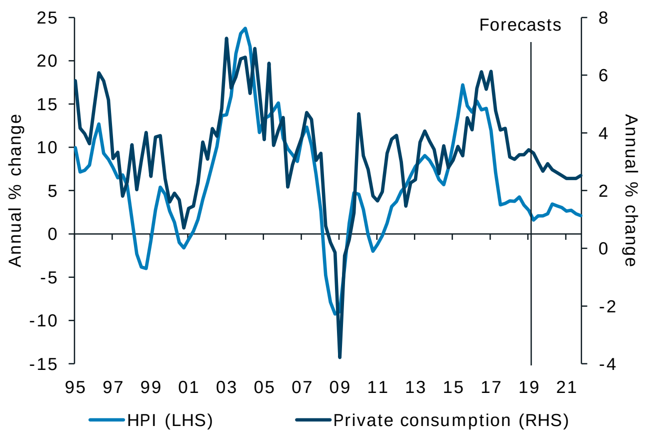
Households represent a rather significant part of the game. Lower interest rates are keeping debt-servicing costs down and incomes are gradually lifting on the back of the tight labour market. However, employment growth has recently softened. We expect this to recover in coming quarters as the economy continues to expand at a modest pace, but we are mindful of the risk that rising labour costs (owing to minimum wage increases and difficulty finding skilled staff), combined with difficulty raising selling prices (owing to heightened competition), could materialise as a broad-based reduction in headcount.

Indeed, recent dataflow suggests this is already happening at the margins, but so far not to the extent that it threatens to spill over significantly into aggregate household incomes or derail the overall tightness of the labour market. From here, we expect the unemployment rate to tick up marginally in the near term as softer growth filters through the labour market. Thereafter, we expect it to return to current levels as growth gradually accelerates and employment and participation growth slow along with growth in the working age population. And that's consistent with ongoing modest growth in real wages, supporting consumption growth.

However, a slower pace for house price inflation is likely to cap the upside for household spending. House price inflation has moderated significantly over the past year or so, and associated household wealth effects and their impact on spending have dissipated accordingly. Of course, the tight correlation shown in figure 3 is not due only to wealth effects, but also the usual historical pattern that house price booms are brought to an end by high interest rates. That has not been the case this time, and so the negative impact on consumption of higher debt-servicing costs is missing. Consumption is indeed holding up better than house price inflation alone would suggest. But the fact that the correlation hasn't broken down completely is testament to the fact that the housing cycle matters.

So where to from here for house prices? Despite solid fundamentals (a shortage of houses and (still) lower mortgage rates) and the Government ruling out a capital gains tax, house prices actually fell 0.7% in Q2. While we don't think negative house price inflation will last the game, we do see limited upside. Affordability and credit constraints, together with still-binding LVR restrictions and the lengthy list of recent policy changes[1], are expected to keep the market from heating up significantly. But there are still pockets of strength in some regions that should keep house price inflation from rolling over at the national level.

Figure 3. House prices and private consumption




Source: Statistics NZ, REINZ, ANZ Research

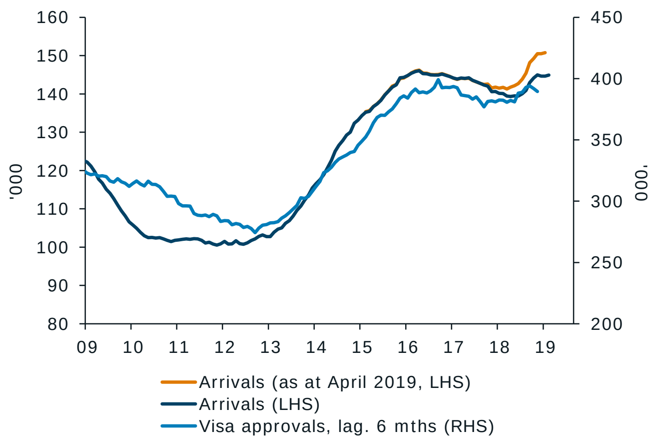
Reflecting already-high house prices, household debt levels are now at a record-high relative to incomes. And while low interest rates mean this is manageable (at least in aggregate), we expect households will be looking to gradually rebuild savings buffers over the next few years, which will limit the scope for a credit-induced spend-up in response to lower interest rates.

Slowing population growth (owing to an easing migration cycle) is also expected to dampen growth in household spending. Migration data is now very noisy (at least the last nine months or so of data), and despite recent outturns suggesting that the cycle has picked up, we just don't buy it. Given migration-

[1] Examples include the banning of foreign buyers, extending the bright-line test on capital gains, ring fencing of tax losses, and increased landlord responsibilities via the healthy homes rules.

led population growth has been one of the most dominant drivers of growth this cycle (if not the most dominant), and that the economy has been gradually losing steam since the migration cycle peaked in mid-2016, it doesn't make a lot of sense that net migration is now reported to have lifted while the broader economy continues to slow. Indeed, the older, more reliable data suggest the cycle was still easing towards the end of 2018. Further, on the arrivals side, we haven't found any evidence in visa approvals data to suggest arrivals have lifted above their 2016 peak (figure 4). But ignoring the noise from the sidelines, arrival numbers do appear to have remained at a high level.

Figure 4. Annual migrant arrivals and visa approvals



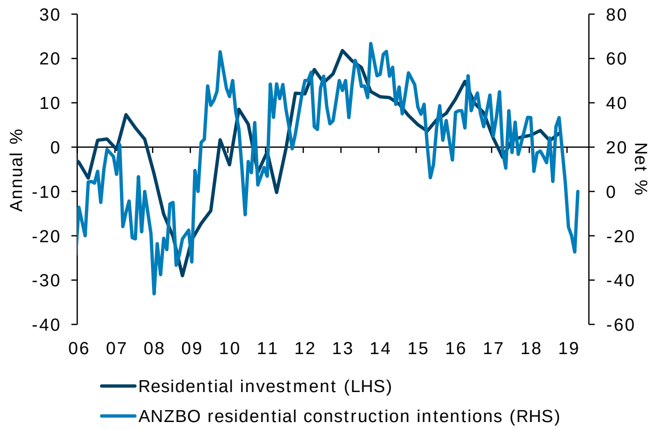

Source: Statistics NZ, MBIE, ANZ Research

Putting it all together, slowing population growth, a modest house price inflation outlook, and gradually lifting real wages suggest private consumption growth will struggle to gain momentum any time soon. But the lower NZD should favour domestic production and soften import volumes to some extent, supporting GDP growth at the headline level.

## The residential construction sector faces some hard yards

Still-high demand for houses is expected to keep the residential construction sector busy, but headwinds in this sector aren't going away in a hurry. Costs, credit and capacity constraints are ongoing issues that are proving difficult to overcome. While there might be a little pipeline strength in residential construction yet to come through in the GDP data, we think activity is close to topping out and will actually soften by year-end before stabilising at a modest pace of expansion in 2020. While we're not forecasting a sharp decline in residential investment, some working in the industry aren't so sure (figure 5). And they tend to know.

Figure 5. Residential construction intentions and investment




Source: Statistics NZ, ANZ Research

## Business investment should pick up gradually

Business pessimism has proven a stubborn feature of the New Zealand economic backdrop, which, together with a few wobbly signals coming out of the global economy, is likely to be weighing on investment and employment decisions. The recent experience of lacklustre investment on the part of firms, combined with a public-sector infrastructure underspend this past decade, is restricting the economy's ability to grow. This provides at least part of the explanation for weak productivity growth this cycle.

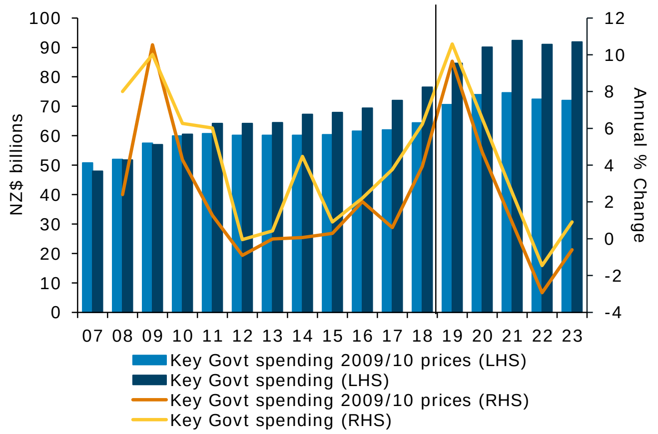
From here, we expect firms will gradually increase investment as labour scarcity slowly but surely intensifies as population growth slows. However, investment in both plant, machinery & equipment and transport equipment has been soft in recent quarters, and it could be a while before firms feel comfortable upping the investment ante. A lower OCR should help to some extent, but we are sceptical that debt-servicing costs are a major impediment at present and hence are equally sceptical that still-lower rates will prove a panacea.

## Government spending expected to be a near-term sponsor

On a slightly more positive note, Budget 2019 included a little extra capital and operational spending over the next few years. However, we think the Government could have gone further – particularly on the capital side.

Looking at the main components of core Crown cash spending (figure 6), it appears fiscal stimulus (through the spending side at least) is peaking about now, with annual growth in real government spending (deflated by the GDP deflator) expected to hit 9.4% in the year ended June 2019. Given we've already got GDP data for three quarters of the 2019 fiscal year, and the forward-looking indicators suggest Q2 GDP growth isn't looking too flash, it appears fiscal settings, even at their stimulatory peak, have been insufficient to prevent the broader economy from slowing. Further, on current forecasts, there's only one year to go where growth in government spending is set to outpace that of the broader economy. Indeed, by the year ended June 2021, government spending will be dragging on growth. Fiscal policy will remain constrained in its ability to stimulate growth beyond the next year so long as the Government continues to stick strictly to its debt target.

Figure 6. Key Government spending[2]




Source: The Treasury, ANZ Research

Should the economy get into trouble, perhaps in the event of a global shock, one would hope the Government uses the ample amount of fiscal headroom available to lean against the wind and support monetary policy in its attempts to revive the economy's spirits. Given the world can change quite quickly, one would hope the Government can respond quickly too.

## Earnings from away games and exports more broadly will be aided by a lower NZD

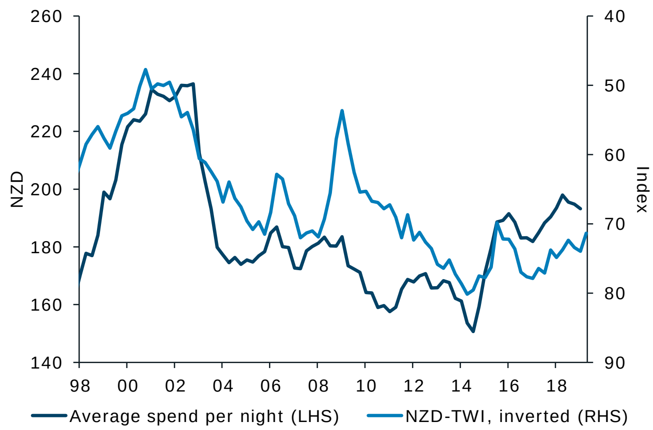
It's a bit of a mixed picture for exporters. Global economic conditions are looking far from rosy, but New Zealand's export commodity prices have so far remained firm, keeping the terms of trade elevated. But there are exceptions – log prices have dropped precipitously of late. More generally, it appears exporters are attentive to the risks associated with softer global demand, and given debt levels are high for some (particularly in the dairy sector) deleveraging while world prices are decent and the NZD is lower will make a lot of sense. And that implies limited pass-through to the broader economy from still-solid average export prices.

As always, the weather will have a lot to say about export volumes. Exports have benefited from favourable weather conditions over the past year, but that can't last forever. We're assuming a return to more 'normal' weather conditions over the coming year, which we expect to offset ongoing productivity gains, leaving agricultural exports broadly unchanged on a season-on-season basis. However, there's likely to be a fair amount of variance by export type, with a bit of near-term weakness on the cards for forestry, but ongoing strength for horticulture (see page 11).

Services exporters, particularly those in the tourism sector, are hoping the global slowing in trade and manufacturing remains contained and has limited implications for foreign household incomes, confidence and discretionary spending. But alas, seasonally adjusted visitor arrivals have already come down slightly from the record levels set in November last year. And while the level is still high overall, the recent decline in visitors from China (our second-largest market after Australia) is a little concerning.

For those who do decide to visit this beautiful country, the lower NZD should at least encourage them to spend a little more during their stay (figure 7).

Figure 7. Average visitor spend and NZD-TWI




Source: Statistics NZ, Bloomberg

All up, net exports are expected to contribute positively to annual growth over the next couple of quarters before becoming broadly neutral as 'normalised' agricultural production matches demand for imports, which is weighed down slightly by the lower NZD. Compared to our last update, net exports' contribution to growth is expected to be slightly stronger, owing largely to softer demand for imports.

Overall, however, given that the economy has been evolving broadly as we expected, the outlook for headline GDP growth isn't very different from our previous (April) update. We have softened our

[2] Includes transfers payments, and subsidies; personnel and operating costs; and net purchase of physical assets.

residential investment forecasts slightly, but a little more government spending and weaker imports growth provide an offset.

## Hat-trick

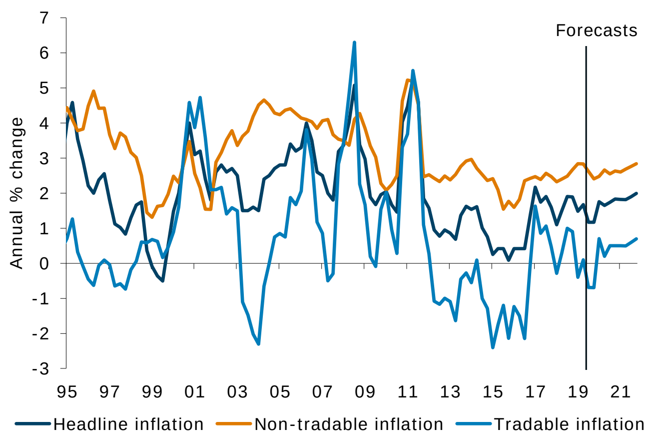
Putting it all together, we're left with an outlook for GDP growth that without a little additional monetary stimulus will struggle to keep inflation around the 2% target mid-point over the medium term. In fact, given the recent loss of momentum, we believe economic growth is now running slightly below potential and that pipeline inflationary pressures are waning.

We've been arguing the case for OCR cuts for some time now, and since December last year have been forecasting three of them. The RBNZ delivered one in May, and at the June OCR Review the Monetary Policy Committee "agreed that more support from monetary policy was likely to be necessary". We expect the remaining two forecast cuts will come in August and November, taking the OCR to 1.0%.

## And tailwinds are ahead on the scoreboard

Reflecting the recent easing in capacity pressures, domestic inflation is expected to soften in the near term. Annual non-tradable inflation is forecast to slow from 2.8% in Q2 to 2.4% by year-end before stabilising into 2020 and gradually lifting over the latter part of the forecast horizon as economic activity lifts and capacity pressures begin to tighten once again. Tradable inflation should get a bit of a bump from a weaker NZD, but annual tradable inflation isn't expected to lift meaningfully until Q1 2020 when 2019's weak (-1.3% q/q) Q1 print falls out of the annual calculation. Overall, annual headline inflation is expected to trough at 1.2% in Q3 this year, before lifting to a touch below 2% in 2021.

Figure 8. CPI forecast




Source: Statistics NZ, ANZ Research

## Just don't stumble

As has been the case for some time, risks to the outlook are heightened and skewed to the downside.

The global economy is facing a lengthy list of risks that could derail our expectation that growth will gradually accelerate (see page 9). It is not atypical for severe (tail-end) shocks to the New Zealand economy to be triggered by an offshore event that transmits directly though financial and trade flows with the rest of the world, and indirectly as both New Zealand households and business become cautious.

Broadly speaking, the most likely risk we see to the outlook is that the domestic economy proves a little more sluggish than anticipated. This could happen for a number of reasons.

- Monetary policy could be less effective at stimulating demand than anticipated, particularly given a lot of the stimulus comes through a lower NZD, and other central banks' easing bias is capping the depreciation.
- The chance that productivity growth stagnates for longer than expected and businesses decide not to lift investment is a slow-burn risk that we need to remain attentive to – particularly given business confidence remains in the doldrums.
- Government spending could run into more significant delays than is typically the case, meaning a lower-for-longer fiscal impulse. Conversely, the Government could decide to throw its debt target out the window at the next election and lift spending or cut taxes.
- Perhaps owing to a more fragile-looking global environment, households could decide to rebuild savings buffers by more than expected by reining in their spending.
- The labour market typically lags economic activity, and it's possible that the recent slowing in economic momentum spills over into a more significant deterioration in employment and household incomes than we expect. Uncertainty on the part of businesses also suggests downside risks to employment growth.
- The housing market could go either way. Our expectation that pockets of strength in some regions will keep annual house price inflation broadly stable could prove optimistic – particularly if the fundamentals in the regional economies don't justify it. But the housing market could also get a second wind on the back of lower interest rates and the Government

taking a capital gains tax off the table. But we think that's unlikely given all the other headwinds at play.

- Reflecting the new inability to gauge the migration pulse in anything remotely resembling real time, the impetus to economic growth by expanding the population could be weaker (or stronger) than we expect – time will tell.
- The RBNZ's proposal to increase banks' capital requirements will, if implemented, lead to tighter credit conditions than otherwise, particularly for the business and agricultural sectors. It is realistic to expect a degree of front-loading of the impact on credit availability, and that's a headwind the economy doesn't need right now. But the final plan won't be revealed until November, so no impact is built into our forecasts as yet.

Despite the balance of risks remaining skewed to the downside, we think there are enough growth supports out there to prevent momentum from stalling completely. That would likely require one of those tail-end global events that happen once in a while, and, unfortunately, are difficult to predict.

# International outlook

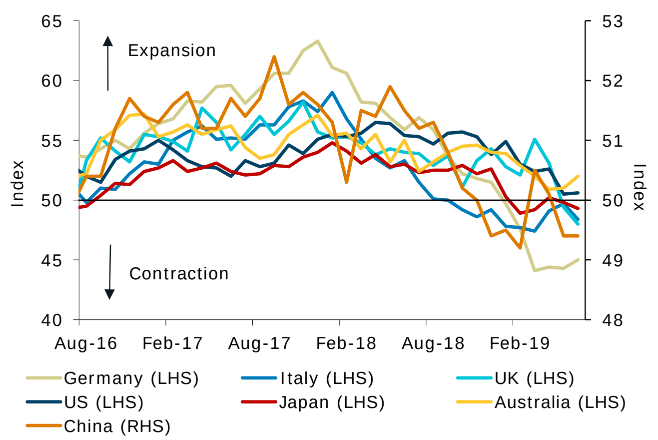
## Summary

The synchronised slowdown in global growth has become more pronounced, with activity indicators weakening further in recent months. Businesses are deferring investment and industrial production activity has slowed. Uncertainties persist regarding trade, Brexit, and global growth and this is now spilling over to a broader slowdown. Inflation is still subdued and below target in many economies, despite tight labour markets and gradually rising wages. Additional policy stimulus is needed to support growth and inflation, with the risks to the outlook remaining to the downside. However, many central banks have little room to stimulate their economies and inflation expectations are near the lower ends of their ranges. There are some signs that the weaker global environment is affecting New Zealand. Commodity prices have softened, particularly for dairy and logs, although this partly reflects supply factors. More stimulatory policy from foreign central banks is adding upward pressure to the NZD, but expectations for further RBNZ easing have kept financial conditions easy and the NZD in check for now.

## Stuck in the ruck

The synchronised slowdown in global growth has become more pronounced, with activity indicators weakening further in recent months (figure 1). The global economy looks set to grow 3.3% y/y in 2019, less than we had previous expected. A small pick-up in global growth to 3.6% is forecast for 2020.

Figure 1. Selected Global PMIs

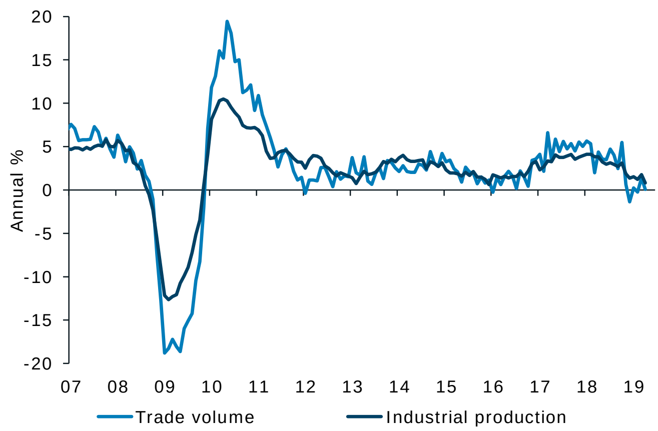



Source: Bloomberg, ANZ Research

Businesses are deferring investment and industrial production activity has slowed, amidst persistent trade, Brexit, and global growth uncertainties. There has been a sharp, synchronised slowdown in both industrial production growth and world trade volumes (figure 2).

There are also signs that the slowdown in industrial production is starting to spill over into other sectors. Retail sales have been weak in key economies in recent months, despite strong labour markets and a gradual rise in wages. Labour markets have remained reasonably resilient to the growth slowdown, but this indicator does lag the economic cycle. We will be watching closely to see if labour markets deteriorate from here.

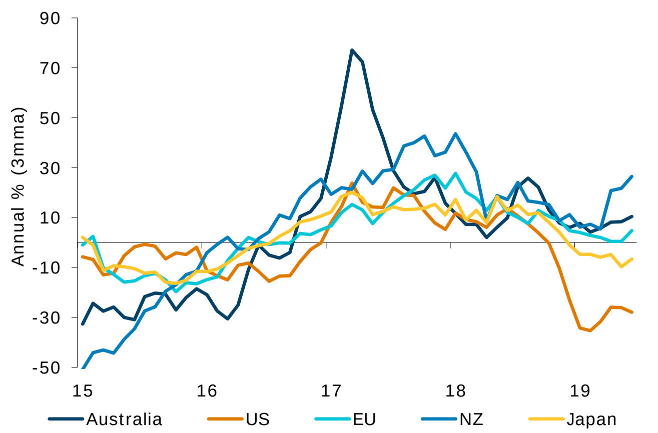
Figure 2. Global trade and industrial production growth




Source: Bloomberg, ANZ Research

A key international theme has been the escalating trade tensions between the US and China. In mid-May, US President Trump raised the tariff rate from 10% to 25% on USD200bn of imports from China. The US is also threatening to impose a further 25% tariff on the remaining USD300bn of Chinese imports, but has held off while the two countries resume trade discussions. The Chinese and US economies have taken a hit from the knock-on effects of the trade war and downside risks have increased.

Figure 3. China imports by country (USD)




Source: Bloomberg, China Customs General Admin, ANZ Research

**China** looks set to slow more sharply than we had previously expected, with growth of 6.2% y/y this year and a further slowing to 6.0% y/y in 2020. Industrial production and retail sales growth has been patchy and producer price inflation suggests little demand or price pressure further up the paddock. There has been a broad slowing in China import demand as the economy has slowed, particularly from the US (figure 3). Fiscal and monetary policy stimulus should stabilise the slowdown, but downside risks to growth remain.

In the US, there has been a sharp loss of momentum in 2019. Amid the global uncertainties, there has been an abrupt slowing in industrial production and business investment. Inflation has remained surprisingly subdued even as the labour market has tightened further, suggesting that there is room for additional stimulus to support the economy.

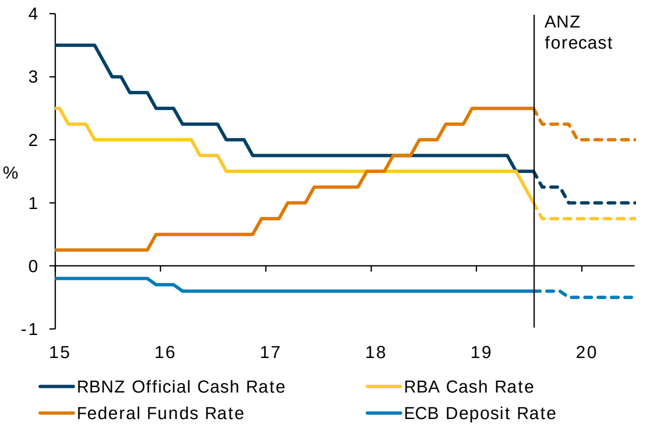
The slowdown in growth has been synchronised across New Zealand's trading partners. Euro area growth has been particularly weak, especially within manufacturing. Lead indicators, such as manufacturing data, point to ongoing weakness in activity in the coming quarters. One bright spot for both the euro area and the UK is the labour market, with the euro area unemployment rate close to pre-GFC lows and the UK unemployment rate near a 45-year low. However, inflation remains low, with core inflation in the euro area stable around 1%, and sub-trend growth is expected to provide further downward pressure.

Closer to home, growth in Australia has disappointed, with weakness in household consumption and housing construction weighing on activity. Weak growth is starting to filter into the labour market. The unemployment rate has increased to 5.2% and forward-looking indicators suggests that it will edge higher in coming months. Inflation and wage growth remains low, with spare capacity still evident. Looking forward, lower interest rates, regulatory easing and fiscal stimulus suggest that 2020 should be a better year, with growth expected to move up to 2.8%.

Support is being provided by more stimulatory global policy settings:

- The Federal Reserve is moving to an easing cycle; we expect two rate cuts this year.
- The PBoC is likely to cut the reserve requirement ratio (RRR) by 100bp this year, boost credit measures, and lower money market rates.
- The ECB is expected to provide more monetary policy support by cutting the deposit rate to 0.5% and new quantitative easing is likely in some form.
- The RBA has cut the cash rate twice and we expect a further cut this year, which would bring their cash rate back to 0.75%.

Figure 4. Central bank policy rates




Source: Bloomberg, ANZ Research

However, the slowdown has come at a time when many central banks have little gas in the tank. Policy rates in some regions are now negative and central bank balance sheets are still bloated from previous rounds of quantitative easing. In addition, inflation expectations in many economies are near the bottom of historical ranges, with a key risk that expectations become unanchored and reinforce low inflation.

In this environment of global monetary policy easing, if the RBNZ doesn't follow the pack it will face a higher NZD. Commodity prices have remained resilient overall, but dairy and log prices have softened (though this partly reflects supply factors). All up, the global environment is likely to make it difficult for the RBNZ to get its employment and inflation objectives over the advantage line next year.

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 | 2.3 | 1.9 |
| Australia | 3.4 | 2.6 | 2.4 | 2.8 | 1.8 | 2.8 |
| Japan | 1.0 | 0.4 | 1.9 | 0.8 | 0.6 | 0.7 |
| Euro area | 2.4 | 0.4 | 2.4 | 1.9 | 1.1 | 1.7 |
| China | 10.0 | 8.4 | 6.8 | 6.6 | 6.2 | 6.0 |
| World | 4.3 | 3.3 | 4.0 | 3.8 | 3.3 | 3.6 |

Source: Bloomberg, ANZ Research

# Primary sector outlook

## Summary

Global demand and pricing generally remains robust for food-based commodities exported from New Zealand despite deteriorating global economies. But prices have declined for fibre exports. At present the food sector is benefitting from our exposure to the Asian markets whose economies are still growing rapidly, albeit at a slower rate than previously. Asia accounts for more than half of New Zealand's export returns.

Growing demand for protein in the developing markets is underpinning meat, dairy and horticultural product prices. These sectors are also benefitting from limited supply growth. Meat returns are expected to remain high through the second half of 2019. Strong demand from China is underpinning both lamb and beef prices, as this market looks to fill the protein gap caused by the reduction in its pork production.

## Out for the count

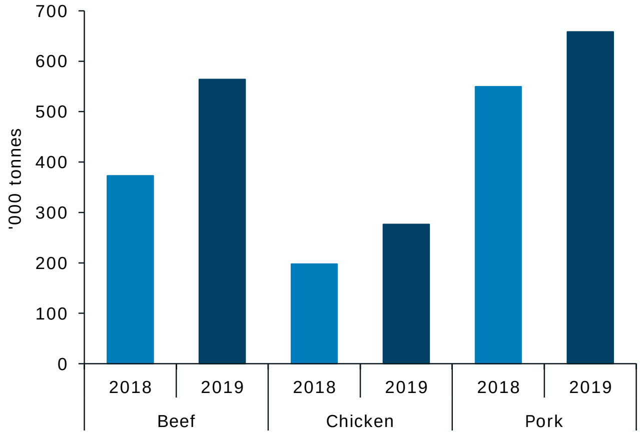
Unfortunately, New Zealand's markets for fibre exports aren't faring as well as they were. Demand for coarse grades of wool remains subdued and it now costs more to shear a sheep than the wool is worth. Log prices have also taken an abrupt tumble as the quantity of logs being supplied into China has now exceeded immediate demand. High prices in this market induced additional supply of logs and lumber from New Zealand, Australia, South America, Europe and Russia. Log prices have fallen sharply while lumber prices have been trending down for the past year. Log prices are expected to keep trending down with an improvement not likely for up to six months.

The recent disruptions to global markets due to the trade war between the US and China and increasing tensions between the US and Europe are a major concern. To date, New Zealand exports have not been majorly impacted. The recent crash in China's log market can be partially blamed on the fall in business confidence brought about by the trade tensions, but it is mainly a fundamental market correction driven by excess supply. Demand for the food ingredients New Zealand exports is expected to remain robust.

## New game plan

China's demand for imported meat has lifted sharply this year as it looks to fill the void in its protein markets caused by the devastation of its domestic pork industry. Official reports indicate a quarter of China's pig population has succumbed to African Swine Flu, but the actual number may well be a lot higher than this. As many as 200 million pigs (70% of China's pig population) may have contracted this deadly disease, which is described as the largest known outbreak of a serious animal disease. It may take China's pork industry a decade to recover from African Swine Flu. This disease is also sweeping through neighbouring countries. Cases have now been reported in Russia, Mongolia, and as far west as Bulgaria, as well as parts of South East Asia.

Figure 1. China meat imports – January to May




Source: China Customs

Understandably, China's demand for imported meat has lifted sharply. In the first five months of 2019 China's imports of pork, beef and chicken increased by 34%. Since October 2018, New Zealand has exported 108,000t of beef to China, which accounts for 12% of the beef China imported during that time.

## Right place, right time

New Zealand has diverted supply of beef from the United States to China. In the US the beef supplied by New Zealand is ground up and combined with locally produced meat to produce hamburger patties. This is a low-value product that is difficult to differentiate. Given the rise of alternative proteins entering the hamburger market it is very timely that New Zealand is becoming less reliant on this market for our beef exports. In China there has been a massive increase in the number of beef restaurants operating in the major cities. This bodes well for the outlook for beef demand for which there is an opportunity to differentiate the source.

## Down but not out

Dairy markets have trended down in recent months as supply chains have filled on the back of the strong end to the New Zealand milk production season and the seasonal peak in Northern Hemisphere supply. Supply is now trending down, but prices have softened as immediate demand from buyers has weakened. The longer-term demand-supply outlook is still supportive of higher dairy prices. Cumulative milk production across the five largest dairy export countries has been tracking behind year-ago levels since February.

A reduction in dairy farming profits and/or reduced future expectations is the main driver behind the slowing in global milk supply. Weather has not been a significant issue. Farmgate milk prices have generally declined in Europe and the United States. Meanwhile, costs have lifted, causing returns to decline further. Farmgate milk prices are strong in New Zealand and Australia but this has been countered by a lack of industry confidence.

In Australia, strong procurement pressure has pushed up the prices milk processors have forecast for the new dairy season that commenced at the beginning of July. But a general lack of confidence means the boost in income is very unlikely to translate into growth in milk supply, with further decreases more likely.

## Higher work rate

New Zealand's milk output is expected to stabilise near current levels for the 2019-20 season. The area used for dairying is easing a tad and cow numbers are expected to reduce slightly. However, this will be offset by ongoing lifts in cow productivity levels. Farmgate milk price forecasts for the new season are strong by historic standards but industry confidence is being contained by expectations of reduced future profits due to rising operating costs and high debt levels. Reducing debt is now a key priority for farmers.

The lack of growth in the global dairy exporting powerhouses is expected to result in a tightening of supply in dairy markets later this year. Assuming demand remains stable, prices will have to lift in response to the reduction in supply. At present, many global buyers are relatively well stocked, meaning the timing of a recovery in prices will depend on how quickly these stocks are worked through.

## Star performer

Horticulture is expected to be the star performer of New Zealand's primary sector this year. The lift in this sector is being driven by the increased volumes of gold kiwifruit being harvested. Gold fruit delivers both higher yields and higher prices than the traditional green varieties.

Apple returns are also looking robust. Returns from wine are expected to be near average levels, albeit on lower yields than normal.

# Financial markets outlook

## Summary

A deterioration in the global data pulse has seen central banks become increasingly dovish, with some (such as the RBNZ) pre-empting a slowdown and embarking on a proactive easing cycle. The Federal Reserve's shift towards an easing bias at the June FOMC meeting set off a global hunt for yield. This saw US Treasury yields plummet, while New Zealand and Australian yields fell to record lows. The RBNZ's dovish bias extended beyond May's proactive cut and into its June OCR Review, leading us to bring forward our rate-cut expectations to August and November. Despite the RBNZ's dovish bias, the NZD has found support via a weaker USD. We expect the slowdown in global activity to weigh on the NZD, and expect the global easing cycle to continue to drag yields lower.

## Head to head

Trade and tariffs were the overarching theme for markets over the quarter as escalating tensions between the US and China weighed on market sentiment and began filtering into the global data pulse. While the US and China have agreed to resume negotiations, it remains to be seen if their actions match their words, as relations between the two nations remain somewhat strained at present.

## Joining the pack

The Federal Reserve joined the line of central banks looking at easing monetary policy. Despite favourable labour market conditions and reasonable growth metrics, inflation remains elusive in the US. This, along with a deteriorating global economic environment, rising geopolitical uncertainties and trade-related issues, prompted the Federal Reserve to sound caution while shifting to an easing bias at the June FOMC meeting. Although market pricing suggests an expectation that the Federal Reserve may be embarking on a full-blown easing cycle, we believe it is a recalibration of policy and foresee the Federal Reserve holding policy after easing to 2% in the final quarter of 2019.

The Fed's shift towards an easing bias sparked a global hunt for yield, with US 10-year Treasury yields rallying below 2.0% for the first time since 2016. The capitulation in the US yield curve had wider market implications, and prompted safe-haven assets such as gold to rally. Going forward, we expect US 10-year yields to remain at current levels for some time, before moving marginally higher as the FOMC finishes recalibrating its monetary policy setting. We are currently forecasting US 10-year yields to push back toward 2.25% over 2019.

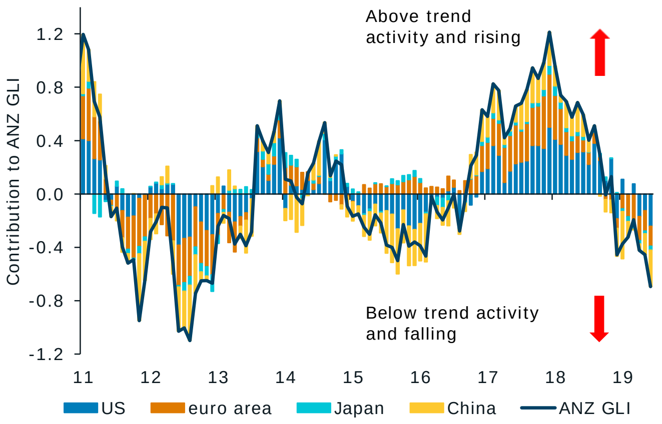
While the end of quantitative tightening in the US was positive for global liquidity conditions, we expect conditions to deteriorate, given the risks an inverted yield curve poses to bank lending behaviour in the US. The potential for central bank stimulus remains high in light of the changing global environment, but we expect this to take time to be delivered.

The ECB remains poised to provide support to the euro area after the data pulse continued to deteriorate over the quarter. Recent comments from ECB President Mario Draghi (amongst others) have pledged support for euro area growth, with the ECB happy to ease policy beyond its current setting (ie set an increasingly negative policy rate) whilst suggesting another round of quantitative easing is also likely.

## Captain calls it a day

Theresa May's departure as Britain's Prime Minister has forced a leadership contest within the Conservative Party. Prior to resigning, she had successfully negotiated an extension to the Brexit deadline (to 31 October) but had failed to gather support for her Brexit deal. Boris Johnson and Jeremy Hunt are in the hunt for Conservative Party leadership, with Johnson the current front runner. Brexit negotiations have all but stalled amidst the leadership contest, prompting a warning from BoE officials around the ongoing uncertainty. Markets are also growing concerned about the impending deadline and as such have raised the odds of a 'hard' Brexit come 31 October.

Figure 1. ANZ Global Lead Index




Source: Bloomberg, Markit, ANZ Research

Ongoing trade tensions have also caused signs of strain in China's economy. China's manufacturing sector has continued to soften, and aside from trade, domestic indicators suggest more support may be required. Consumer sentiment remains weak and investment remains the sole meaningful growth support for the Chinese economy at present. There are signs that the Government's stimulus has been helpful, but it may be too soon to judge.

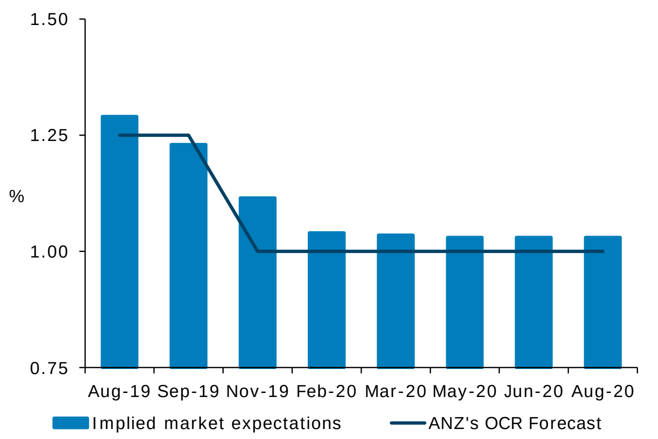
All up, the global markets outlook has fresh question marks over it. Uncertainties remain, and while the trade tensions between the US and China have eased, there is still a long road to travel before favourable outcomes present themselves. As such, market risk sentiment will remain fragile.

## Utilising the reserve bench

The risk of a global economic slowdown amidst rising trade and geopolitical uncertainties continues to weigh on the RBNZ. The RBNZ delivered a 'proactive' 25bp cut to the OCR at the May MPS and subsequently signalled another 25bp cut is likely in the near future. Market pricing has been resilient to the better-than-expected domestic data pulse, and continues to price an 80% chance of a further 25bp cut to the OCR at the RBNZ's August meeting. Based on market pricing, there is currently a 50% chance the OCR will be at 1.00% by December this year.

While the RBNZ led its peers with the 25bp cut in May, it has subsequently fallen off the pace with the RBA easing at their June and July meetings (to 1.00%) and the Fed likely to cut the fed funds rate by 25bp later this month – all before the RBNZ's August MPS. We maintain the view that a further two cuts will be necessary to support growth and push inflation towards where the RBNZ wants it to be. A deteriorating global economy poses a risk to NZ's key export commodity prices; and downside domestic risks, particularly for construction activity, could also weigh on the RBNZ. Also, should the RBNZ fall out of sync with its central banking peers, it risks upward pressure being applied to the TWI.

Figure 2. Market pricing for OCR




Source: Bloomberg, ANZ Research

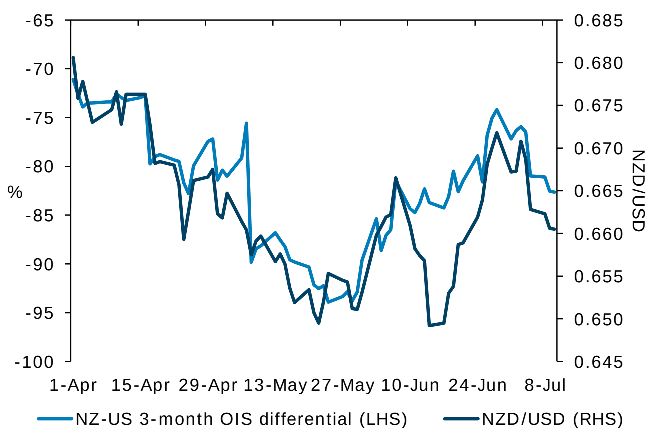
Local yields have rallied to fresh lows this quarter, but underperformed the global rally seen in the aftermath of the June FOMC meeting. The New Zealand 10-year Government bond yield touched a low of 1.50% before a surprisingly strong US payrolls figure forced a repricing of global long-end yields – and US rate cut expectations. Nonetheless, with the global easing cycle well underway, we expect the NZ yield curve to continue to grind lower over the second half of 2019 as rate cuts are delivered both domestically and in the US. We expect the spread between NZ and US 10-year yields to continue to widen to 80bp by the end of the year. Our expectation is that the short end of the curve will remain anchored at current levels before moving lower with the forecast OCR cuts.

## Stuck in middle of the paddock

The NZD has stuck to its knitting for much of this quarter, trading largely within a two cent range against the USD. The impact of the RBNZ's 'proactive' cut to monetary policy was dampened by the modest forward guidance provided, while an explicit move towards an easing bias by the FOMC saw the USD spiral lower, boosting the NZD.

Interest rate differentials remained the primary driver for the NZD this quarter. Their influence became increasingly evident as the FOMC signalled rate cuts and the prospect of narrowing interest rate differentials drove the NZD higher. We expect some volatility in the short term as central banks work through their policy cycles, but expect the spread between NZ and US policy rates to widen and create further downside for the currency once the dust settles. Commodity prices continue to support the NZD but ongoing trade uncertainties and heightened risk aversion remain drags on the currency.

Figure 3. The recent influence of short-term NZ-US interest rate differentials on the NZD/USD




Source: Bloomberg, ANZ Research

# Financial markets outlook

Domestic growth metrics will provide support to the NZD in the short term while the difference in timing between cuts in the US and NZ may provide additional buoyancy to the NZD over the same period.

All up, deteriorating global liquidity, coupled with slowing activity globally, creates a negative backdrop for cyclical currencies like the NZD. While the easing of trade tensions and USD weakness may provide a reprieve in the short term, weakness in China's manufacturing sector, alongside concerns for growth in other major economies, will dampen global growth prospects, which will weigh on the NZD.

## Opposite numbers

NZD/USD: Overpowered. The NZD found support as the Federal Reserve's dovish bias pushed the USD lower. While we continue to expect the RBNZ to ease, the FOMC's easing bias and a market that's gung-ho on US rate cuts has put the USD back in the spotlight. That said, as the dust settles in the US we expect the NZD to struggle in light of the 'low growth' and 'low liquidity' state of the global economy and expect the NZD to fall to USD 0.63 over the coming quarter.

NZD/AUD: Ahead of the pack. While the RBNZ was proactive in easing, the RBA has caught up by delivering two cuts at successive meetings. We believe the RBA will need to ease policy again, but given their data-dependent guidance, the AUD is likely to firm in the short term. Further easing by the RBNZ will also see this pair weaken.

NZD/EUR: Digging deep. Europe's economic woes deepened over the past quarter. This has seen the EUR soften against the NZD. Amid the weak economic data pulse, the ECB has vowed to support the euro area by cutting rates and re-introducing QE if necessary. We expect the NZD to remain at around EUR 0.58 over the coming quarter.

NZD/GBP: Hospital pass. Failure to pass a deal on Brexit saw the pressure mount on Britain's former Prime Minister Theresa May, forcing her to resign as Britain's leader. The resulting Conservative Party leadership contest, currently underway, has seen Brexit negotiations stall while UK's data pulse has shown fresh signs of strain as a result of the ongoing uncertainty. While the uncertainty is unlikely to aid the GBP, we expect the NZD to weaken on the back of the RBNZ easing the OCR, to approximately GBP 0.50 over the next quarter.

NZD/JPY: Safe option. This pair continues to trade in a binary fashion with risk sentiment. The FOMC's explicit shift toward an easing bias coincided with a flight to safety, which saw the JPY strengthen markedly against the NZD. This dynamic is unlikely to change in the short term, and we expect the JPY to continue to firm in light of the ongoing trade and geopolitical uncertainties.

Table 1: Forecasts (end of quarter)

| FX Rates | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 |
|---|---|---|---|---|---|---|---|
| NZD/USD | 0.67 | 0.63 | 0.61 | 0.61 | 0.63 | 0.65 | 0.65 |
| NZD/AUD | 0.96 | 0.94 | 0.94 | 0.92 | 0.93 | 0.94 | 0.93 |
| NZD/EUR | 0.59 | 0.58 | 0.55 | 0.53 | 0.53 | 0.54 | 0.52 |
| NZD/JPY | 72.5 | 68.0 | 65.9 | 64.1 | 66.2 | 68.3 | 68.3 |
| NZD/GBP | 0.53 | 0.50 | 0.48 | 0.46 | 0.46 | 0.48 | 0.48 |
| NZD/CNY | 4.61 | 4.37 | 4.22 | 4.21 | 4.32 | 4.42 | 4.39 |
| NZ$ TWI | 71.6 | 68.6 | 66.7 | 65.2 | 66.1 | 67.9 | 66.9 |
| Interest Rates | Jun-19 | Sep-19 | Dec-19 | Mar-20 | Jun-20 | Sep-20 | Dec-20 |
| NZ OCR | 1.50 | 1.25 | 1.00 | 1.00 | 1.00 | 1.00 | 1.00 |
| NZ 90 day bill | 1.64 | 1.32 | 1.15 | 1.15 | 1.15 | 1.15 | 1.15 |
| NZ 2-yr swap | 1.35 | 1.17 | 1.13 | 1.13 | 1.16 | 1.19 | 1.21 |
| NZ 10-yr bond | 1.57 | 1.50 | 1.45 | 1.35 | 1.35 | 1.35 | 1.35 |

Source: Bloomberg, ANZ Research

# Key economic forecasts

| Calendar Years | 2015 | 2016 | 2017 | 2018 | 2019(f) | 2020(f) | 2021(f) |
|---|---|---|---|---|---|---|---|
| NZ Economy (annual average % change) | | | | | | | |
| Real GDP (production) | 3.5 | 3.9 | 3.1 | 2.9 | 2.2 | 2.5 | 2.9 |
| Private Consumption | 3.6 | 5.3 | 4.8 | 3.2 | 3.1 | 2.7 | 2.4 |
| Public Consumption | 2.5 | 2.0 | 2.9 | 1.9 | 2.9 | 3.5 | 3.2 |
| Residential investment | 5.6 | 10.8 | 0.9 | 2.6 | 4.7 | -2.0 | 1.3 |
| Other investment | 3.2 | 2.1 | 4.4 | 4.0 | 1.6 | 3.0 | 4.0 |
| Stockbuilding[1] | -0.3 | 0.1 | -0.1 | 0.4 | -0.9 | 0.0 | 0.0 |
| Gross National Expenditure | 3.0 | 4.6 | 4.0 | 3.5 | 1.8 | 3.1 | 3.0 |
| Total Exports | 7.4 | 2.1 | 1.8 | 3.1 | 4.7 | 0.9 | 2.4 |
| Total Imports | 4.0 | 3.3 | 6.9 | 5.8 | 1.7 | 3.0 | 2.9 |
| Employment (annual %) | 1.4 | 5.8 | 3.7 | 2.3 | 1.1 | 1.5 | 1.4 |
| Unemployment Rate (sa; Dec qtr) | 4.9 | 5.2 | 4.5 | 4.3 | 4.4 | 4.3 | 4.1 |
| Labour Cost Index (annual %) | 1.6 | 1.6 | 1.9 | 2.0 | 2.0 | 2.1 | 2.2 |
| Terms of trade (OTI basis; annual %) | -3.1 | 6.7 | 7.9 | -4.8 | 1.1 | 0.8 | 0.4 |
| Current Account Balance ($bn) | -7.1 | -5.7 | -8.1 | -11.0 | -11.5 | -12.7 | -13.4 |
| as % of GDP | -2.8 | -2.2 | -2.9 | -3.8 | -3.8 | -4.0 | -4.1 |
| Prices (annual % change) | | | | | | | |
| CPI Inflation | 0.1 | 1.3 | 1.6 | 1.9 | 1.2 | 1.8 | 2.0 |
| Non-tradable Inflation | 1.8 | 2.4 | 2.5 | 2.7 | 2.4 | 2.6 | 2.8 |
| Tradable Inflation | -2.1 | -0.1 | 0.5 | 0.9 | -0.7 | 0.5 | 0.7 |
| REINZ House Price Index | 14.8 | 14.5 | 3.5 | 3.3 | 2.1 | 3.0 | 2.1 |
| NZ Financial Markets (end of December quarter) | | | | | | | |
| TWI | 73.6 | 76.1 | 73.0 | 71.5 | 66.7 | 66.9 | -- |
| NZD/USD | 0.68 | 0.69 | 0.71 | 0.67 | 0.61 | 0.65 | -- |
| NZD/AUD | 0.94 | 0.96 | 0.91 | 0.95 | 0.94 | 0.93 | -- |
| NZD/CNY | 4.43 | 4.81 | 4.62 | 4.62 | 4.22 | 4.39 | -- |
| NZD/EUR | 0.63 | 0.66 | 0.59 | 0.59 | 0.55 | 0.52 | -- |
| NZD/JPY | 82.1 | 81.1 | 80.0 | 73.7 | 65.9 | 68.3 | -- |
| NZD/GBP | 0.46 | 0.56 | 0.53 | 0.53 | 0.48 | 0.48 | -- |
| Official Cash Rate | 2.50 | 1.75 | 1.75 | 1.75 | 1.00 | 1.00 | -- |
| 90-day bank bill rate | 2.75 | 2.00 | 1.88 | 1.97 | 1.15 | 1.15 | -- |
| 2-year swap rate | 2.85 | 2.46 | 2.21 | 1.97 | 1.13 | 1.21 | -- |
| 10-year government bond rate | 3.57 | 3.33 | 2.72 | 2.37 | 1.45 | 1.35 | -- |

[1] Percentage point contribution to growth

Forecasts finalised 17 July 2019

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

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