ANZ Research

October 2019

Quarterly Economic Outlook

Uncharted

ANZ

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Contents

NZ Economic Outlook 3
International Outlook 9
Primary Sector Outlook 11
Financial Markets Outlook 13
Key Economic Forecasts 16
Important Notice 17

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New Zealand economic outlook

No one's disputing the fact that the New Zealand economy has a little less wind in her sails. We've been seeing it in the leading indicators for a while; it's now been confirmed in the hard data; and the view from the crow's nest is that there's a little more softening to come. While it's our expectation that growth will stabilise and begin to recover gradually in early 2020, this is contingent on a couple of key economic drivers holding steady as the swell continues to pick up. And with the RBNZ expected to use up all of its conventional fuel just keeping the ship on course, we're only one storm away from being blown into the uncharted territory of unconventional monetary policy. Let's hope the Government can see the darkening clouds on the horizon and is readying its fleet to lend a hand if the SOS goes from monetary policy needing friends to New Zealanders' wellbeing needing a lifebuoy.

International outlook

Growth in New Zealand's trading partners has deteriorated further, and near-term indicators don't suggest that things are going to get better any time soon. Weakness has so far largely been concentrated in trade, manufacturing and business investment, but things could get rather ugly if global labour markets and household sentiment and thus spending follow suit. Global central banks have stepped up their monetary policy easing efforts but are becoming increasingly constrained – time will tell whether their actions will be enough to avert a further sharp slowdown. It hasn't been smooth sailing, but so far the global environment hasn't blown the New Zealand economy off course.

Primary sector outlook

Global demand for New Zealand's food-based exports remains strong despite economic growth slowing in key markets. Markets for dairy and red meat are supported by tight global supply, which is underpinning prices. The softer NZD is also supporting prices at the farmgate level in New Zealand. Confidence in the horticulture sector is strong but farmer confidence in the livestock sector is low.

Financial markets outlook

The RBNZ's surprise 50bp cut in August was a major talking point for the market over the quarter. Meanwhile, the Federal Reserve maintained an easing bias, and cut its policy rate by a further 25bp and the RBA, too, felt the need to ease policy, with its latest cut reigniting talks of unconventional monetary policy on both sides of the Tasman. NZ yields hit fresh lows as the global data pulse deteriorated, with the September 2025 inflation-indexed bond becoming the first NZD-denominated asset to yield a negative interest rate. We expect the slowdown in global and domestic activity to continue to weigh on the NZD over coming quarters, 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	2.0	2.3
Real GDP (annual % change)	3.5	3.4	2.4	2.0	2.1	2.4
Unemployment Rate (Dec quarter)	5.2	4.5	4.3	4.2	4.5	4.4
CPI Inflation (annual %)	1.3	1.6	1.9	1.6	1.7	1.7
Terms of Trade (OTI basis; annual %)	6.7	7.9	-4.8	2.9	0.4	0.2
Current Account Balance (% of GDP)	-2.0	-2.7	-3.9	-3.4	-3.9	-4.0
NZ Financial Markets (end of Dec quarter)						
TWI	76.1	73.0	71.5	67.2	67.9	--
NZD/USD	0.69	0.71	0.67	0.61	0.63	--
NZD/AUD	0.96	0.91	0.95	0.94	0.90	--
Official Cash Rate	1.75	1.75	1.75	0.75	0.25	--
10-year Bond Rate	3.33	2.72	2.37	0.90	1.20	--

Source: Statistics NZ, Bloomberg, ANZ Research

New Zealand economic outlook

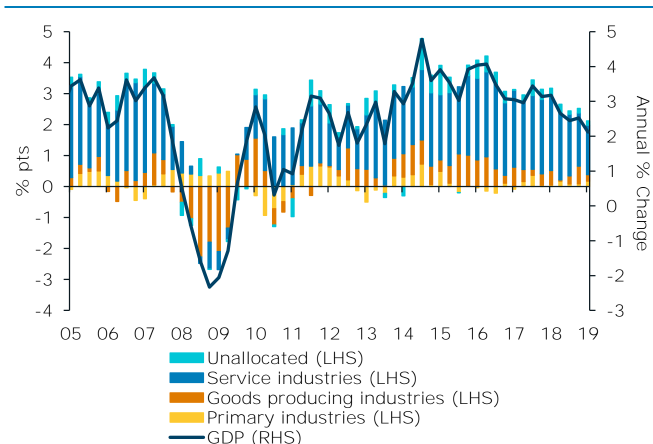
Summary

No one's disputing the fact that the New Zealand economy has a little less wind in her sails. We've been seeing it in the leading indicators for a while; **it's now been confirmed in the hard data; and the view from the crow's nest is that there's a little more softening to come. While it's our expectation that** growth will stabilise and begin to recover gradually in early 2020, this is contingent on a couple of key economic drivers holding steady as the swell continues to pick up. And with the RBNZ expected to use up all of its conventional fuel just keeping the **ship on course, we're only one storm away from** being blown into the uncharted territory of **unconventional monetary policy. Let's hope the** Government can see the darkening clouds on the horizon and is readying its fleet to lend a hand if the SOS goes from monetary policy needing friends to **New Zealanders' wellbeing needing** a lifebuoy.

Adrift on a southern explorer

This ship is slowing. The pace of headline GDP growth has almost halved from around 4% y/y in 2016 to 2.1% in June 2019 – and the slowing has been broad-based (figure 1).

Figure 1. Production GDP

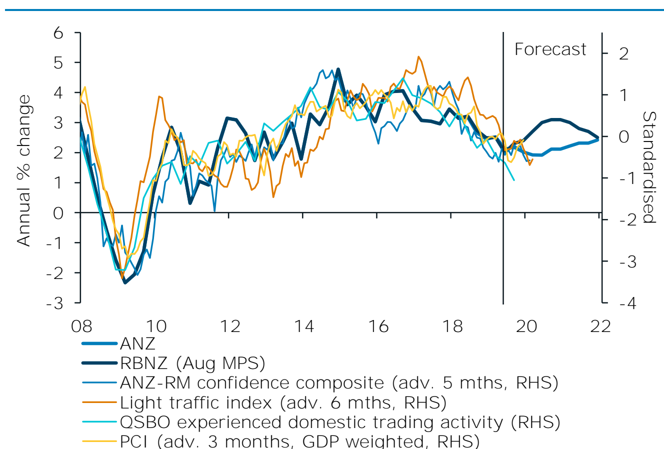


Source: Statistics NZ, ANZ Research

Growth for the September quarter is poised for another soft print, with the range of indicators **we're** monitoring suggesting quarterly growth will come in somewhere between 0.1% q/q and 0.5% q/q. **We've** pencilled in 0.4% q/q. While this would see annual growth pick up slightly (from 2.1% y/y to 2.2%), this **shouldn't** be thought of as a turning point for economic momentum.

Looking at the current quarter, tailwinds are yet to show any sign of picking up. We expect annual growth will be running at just 2.0% by the end of the year, and will feature a 1-handle in the first half of 2020 – with risks skewed towards this happening sooner. Thereafter, growth is forecast to recover gradually as easier monetary conditions kick in. But **it's** nothing like the recovery baked into the **RBNZ's** August MPS forecasts, which once again are ripe for a downgrade.

Figure 2. Forward indicators and GDP forecast



Source: Statistics NZ, NZTA, NZIER, BNZ-BusinessNZ, Roy-Morgan, ANZ Research

Now **let's** be clear, **we're** not forecasting recession. But **we're** not forecasting the economy to recover speed any time soon either. And that means inflation pressures are going to wane. We expect the RBNZ will use up its entire conventional fuel supply keeping the ship on course and preventing inflation expectations from sinking. We expect cuts in November, February and May, to take the OCR to just 0.25% – which we think is around its useful limit.

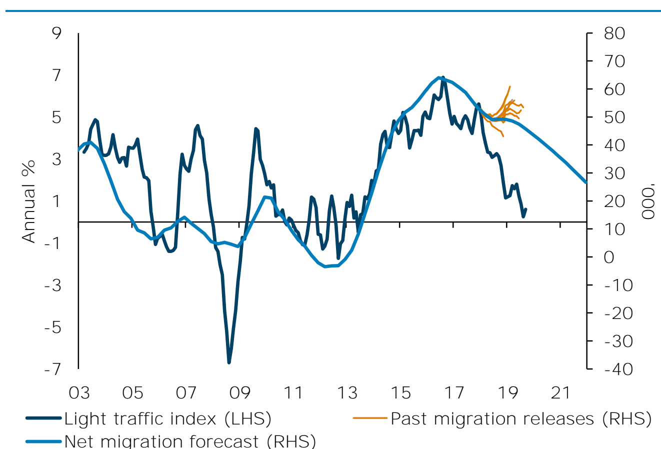
All hands on deck

Migration-led population growth has been one of the most dominant drivers of economic growth in recent years. The new susceptibility of these data to substantial revisions month-on-month is a broken anemometer for anyone trying to keep tabs on the **economy's** momentum. On the latest estimates, net migration has not declined at all over the past 18 months. However, the broad-based slowing in the economy alongside non-existent growth in light traffic (and a range of other weakening indicators) does raise some questions. Traffic growth and population growth can diverge markedly, but when they do, it sends pretty strong signals about the state of the economy.

In fact, if net migration is holding up as much as the latest data suggests then the underlying productivity picture (a sad tale to start with) is looking dismal, suggesting GDP per capita is very weak, if not outright contracting. It might be, but we suspect

there are probably a few more people jumping ship than the data currently suggest and that the migration cycle is turning a little faster (figure 3). If we're right, that implies a little less housing demand but a little more wage pressure than otherwise. But it wouldn't be a game changer from a monetary policy perspective.

Figure 3. Light traffic and migration



Source: Statistics NZ, ANZ Research

A merry crew beneath the setting sun

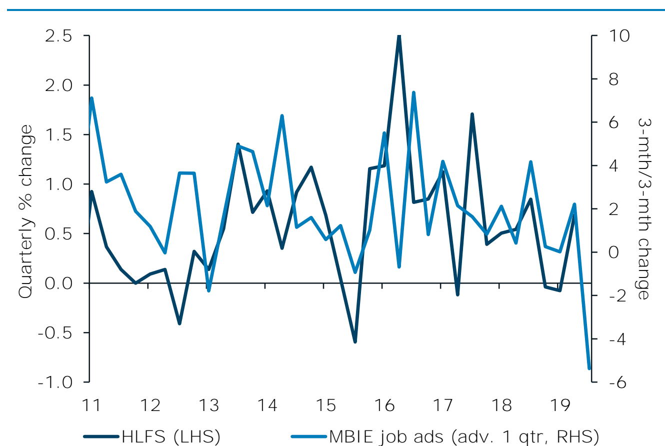
Our view that the economy is not about to capsize depends very much on the household sector's pulling power. Lower interest rates are keeping debt-servicing costs contained, and the labour market is "tight" with real incomes gradually lifting, and the unemployment rate recording an 11-year low in Q2.

That said, the labour market tends to lag economic activity, suggesting Q2's 3.9% unemployment rate is probably as good as it's going to get for a while. We're forecasting the unemployment rate to average 4.4% over the next couple of years, which in our view is still within the range of maximum sustainable employment – and consistent with ongoing gradual growth in real wages.

And while consumer sentiment has slipped a little recently, there are still a few gold nuggets in the cargo hold. For example, the proportion of households who think it's a good time to buy a major household item is holding up. Combined with still-positive (albeit uncertain) net migration inflows, private consumption should remain buoyed.

But there are a few ominous signs emerging from under the surface that we need to keep a close eye on. Employment indicators, including job ads, surveyed experienced employment, and employment intentions all suggest jobs growth could disappoint our expectation (figure 4). Should slack in the labour market open up, further increases in the minimum wage could end up becoming an additional anchor on employment growth, which in aggregate could have a net negative impact on household incomes. But we note that further minimum wage increases were made conditional on the economic situation for exactly this reason.

Figure 4. MBIE job ads, QES employment



Source: MBIE, Statistics NZ, ANZ Research

If employment growth falls as fast as some of the indicators suggest (and does so persistently), the drag on economic growth will be significant. Fewer employment opportunities mean the migration cycle would turn much faster. Household incomes could be lower than otherwise. But perhaps most importantly, household sentiment could deteriorate quickly – particularly if the same thing is happening in other parts of the world (a typical late-cycle move). If households begin to question their employment prospects, they might mutiny against the RBNZ's instruction to "go out and spend" and decide rather to pay down that rather uncomfortable pile of debt – currently sitting at an all-time high of 164.4% of disposable income. The household sector is currently in fine spirits but is nonetheless vulnerable. Any labour market spill-overs from weakness in construction or manufacturing (for example) could see the ship go from making slow but steady progress to drifting well off course.

Funding the voyage

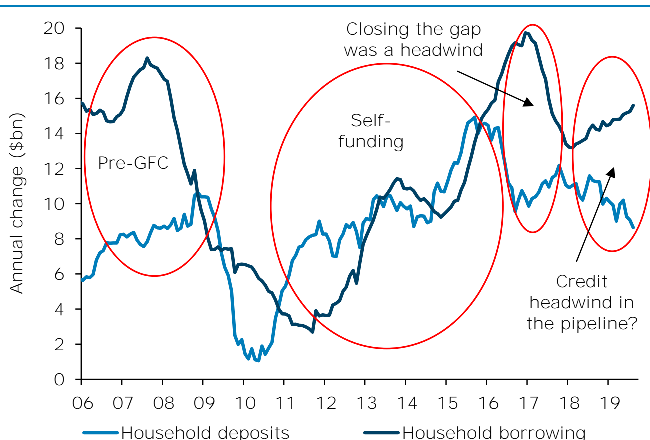
Accommodative credit conditions are of paramount importance when it comes to keeping this ship moving. The RBNZ is certainly throwing everything at it: it has already cut the OCR to an all-time low, and with economic activity poised to remain sub-par, and inflation expectations threatening to sink, we expect the RBNZ will cut the OCR to just 0.25% by May 2020 – which we think is around its useful limit.

New Zealand economic outlook

Since core funding ratio requirements were introduced in the aftermath of the Global Financial Crisis (GFC), New Zealand banks have become more dependent on household deposits to fund new lending. That means that without growth in household deposits banks are limited in how much they can grow their lending (for the purchase of new houses for example).

Figure 5 shows that the post-GFC era has been characterised by a broad matching between deposit and credit growth. When a gap opens up ("the funding gap"), either the price of credit needs to rise (enticing household deposits back into the banking system and lowering demand for credit), or credit availability deteriorates. This mini credit cycle matters for economic activity. It was a headwind when the gap was closed in 2017, and now that it's opened up again, it may become a headwind again in the not-too-distant future.

Figure 5. Bank funding gap



Source: RBNZ, ANZ Research

Because banks need to strike a balance between household deposits and lending, we expect that as the OCR continues lower the pass-through to deposit rates (and therefore lending rates) will diminish.

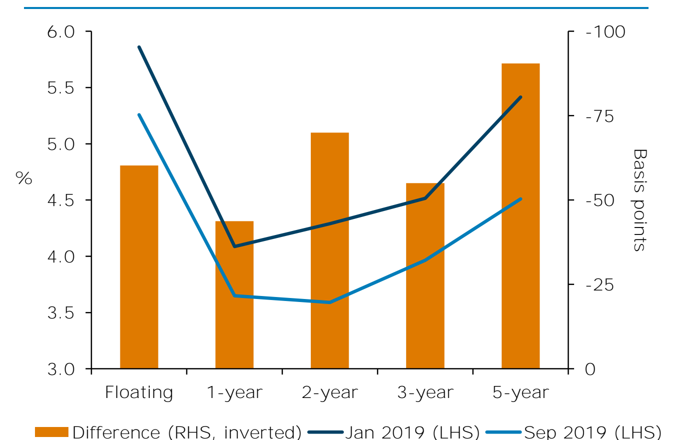
Tight sleeping quarters

What happens in the housing market from here is very uncertain, but it is going to matter. It will matter for private consumption (particularly durable goods), and it will matter for residential investment. The housing cycle has well and truly cooled, with prices running at 2.6% y/y in Q3 down from their cycle peak of 17.2% in 2015.

There are varying views out there on the outlook for house prices from here. We expect annual house price inflation to pick up slightly to just under 4.5% y/y by mid-2020, and average around 3% over the next couple of years. That's a relatively modest outlook compared to some. But given everything that's influencing the market at present, our view feels pretty balanced.

- **Lower mortgage rates** are the main tailwind for the housing market. Recent OCR cuts have pushed mortgage interest lower, albeit not 1:1 (figure 6). However, if this housing cycle has taught us anything, it's that interest rates aren't the be-all and end-all when it comes to house price inflation. House price inflation has slowed considerably at the same time as mortgage rates have fallen. So there's clearly a lot else going on.

Figure 6. Change in mortgage interest rates



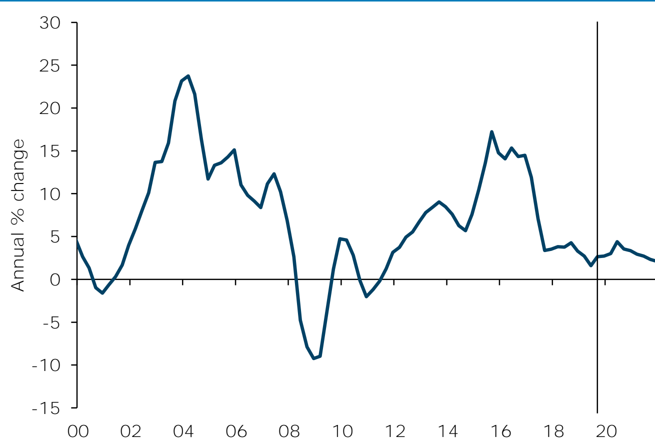
Source: RBNZ, ANZ Research

- **Affordability constraints** remain a factor. Auckland has seen some improvement but is still the most expensive major city. But the house price/income ratio excluding Auckland is now at a record high. Affordability has become a national problem.
- Good old-fashioned **supply and demand** should put a floor under things. But it's fair to say that if our hunch is right that migration is actually running a little softer than the official data show, than this might not be as significant as previously thought. One shouldn't overlook the fact that residential investment activity has been at a high level (and will hopefully remain so) for quite some time. Housing supply is gradually catching up with pent-up demand.
- Let's not forget why interest rates are being cut in the first place – ie **a deteriorating macroeconomic backdrop**. Despite falling interest rates, the outlook for employment is still softening, the global backdrop has continued to weaken, and caution among households is threatening to intensify. This hardly sounds like the makings of a housing market surge.

- And let's not forget **credit headwinds.** Yes, LVR restrictions are likely to be loosened slightly in November, but as we saw almost a year ago, this is unlikely to be a game changer. The RBNZ can't let it be, on financial stability grounds. And more credit headwinds are in the pipeline, such as the funding gap, and the RBNZ capital proposals (more below). The price of credit (the interest rate) quickly becomes less relevant if credit availability tightens up.
- Finally, and probably very important for the housing market outlook, we shouldn't overlook **the lengthy list of recent actual and potential policy changes** that are weighing particularly heavily on investors. This is the stuff that's quite difficult to estimate the effects of, but ultimately we believe policy changes have contributed significantly to the recent slowing in house price inflation, and that is likely to persist. Overlay this with banning of foreign buyers, extension of the bright line test, increased tenant rights and healthy homes standards (not a bad policy, but negative for investor demand), and the ring-fencing of tax losses and it adds up. That said, the policy landscape hasn't been all bad for housing demand – the KiwiBuild reset includes some first home buyer demand policy tweaks.

Given everything that's affecting the housing market at present, it seems overly simplistic to argue that lower mortgage rates alone will be sufficient to alter the course for house price inflation. But time will tell. The housing market is notorious for second winds after all – and term deposit rates are getting less attractive by the week.

Figure 7. House price inflation



Source: REINZ, ANZ Research

On the supply side, residential investment activity is expected to remain at a high level. However, headwinds in this sector aren't going away in a hurry, and looking beyond the recent consents data, growth looks likely to slow a little, which will help put a floor under prices. Costs, credit and capacity constraints are ongoing issues that are proving difficult to overcome. While we're not forecasting a sharp decline in residential investment, some of the survey data is – in particular, residential construction intentions in the ANZ Business Outlook Survey. And this is a risk firmly on our radar.

Sailing against the tide

Not only are we at risk of being blown off course; the credit current may turn. The impacts of the RBNZ's proposed capital changes are highly uncertain – no one is disputing that. But it's also true that no one is disputing that the proposed changes would result in at least some tightening in financial conditions during the transition period – through higher-than-otherwise interest rates, and/or reduced credit availability. This represents a downside risk to the outlook for economic activity.

Things have changed significantly since the RBNZ announced its proposals a year ago. The economy has slowed and the OCR is now 75bp closer to zero – and widely expected to be at 0.5% or lower by the time the policy is proposed to kick off. Of course there will be a transition period, so the OCR on Day 1 is far from the be-all and end-all. But other countries' experience this decade has been that it is very difficult to get policy rates out of the lower-bound corner once they're painted in there. In that light, it's no longer a given that the RBNZ's estimated 20-40bp impact (we anticipate a larger effect) would "come out in the wash", as the ability to cut the OCR to offset the impacts may be limited, at least initially.

An announcement of the RBNZ's decision is expected in early December. Our May 25bp OCR cut is a place-holder until the details are known.

Merchants of the high seas

Even if credit availability weren't threatening to constrain business investment, it seems unlikely that lower interest rates will entice a significant pick-up in investment any time soon. Business pessimism is a stubborn feature of the economic landscape, which, together with the uncertain policy and demand outlooks, is weighing on both investment and employment.

New Zealand economic outlook

We were previously of the view that as labour becomes increasingly scarce (with net migration inflows slowing) business investment would gradually lift to fill the void. But as the mood continues to deteriorate and storm clouds gather on the horizon, this seems less likely. While still elevated, recent survey data suggest lack of skilled labour is now becoming less of a constraint for firms, and that weakening demand is becoming more of an issue. That's unlikely to drive investment higher, but at the same time, provided household demand holds up, business investment shouldn't fall off a cliff.

Trade routes

Likewise, exporters don't appear likely candidates for upping their discretionary investment any time soon. But a little more investment by farmers on environmental grounds is on the cards. Despite the lower NZD (which we see going lower still, see page 13) and still-solid world prices keeping the terms of trade elevated, we expect exporters to remain cautious, choosing to deleverage rather than chase opportunities vigorously. Against this increasingly murky global backdrop, that's understandable. Export intentions in the ANZ Business Outlook survey track non-food manufactured exports pretty well, and have dropped to very low levels that suggest that weaker global demand is already being experienced (figure 8).

Figure 8. Export intentions and non-food exports

Source: Statistics NZ, ANZ Research

For agricultural export volumes, the weather will have the final say. Slightly less-stellar weather conditions over the year ahead, alongside ongoing productivity gains, would leave volumes broadly stable. However, we're expecting a fair amount of variance by export type (see page 11).

Weaker global growth suggests international tourism receipts will struggle to pick up. NZD depreciation will help, but growing caution among households abroad will likely see this highly discretionary form of spending retreat at the low- to mid-income levels. Higher-value tourism may be less affected, so perhaps this is the opportunity for the sector to tack away from 2-minute noodle-eating backpackers towards Otago Pinot Noir drinkers.

All up, net exports are expected to contribute positively to annual growth in the very near term. A lower NZD should contain import growth to some extent (supporting import-competing firms), but let's not forget that despite the solid terms of trade this is still a migration-led domestic demand cycle, and that's generally pretty conducive to buoyant import growth.

Ready the fiscal fleet

No doubt the Government can see the storm clouds gathering on the horizon, but deviating from their charted fiscal course (the one they were elected on) isn't something they can easily do just because the RBNZ's is asking for a friend. While we think there is scope for the Government to do a little more, this is ultimately a political decision that requires a very considered approach.

There are logistical challenges too. While the economy would benefit significantly from a little more spending on infrastructure, as we have noted previously it's not just a matter of turning on the taps. On the bright side, the audited Financial Statements of the Government for the year ended June 2019 showed the Government's books are in great shape, and a little heathier than forecast in the 2019 Budget Update. However, that's all history now and the real economy has been underperforming the Treasury's most recent published forecasts, which are also due for a downgrade.

This could result in a softer outlook for revenue and higher expenses, making it difficult for the Government to meet its self-imposed 20% of GDP net debt target in 2022. So while the starting point is strong, assuming the Government continues to operate within the constraints of its 20% debt target, it looks like the bulk of any fiscal stimulus is now behind us, and that within the next year fiscal policy could in fact be dragging on growth.

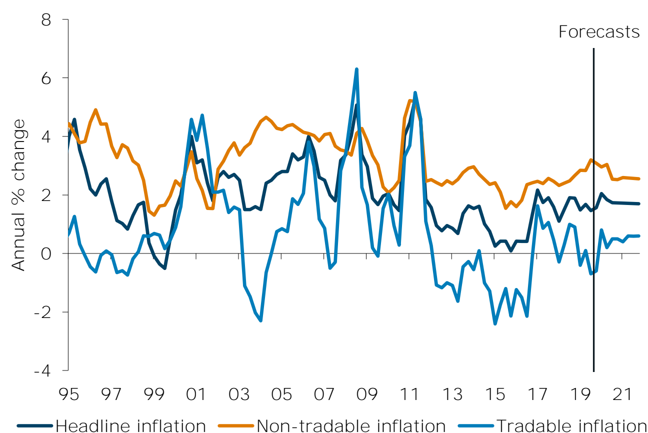
We'll see how things evolve heading into the 2020 election, but for now we have not significantly changed our outlook for Government activity. That said, should the storm clouds roll in, the swell pick up, lightning strike the mast, and the ship become rudderless, that's a pretty good reason for fiscal policy to (temporarily) throw its debt target out the window and deploy the rescue fleet.

New Zealand economic outlook

More room in the cargo hold

Spare capacity in the economy is opening up as the economy continues to slow gradually. Annual GDP growth at a little above 2% in Q2 is not consistent with intensifying inflation pressures. And with growth expected to slow further this is not about to improve. From a respectable starting point for non-tradable inflation (3.2% y/y in Q3, reflecting previous capacity pressure and some transitory factors, such as the minimum wage rise) we expect non-tradable inflation will slow to 2.5% by mid-2020. Tradable inflation should get a bump from the 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 average 1.7% over the next couple of years, and make hard work of lifting towards 2% over the medium term (figure 9).

Figure 9. CPI forecast



Source: Statistics NZ, ANZ Research

A small vessel in a big ocean

The New Zealand economy is a small vessel in a very large ocean. And while the outlook certainly isn't suggesting a shipwreck, both domestic and global momentum is slowing and it's becoming increasingly clear that headwinds will continue for a little longer. Accommodative monetary conditions, a buoyant household sector and still-solid export earnings should keep enough wind in the sails to keep the ship on course, but gathering pace from here will be a challenge.

In that environment, inflation pressures will wane. As the under-par signal from the leading indicators continues to be confirmed in the hard data and inflation expectations threaten to sink, we expect the RBNZ will cut the OCR further.

Should employment growth weaken, households get spooked, and/or the global economy slow sharply it's likely the RBNZ would feel the need to venture into the uncharted territory of unconventional monetary policy. The RBNZ has already sent an SOS to the Government for help getting inflation back to target. And we do think there's a little more the Government can do – and on the infrastructure side, the time to start planning is now. Let's hope the Government can see the darkening clouds on the horizon and is readying its fleet to lend a hand if the SOS goes from monetary policy needing friends to New Zealanders' wellbeing needing a lifebuoy.

International outlook

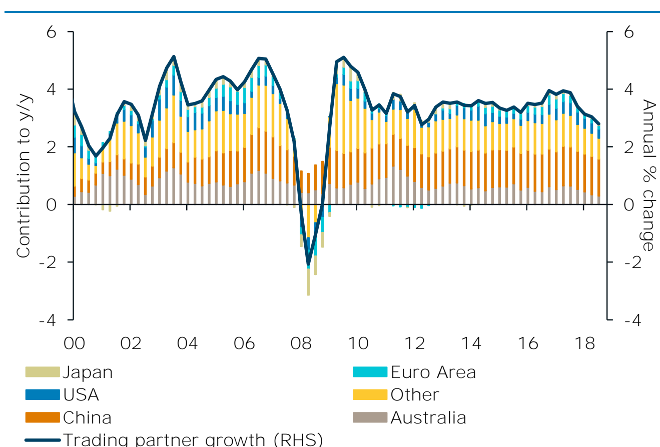
Summary

Growth in New Zealand's trading partners has deteriorated further, and near-term indicators don't suggest that things are going to get better any time soon. Weakness has so far largely been concentrated in trade, manufacturing and business investment, but things could get rather ugly if global labour markets and household sentiment and thus spending follow suit. Global central banks have stepped up their monetary policy easing efforts but are becoming increasingly constrained – time will tell whether their actions will be enough to avert a further sharp slowdown. The prospect of inflation moving back up towards central banks' targets is diminishing. Inflation expectations are low and at risk of becoming unanchored. It hasn't been smooth sailing, but so far the global environment hasn't blown the New Zealand economy off course. However, the risks to New Zealand growth and inflation are elevated and skewed to the downside.

A storm brews

Global growth has continued to slow, with New Zealand trading partner growth dipping from 4% in 2017 to under 3% in mid-2019 (figure 1). The slowdown has been broad-based across economies, and near-term indicators don't suggest that things are going to get better any time soon. At a global level, we expect the world economy to grow 3.2% y/y in 2019, with a small pick-up in global growth to 3.5% in 2020.

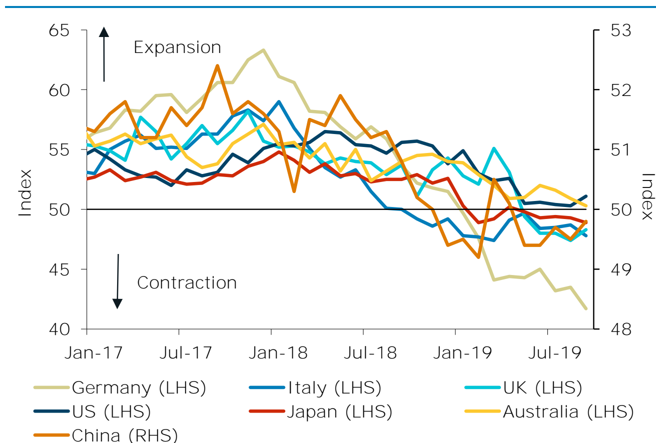
Figure 1. New Zealand trading partner growth



Source: Haver Analytics, ANZ Research

Trade tensions are continuing to add uncertainty, and that's having real consequences on economic activity and business investment. Global trade volumes and industrial production have fallen over the past year, with the weakest growth since the Global Financial Crisis (GFC). Manufacturing indicators have plunged into contractionary territory and largely remained there in recent months (figure 2). Weakness has been concentrated in trade, manufacturing and business investment, but things could get rather ugly if global labour markets and household sentiment and thus spending follow suit.

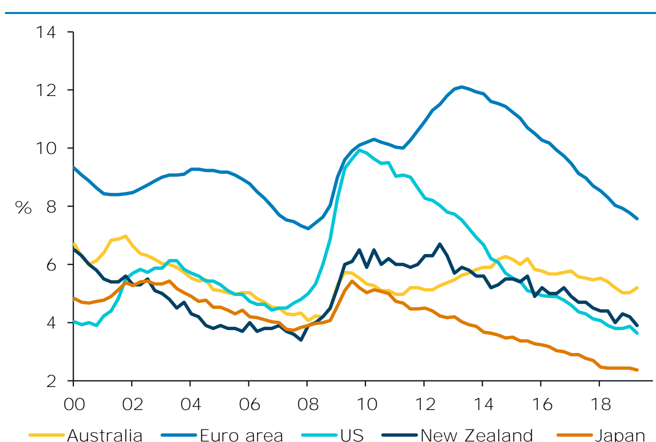
Figure 2. Global PMI manufacturing activity indicators



Source: Bloomberg, ANZ Research

Indeed, retail sales and services sector activity have been weak in key economies in recent months, suggesting that slowing manufacturing activity may be spilling over into the services sector. Importantly for New Zealand's food commodity exports, labour markets have remained remarkably robust to the growth slowdown to date (figure 3), and wages have been gradually rising. But against the deteriorating backdrop, there is a risk that households do start to batten down the hatches.

Figure 3. Unemployment rates



Source: Bloomberg, ANZ Research

In **Australia**, that households are embattled is particularly evident. Weakness in the economy has become more broad-based in recent months, with growth falling to a post-GFC low of 1.4% y/y in Q2. The household sector is under pressure, with low income growth, high debt, and earlier declines in house prices weighing on consumption. House sales are turning upward again, but housing construction, particularly of apartments, is now falling sharply. Amid this slowdown, the public sector and net exports have

International outlook

played a key role in propping up growth. Economic growth is set to pick up from the second half of this year, supported by interest rate cuts and tax cuts. The **Reserve Bank of Australia** has cut the cash rate three times this year and we expect further cuts to bring their cash rate down to 0.25%.

In **China**, New Zealand's biggest trading partner, growth momentum has headed south in the second half of 2019. In addition to a slowdown in manufacturing activity, employment indices in business surveys have fallen sharply into contractionary territory, which poses risks to domestic consumption. The producer price index (PPI) slid to -1.2% y/y in September, suggesting very little in the way of price pressures bubbling under the surface. China has bumped up fiscal and monetary stimulus and allowed the yuan to depreciate, but with debt levels as high as they are, policy options are becoming more limited. Growth is expected to dip below 6% in 2021 as China's high-growth phase continues to wind down – a combination of the diminishing working age population, ongoing transition towards consumption-led growth, weaker credit growth reflecting high debt levels, difficulty in redirecting credit from the public to the private sectors, and slower export growth.

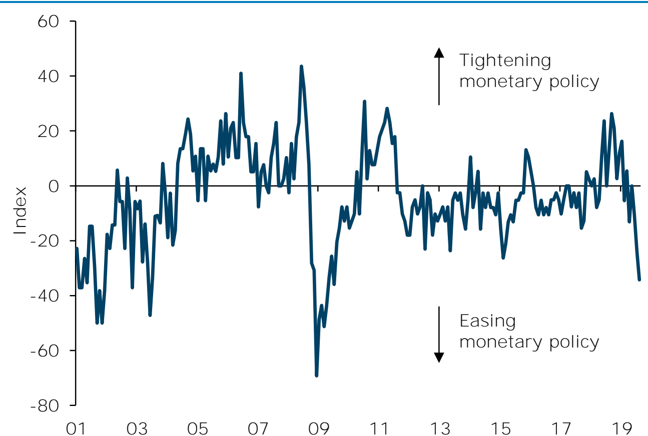
In the **US**, trade tensions and uncertainty over trade policy are negatively affecting business investment and sectors exposed to trade, such as manufacturing and agriculture. Business fixed investment contracted in Q2 2019 for the first time since late 2015. That said, private consumption is growing at a healthy clip. Wages are rising and demand for labour remains solid so far. The sharp reduction in mortgage rates has also seen sentiment toward housing pick up in 2019. Our outlook for US growth in the next couple of years is a slightly above-trend pace of 1.8%, but the risks are to the downside. The **Federal Reserve** has already cut twice this year, and we expect another by year-end.

In the **euro area**, private spending is holding up so far but the export-focused manufacturing sector is sliding. Brexit uncertainty continues to weigh on the UK economy, and a general election is expected by year-end. To support the economy, the **European Central Bank** has cut the deposit rate to -0.5%, extended the term lending programme, introduced tiering of reserves, and reintroduced open-ended quantitative easing of EUR20bn a month.

The significant easing in monetary policy settings (figure 4) should help the global economy navigate the slowdown. But if the outlook darkens further, monetary policy will become increasingly constrained. Central banks will try and stem the tide, but more and more are crying out for fiscal policy support, in recognition that their monetary policy tools can only do so much.

Amid the growth slowdown, the prospect of inflation moving back up towards central banks' targets is diminishing. Inflation expectations are low and at risk of becoming unanchored to the downside in many economies, which would reinforce low inflation into the future. More is needed to keep inflation afloat.

Figure 4. Central bank policy rate moves index



Source: Bloomberg, BIS, ANZ Research

In this environment, the risks to New Zealand growth are elevated. It hasn't been smooth sailing, but so far the global environment hasn't blown the New Zealand economy off course. Commodity prices have been shielded by global supply-side factors, global financial conditions have remained accommodative, and further RBNZ easing will help avoid the NZD shooting higher. But tourism has slowed and uncertainty is weighing on activity. All up, the global environment is now an additional headwind for the RBNZ and its employment and inflation objectives, but it could be worse.

Table 1: GDP Growth

Calendar Years (annual average % change)	1998-2007 average	2008-2016 average	2017	2018	2019(f)	2020(f)	2021(f)
United States	3.1	1.4	2.2	2.9	2.3	1.9	1.8
Australia	3.4	2.6	2.4	2.7	1.9	2.8	2.8
Japan	1.0	0.4	1.9	0.8	0.9	0.6	0.7
Euro area	2.4	0.4	2.4	1.9	1.1	1.3	1.4
China	10.0	8.4	6.8	6.6	6.2	6.0	5.9
World	4.3	3.3	4.0	3.8	3.2	3.5	3.6

Source: Bloomberg, ANZ Research

Primary sector outlook

Distant lands still deliver the booty

Global demand for New Zealand's food-based exports remains strong despite economic growth slowing in key markets. Markets for dairy and red meat are supported by tight global supply, which is underpinning prices. The softer NZD is also supporting prices at the farmgate level in New Zealand. Confidence in the horticulture sector is strong but farmer confidence in the livestock sector is low – particularly dairy.

Buoyant

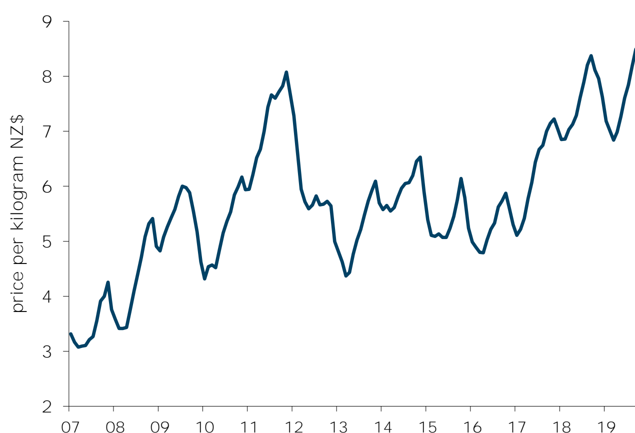
The red meat sector is benefiting from the reduction in China's domestic pork production, which means the country now has a hearty appetite for imported beef and lamb. Pork prices have soared in China, due to the swine flu epidemic cutting a swathe through China's swine population: 40% fewer animals according to the latest official numbers.

The sharp lift in pork prices has encouraged Chinese buyers to look across the seas for alternative protein sources, including New Zealand beef and lamb. These meats are still expensive relative to pork but the gap has narrowed considerably already and is poised to close further. Pork prices are expected to lift even higher ahead of the Spring Festival in January.

Demand from Chinese consumers for beef and lamb is expected to continue even once their pork industry eventually recovers, due to consumers developing a taste for these alternative meats.

The strength of demand from China's importers is underpinning export prices, with buyers from other regions needing to at least match their prices. Strong international prices combined with a weaker NZD means returns at the farmgate level are at record levels for lamb and mutton, and not far off for beef.

Figure 1. Farmgate lamb price (19kg CW)



Source: AgriHQ

However, at this time of the season there are very few lambs walking the gangplank from farm to processor so the current farmgate prices have little bearing on full-season income levels. Processing volumes for both beef and lamb will remain subdued in the coming months. Production of old-season lamb is all but over while new-season lamb is yet to come on board in any significant numbers.

The new-season lamb crop is likely to be slightly back on last season. Ewe numbers are down, as were pregnancy rates, but a lack of spring storms means lamb survival rates are expected to be elevated.

Shiver me timbers

The forestry sector has slowed harvesting activity following the spectacular fall in log prices in China earlier this year. Small-lot owners tend to view their forestry investments as a treasure chest that they only want to plunder when returns are high. Therefore the quantity of small forestry lots being felled has decreased but harvesting of the larger forests continues. This means the quantity of logs felled in Q4 is expected to be 10-20% back from the Q2 peak in harvesting activity.

Figure 2. Unpruned A-grade log in-market price

Source: AgriHQ

Prices for export logs have recovered slightly in recent months. During this time domestic prices have held up due to ongoing demand for timber for housing, but domestic log prices are expected to ease back now that sawmills don't have to compete so hard against demand from across the seas.

Pulling anchor

The New Zealand milk production season has started at a solid rate with production up 3.8% during the first three months of the season. This lift was driven primarily by strong production during the winter months and provides little guidance to full-season

volumes. We anticipate milk output in the season to May 2020 will be marginally down on last season.

Milk output in New Zealand is set to fall further in coming years, meaning our dairy companies will need to compete harder for supply to keep processing facilities full.

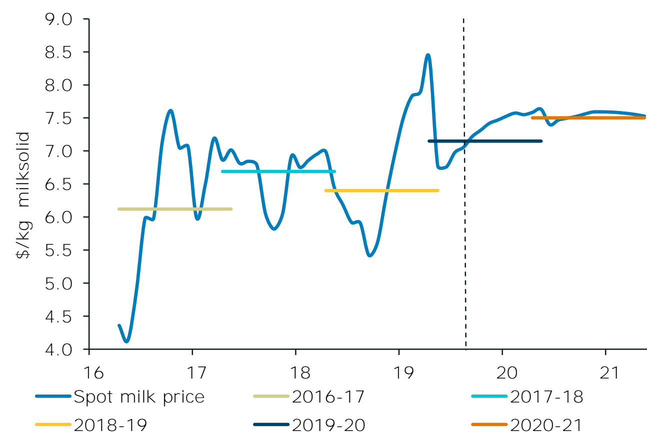
Investment in farms in New Zealand is being constrained by the uncertainty associated with changes in environmental policy. Rules aimed at improving water quality are expected to limit output for intensive farming operations such as growing vegetables, cropping and dairying.

The reduction in investment in dairying is already evident and land values are easing. Some farmers are pulling the anchor on dairying as they look to put their land into less-intensive uses such as finishing lambs and beef stock.

Milk prices are forecast to lift this season. We are forecasting a milk price of $7.15 per kg MS while Fonterra maintains its guidance range of $6.25-7.25/kg MS.

For the 2020-21 season we have a preliminary forecast of $7.50/kg MS based on dairy commodity futures prices and our current outlook for the NZ dollar.

Figure 3. Farmgate milk price



Source: ANZ Research, Fonterra

Batten down the hatches

Despite the buoyancy of global food commodity markets, confidence levels of our producers are low. Farmers are moving into uncharted territory with tightening environmental regulations and the fear of unknown waters is limiting confidence and investment in the sector.

Farmers are committed to improving environmental outcomes but fear some of the rules currently proposed will mean their businesses are not economically viable in the future. Headwinds are strong for livestock producers, with the dairy sector having a clearer view of the challenges ahead than their sheep and beef counterparts. Both sectors risk being blown off course by tightening regulations unless they can adapt their rigging to suit the new conditions.

For now, farmers are battening down the hatches and reducing debt rather than undertaking capital spending. This approach will mean they are better positioned to move forward when the winds of change pick up.

Keeping scurvy at bay

The horticulture sector is seeing plenty of opportunities as international consumers develop a taste for the likes of Sungold kiwifruit. Investment in kiwifruit and apple orchards is strong, as is investment in more niche fruits such as avocados and berries.

However, the horticulture sector also faces challenges meeting the new water-quality regulations due to the high level of nutrients required to grow fruit and vegetables. Tighter regulations in NZ may have unforeseen consequences such as encouraging importation of less nutrient-dense foods if the cost of producing fruit and vegetables locally increases significantly.

Financial markets outlook

Summary

The **RBNZ's** surprise 50bp cut in August was a major talking point for the market over the quarter, with business sentiment failing to bounce in the aftermath. The Federal Reserve maintained an easing bias, and cut its policy rate by a further 25bp to 2.00% over the same period. The RBA, too, felt the need to ease policy, cutting to 0.75% and reigniting talks of unconventional monetary policy on both sides of the Tasman. NZ yields hit fresh lows as the global data pulse deteriorated (and geopolitical tensions continued to mount), with the September 2025 inflation-indexed bond becoming the first NZD-denominated asset to yield a negative interest rate following the **RBNZ's** August decision. We expect the slowdown in global and domestic activity to continue to weigh on the NZD over coming quarters and yields to remain supported.

Into the unknown

Markets have been unsettled by the ongoing weakness in the global data pulse, with ongoing evidence of a slowdown in global manufacturing forcing participants to reconsider their outlook for global growth in the coming year. US-China trade talks also created volatility as President Trump's rhetoric intensified, as did China's retaliatory stance, before both parties called a truce. While markets are sceptical about the possibility of a meaningful deal, the recent ceasefire has been a welcome development. However, a worsening in a US-Europe trade dispute, after a WTO ruling allowed the US to impose tariffs, added to the list of trade worries, and further hinders the outlook for global growth.

Closer to home, the RBNZ surprised markets with a 50bp cut to the OCR in August, before adjusting its tone in a follow-up OCR Review, attempting to shore up domestic confidence. Meanwhile, the RBA also continued to ease monetary policy while calling for fiscal support, but less dramatically than its kiwi counterpart. Both adjustments to policy have, however, raised the issue of potential unconventional monetary policy and what it would mean for the economies and markets.

Back to where it all began

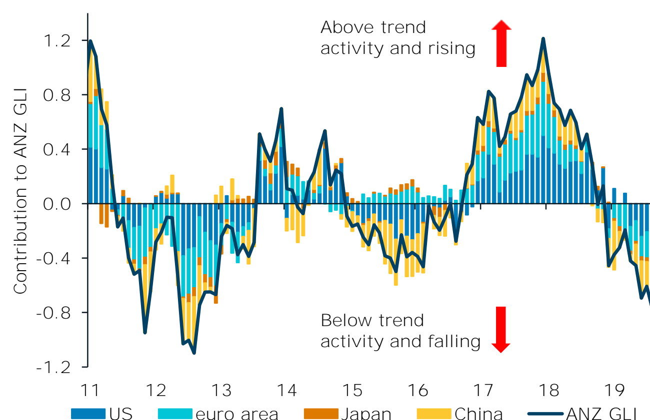
The Federal Reserve maintained its easing bias over the quarter, despite the US data pulse offering a mixed read on the economy. While the committee remained somewhat at odds on the need for further easing, the Federal Reserve continued to characterise its cuts as an 'insurance policy' or a 'mid-cycle adjustment', as opposed to a full-blown easing cycle.

Meanwhile, the recent debt ceiling arrangement has given way to a new issue for the Federal Reserve. A marked rise in the overnight repurchase rate (a market where participants secure cash) forced the Federal Reserve to deploy a number of standing cash facilities to ensure the market did not undermine its monetary policy settings and lead to an unwanted tightening in monetary conditions. The tightness in this market saw central bank offer up to USD175bn in cash via an overnight and term repurchase facility. This offering remains time-limited but the Federal Reserve has indicated it will begin purchasing US Treasury notes in an attempt to neutralise these pressures. This will also increase the size of their balance sheet over time.

Yields on the 10-year US Treasury bond rallied approximately 60bp over the quarter, but a mixed-to-positive US data pulse provided some impetus for a swift retracement early in September. That said, as a softer outlook for global growth becomes more apparent, yields have crept lower in anticipation of future FOMC easing.

In Europe, the ECB followed through with its talk and cut its cash rate to -50bps, while committing to another round of quantitative easing. The central bank – like many others recently – has also called for fiscal policy to support monetary policy, suggesting that the latter cannot support the current economic expansion all on its own.

Figure 1. Global activity remains below trend



Source: Bloomberg, Markit, ANZ Research

The hunt for certainty

Prime Minister Boris Johnson has followed his predecessor, Theresa May, in attempting to secure a deal in the never-ending Brexit saga. The resistance encountered by Johnson has highlighted the fractured nature of Brexit negotiations, with many MPs resigning or shifting allegiances shortly after Johnson's appointment. The 31 October Brexit deadline has set the market up for a showdown. In the meantime, markets continue to sweat the ramifications of the various possible outcomes – with the Bank of England

repeatedly highlighting the impact a 'hard' Brexit would have on Britain's economy. In ANZ's view, a general election remains the most likely outcome.

The fragile nature of US-China trade relations has kept any significant upward momentum in financial markets in check, with safe-haven assets (eg the USD, the Japanese yen, and gold) remaining well sought after. And the list of uncertainties continues to grow, as geopolitical tensions continue to grab the markets attention. The attack on Saudi Arabia's oil fields, the upswing in trade tensions between the US and Europe, and a re-escalation of the situation in Syria have also negatively impacted the market's risk appetite, as many seek out greater certainty.

All up, the global markets outlook remains soft. The hurdle for an improvement in risk appetite remains elevated, and will be of concern to market participants and policymakers alike.

Rocking the boat

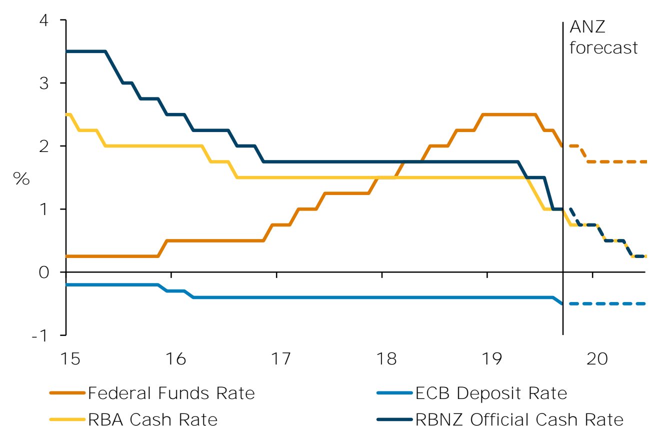
The RBNZ shook things up this quarter and cut the OCR by an unexpected 50bp at the August MPS. While the RBNZ has traditionally reserved 50bp cuts for crises and other significant unexpected events, Governor Orr repeatedly reinforced that this was not the reason for the cut on this occasion, with the cut rather aimed at spurring spending. The decision nonetheless saw market interest rates plummet, with the September 2025 inflation-indexed NZGB becoming the first NZD-denominated asset to yield a negative interest rate.

The decision was closely followed by RBNZ comments on the potential use of negative interest rates and unconventional monetary policy, which gave the rates market further impetus to continue its bull run. The RBNZ pulled its dovish bias back at the September OCR Review but the statement had only a very brief impact on market pricing, as markets quickly refocused on the data pulse after a very weak Quarterly Survey of Business Opinion. Expectations of further RBA easing also weighed on our curve, with markets seeing little chance of the RBNZ holding the OCR while the RBA eases its cash rate.

Following a further deterioration in our forward-looking indicators, we adjusted our OCR forecast during the quarter and now see the RBNZ pushing conventional monetary policy to its limits with a 25bp cut at the November MPS, and with two further 25bp cuts in February and May 2020, taking the OCR down to just 0.25%. At the time of writing, the market is pricing in a 100% chance of a 25bp cut at the RBNZ's November MPS. The market's implied terminal cash rate sits at 0.54%.

Local yields set another new low this quarter. The New Zealand 10-year government bond yield continued to test levels below the OCR, and has recently set a new low, below the OCR, at 0.99%. Meanwhile, short-dated yields remain anchored by future RBNZ rate cut expectations, with expectations about global central banks' actions providing additional impetus. We expect the slowdown in global growth and geopolitical tensions to continue to weigh on long-end yields, and see the spread between NZ and US 10-year yields widening to 60bp by the end of the year.

Figure 2. The global easing cycle



Source: Bloomberg, ANZ Research

To break the USD 0.60 barrier

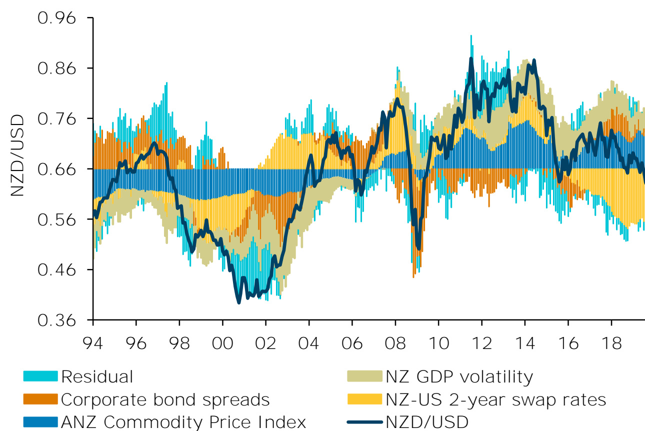
The NZD succumbed to the deteriorating global and domestic economic outlook over this quarter, falling to levels not seen since mid-2015. While this transition was swift, we believe further weakening is in store given the myriad headwinds facing the NZ economy at present. Of note is the ongoing weakness in business sentiment, with increasing evidence that this is impacting investment and employment despite easier monetary conditions. Talk around the prospects of unconventional monetary policy has also been unsupportive of the NZD. The softer domestic business outlook underpins our expectations for a slower recovery in domestic growth, which will result in further OCR cuts in the months ahead.

Widening interest rate differentials between NZ and the US continued to limit any upside for the NZD, while a general aura of risk aversion also created a drag on the currency. Further OCR cuts by the RBNZ will weigh further on the currency, and while markets expect the Federal Reserve to continue to ease, we don't believe they will be as aggressive as the RBNZ. As such, we expect the differential between NZ and US interest rates to remain wide in the quarter and year ahead.

Firmer commodity prices will provide some support to the NZD in the short term but we expect the domestic and global growth environment to offset this. Moreover, the RBNZ's proposed capital changes are likely to have

a detrimental impact on credit conditions in the domestic economy, which is likely to more negatively affect the agricultural sector relative to others.

Figure 3. Rates remain a drag as growth slows



Source: Bloomberg, ANZ Research

All up, the outlook for the NZD remains dominated by downside risks. It is unlikely to be smooth sailing downwind as the global economic slowdown becomes more evident, and risk aversion grows, cyclical currencies like the NZD will remain under pressure. Meanwhile, strengthening domestic headwinds will see NZD break the USD 0.60 barrier in the coming quarter.

Forgotten lows

NZD/USD: Capsizing. The NZD struggled to maintain buoyancy as the **RBNZ's** surprise 50bp cut and talks of unconventional monetary policy weighed. Expectations of FOMC easing have provided some short-term resilience, as have positive shifts to risk sentiment, but support is diminishing as focus turns to the deterioration in the domestic economic outlook.

NZD/AUD: Shifting tides. NZ **hasn't** been alone in dealing with a softer economic outlook. The outlook for Australia remains similarly downbeat. That said, the **RBNZ's** 50bp cut saw this pair break away from its year-to-date highs and set a fresh low for 2019. Further cuts are likely from both central banks, which may see this pair break out of recent ranges.

NZD/EUR: Fire those flares. The ECB matched words with action this quarter and cut its cash rate to -50bp while redeploying QE. This helped stem the post-RBNZ decline in this pair but **hasn't** allowed for much of a rebound. The beleaguered common currency remains under pressure as **Europe's** economic woes continue amidst rising US-Europe trade tensions.

NZD/GBP: Search and rescue. **Britain's** Prime Minister, Boris Johnson, encountered similar roadblocks to former Prime Minister, Theresa May, with his ambitious Brexit plans over the quarter. As such, **it's not clear** Britain is any closer to resolving this political ordeal, and the GBP remains hostage to Brexit headlines. With the deadline of 31 October rapidly approaching, it sets the GBP and Britain up for an interesting showdown in the run up to Christmas.

NZD/JPY: Hidden treasure. This pair set a seven-year low this quarter as significant demand for safe-haven assets saw the JPY strengthen materially. While some of these concerns have eased in the short term, this pair is unlikely to unwind its recent losses as geopolitical tensions continue to plague markets. We **don't** expect this scenario to change in the near term, and thus foresee the JPY strengthening further in light of the ongoing trade and geopolitical uncertainties.

Table 1: Forecasts (end of quarter)

FX Rates	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
NZD/USD	0.61	0.59	0.61	0.61	0.63	0.63	0.65
NZD/AUD	0.94	0.89	0.90	0.88	0.90	0.90	0.93
NZD/EUR	0.56	0.56	0.58	0.58	0.58	0.57	0.59
NZD/JPY	65.9	62.0	64.1	64.1	66.2	66.2	68.3
NZD/GBP	0.50	0.49	0.50	0.50	0.50	0.50	0.51
NZD/CNY	4.39	4.27	4.44	4.47	4.63	4.63	4.78
NZ$ TWI	67.2	64.9	66.8	66.6	67.9	67.6	69.7
Interest Rates	Dec-19	Mar-20	Jun-20	Sep-20	Dec-20	Mar-21	Jun-21
NZ OCR	0.75	0.50	0.25	0.25	0.25	0.25	0.25
NZ 90 day bill	0.92	0.67	0.50	0.50	0.50	0.50	0.50
NZ 2-yr swap	0.74	0.61	0.64	0.66	0.65	0.74	0.77
NZ 10-yr bond	0.90	1.00	1.25	1.25	1.20	1.45	1.50

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	2.0	2.3
Private Consumption	3.6	5.4	4.8	3.3	2.8	2.3	2.3
Public Consumption	2.5	2.0	2.8	2.2	3.2	3.5	3.0
Residential investment	5.7	10.8	0.9	2.6	4.9	-2.1	-0.4
Other investment	3.2	2.1	4.4	4.0	1.8	2.2	3.1
Stockbuilding[1]	-0.3	0.2	-0.1	0.4	-0.7	0.1	0.0
Gross National Expenditure	3.0	4.6	3.9	3.7	2.2	2.7	2.5
Total Exports	7.7	2.3	2.3	2.5	2.8	1.0	1.9
Total Imports	4.0	3.4	6.8	5.9	0.8	2.3	2.4
Employment (annual %)	1.3	5.5	3.1	1.9	1.2	1.3	1.4
Unemployment Rate (sa; Dec qtr)	4.9	5.2	4.5	4.3	4.2	4.5	4.4
Labour Cost Index (annual %)	1.6	1.6	1.9	2.0	2.3	2.3	2.4
Terms of trade (OTI basis; annual %)	-3.1	6.7	7.9	-4.8	2.9	0.4	0.2
Current Account Balance (sa, $bn)	-6.8	-5.4	-7.7	-11.3	-10.5	-12.4	-13.1
as % of GDP	-2.7	-2.0	-2.7	-3.9	-3.4	-3.9	-4.0
Prices (annual % change)							
CPI Inflation	0.1	1.3	1.6	1.9	1.6	1.7	1.7
Non-tradable Inflation	1.8	2.4	2.5	2.7	3.1	2.5	2.6
Tradable Inflation	-2.1	-0.1	0.5	0.9	-0.6	0.5	0.6
REINZ House Price Index	14.8	14.5	3.5	3.3	2.7	3.3	2.1
NZ Financial Markets (end of December quarter)							
TWI	73.6	76.1	73.0	71.5	67.2	67.9	--
NZD/USD	0.68	0.69	0.71	0.67	0.61	0.63	--
NZD/AUD	0.94	0.96	0.91	0.95	0.94	0.90	--
NZD/CNY	4.43	4.81	4.62	4.62	4.39	4.63	--
NZD/EUR	0.63	0.66	0.59	0.59	0.56	0.58	--
NZD/JPY	82.1	81.1	80.0	73.7	65.9	66.2	--
NZD/GBP	0.46	0.56	0.53	0.53	0.50	0.50	--
Official Cash Rate	2.50	1.75	1.75	1.75	0.75	0.25	--
90-day bank bill rate	2.75	2.00	1.88	1.97	0.92	0.50	--
2-year swap rate	2.85	2.46	2.21	1.97	0.74	0.65	--
10-year government bond rate	3.57	3.33	2.72	2.37	0.90	1.20	--

[1] Percentage point contribution to growth

Forecasts finalised 17 October 2019

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

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