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INSIDE

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BRINGING HOME THE BACON

FEATURE ARTICLE: BIG THEMES OF 2014

We outline some of the key themes that will play an influential role in determining New Zealand's economic prospects over the year ahead. They are: Managing Friction; Appreciating the Unappreciated; The Sacrificial Pawn; Tapering Tantrums, Sovereign Risk, and Inflation Watch. The bottom line: New Zealand is firmly into an economic expansion. Good times are here. However, the good times will mask frictions and tensions, many of which have built up over time and, as yet, have not been fully addressed. A common sub-theme across all thematics is the heightened importance of the microeconomic story. Leadership needs to trump populism, the policy agenda must be constructive, and firms need to maintain that harder edge. A key risk over the coming years is one of complacency setting in.

THE MONTH IN REVIEW

Over the past two months pasture growth has varied across the regions. Generally it has been windier than normal, which has depleted soil moisture and slowed pasture production. Rain has been unevenly distributed. However, every time a real pinch has started to be felt, some rain seems to have been delivered. Milk production is on track to hit a new record. Lamb production forecasts have been raised. The 2014 vintage is expected to be very large and up on last year.

RURAL PROPERTY MARKET

The rural property market looks like it has hit fifth gear in recent times. Turnover across all property types, except horticulture, surged above 10-year averages. Average pricing while coming off the peaks of the spring period has a definite strengthening trend that stretches back 18 months. The charge is being led by existing dairy farms, land suitable for future conversion and dairy support blocks. Most other property types have seen more modest gains in price.

KEY COMMODITIES AND FINANCIAL MARKET VARIABLES

In-market prices for most of New Zealand's main soft commodities continue to show stability at high levels. Early prospects for 2014/15 look promising and a forecast softening in the NZD/USD later in the year could provide an additional boost for some sectors.

BORROWING STRATEGY

While indicative short-term rural fixed lending rates have moved a touch higher, long-term rates have moved lower, "flattening" the lending curve. Fixing for longer is thus cheaper. Although the "horse has bolted" for those wishing to fix ahead of upcoming OCR increases, there is still likely to be some benefit in fixing for terms like 3 years. This is because while it is more expensive to fix now than it was a year ago, if the RBNZ lifts the OCR by 1 percent this year, as we expect, term rates are likely to rise more rapidly than implied by breakevens.

EDUCATION CORNER: NEW ZEALAND'S CHANGING TRADE PATTERNS

New Zealand's main export markets have changed rapidly in the last six years. The change has been mainly driven by the rise of China, which overtook Australia as our largest export destination in November 2013. Additionally there has also been strong growth in exports to ASEAN and wealthier Middle East countries. Our more traditional markets such as Australia, the US and Europe remain important for specific sectors and higher grade/quality products though. While the rapid growth to non-traditional markets has brought opportunity, as trade matures a deeper understanding of the regulatory framework, business practices and local culture which affects consumer trends, tastes and customer service requirements are needed to continue to drive growth.

FEATURE ARTICLE: KEY THEMES OF 2014

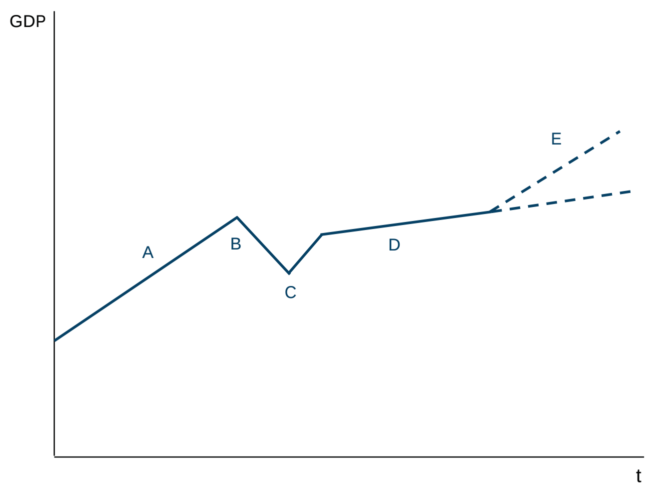
SUMMARY

The following paper outlines the key themes that we think will influence New Zealand's economic prospects over the coming years. While economists and commentators often focus on macroeconomic variables, such as interest rates, the currency, commodity prices, employment, household wealth etc, there are often deeper thematics that reside in the background. Key thematics we are eyeing over the coming year include: Managing Friction; Appreciating the Unappreciated; The Sacrificial Pawn; Tapering Tantrums, Sovereign Risk; and Inflation Watch. The bottom line: New Zealand is firmly into an economic expansion. Good times are here. However, the good times will mask frictions and tensions, many of which have built up over time and, as yet, have not been fully addressed. How these challenges are addressed needs to be managed carefully, and means we might be prone to experiencing the odd economic wobble. Some are controllable locally and other facets i.e. the global scene, are not. In an environment of managing these frictions and tensions a common sub-theme across all thematics is the heightened importance of the microeconomic story. Leadership needs to trump populism, the policy agenda must be constructive, and firms need to maintain that harder edge. A key risk New Zealand will face over the coming years is one of complacency setting in.

Our aim in writing this article is to alert our readers to some of the wider economic forces influencing the economic outlook. Its contents are highly relevant to the rural sector. We want to highlight the tensions that exist within the economic system, and to encourage farmers to think about the implications for their own businesses. Ultimately, it is the average rate of growth over a number of years (and volatility around that growth) that matters, as opposed to what GDP growth will be in any single year. New Zealand might be in a sweet spot at present, but the repercussions of the global financial crisis and interplay of complex structural forces will continue to be felt for years. For us, the key macro themes over a five-year time horizon are:

- **Theme 1: Managing Friction:** the economy is expanding, but this masks tensions as structural and cyclical forces collide. The interplay of complex structural challenges requires even more attention on the microeconomic picture. A simple example is addressing the dilemma of the Auckland property market. The economy can ill-afford to be dominated by individual events, such as a city rebuild and housing shortages.
- **Theme 2: The Sacrificial Pawn:** accommodating a *"Ben-Hur"* style construction boom.
- **Theme 3: Appreciating the Unappreciated:** six key under-acknowledged legs of the New Zealand story we're watching.
- **Theme 4: Tapering Tantrums:** removing the liquidity sugar pill. Recent fears over some emerging market economies highlight the bumpy road ahead.
- **Theme 5: Sovereign Risk:** the global economy is improving, but deep-rooted challenges remain in the fiscal arena.
- **Theme 6: Inflation Watch:** up, up and away on the face of it, if history repeats. The performance of the supply-side will be critical in suppressing this dynamic. While demand-side facets of the outlook tend to dominate most analysis, it will be the supply-side that needs to emerge as more of a focal point if the expansion is to have greater longevity.

The New Zealand economy is going through a material transition – probably one of the most significant in fifty years. We're moving from legacy to opportunity, amidst demands of rebuilding our second-largest city, housing shortages in our largest city, and an overvalued currency. Legacy involves a weak national balance sheet. We have champagne tastes, but for a long time have generated beer income. This is a mismatch needing further correction. Opportunity centres around connections to the fast-growing Asian region and other wealthy emerging markets, inroads in the free-trade area, utilising New Zealand's abundant natural resources, businesses being fighting fit with plans in place to grow, and pulling it together with that number eight wire mentality (innovation). While the changes are economic, including massive amounts of resource shifts, they also involve altering human behaviour. Throw in the above-mentioned sources of friction and it's a tall order to navigate.



We can stylise what New Zealand has gone (and is still going) through into five stages.

- **Borrowed growth (from the future) – A.** An under-leveraged balance sheet in 1990 was

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replaced by a heavily leveraged one by 2008. Credit growth exceeded incomes by a factor of three between 2003 and 2007, traditional risk-return identities were ignored, central banks kept interest rates too low, the regulatory hand was too light (think of finance companies in New Zealand's instance), growth became lopsided, imbalances ballooned, asset price bubbles materialised and artificial wealth drove spending. The Freddie Mercury (I want it all and I want it now) style economy ruled. The tradable sector was plundered at the expense of non-tradable centric growth and we're left with an unbalanced economy.

- **The inevitable purging and correction process – B.** Welcome to the GFC, and in New Zealand's case, tight monetary policy settings that induced a recession prior to the start of the GFC.
- **Upturn – C.** Night follows day and day follows night with the sun rising in the morning. Recessions are followed by recoil with monetary policy (and global stimulus) working its magic. However, the upturn remained fractured locally and around the globe with deleveraging curtailing the ability of normal pro-cyclical forces, such as a rampant consumer to drive strong growth.
- **Transition and execution – D.** We settle into an economic expansion. However, the slope of D is less than A. We can grow during the expansion phase – but not as fast as we're used to and will **be prone to the odd wobble. So for many the growth we see doesn't feel like growth (it took until Q3 2013 for per GDP capita to climb back to late-2007 levels).** For New Zealand, we believe this trend rate is somewhere around 2 percent in terms of real GDP growth. Transition involves a **different mix to growth.** It is untenable to imagine a debt-laden nation borrowing and spending its way out of a debt-induced jam (though NZ recently tried this on). Household debt is around 1½ x disposable income and we don't have a savings buffer to lean on: spending parts of the economy need to underperform if the saving rate is to improve. It requires the **re-mobilisation of resources**, including labour and capital across sectors, as a spend-centric model is replaced by a more balanced model for growth. Capital and labour does not respond instantaneously. You don't change the DNA of an economy overnight. We're talking a long-journey, and it will be messy. The length of the journey in D, or period of moderate growth, can be shortened by getting resources shifting and responding in a timely manner. On some levels we can see price signals working (i.e. real wages falling in some industries, up in others) and economic incentives tilting behaviour. On others, we're not (i.e. an inflated NZD beyond local fundamentals, signs of pre-2008 style behaviour). Hence, it's a journey fraught with frictions.
- **Promised land (we hope) – E.** Imbalances are finally purged. Growth is stronger on average. This is where choices in the transition stage will be influential. We either see stronger and better economic performance (i.e. living standards and real incomes), or not. And let's not forget it will be harder for New Zealand to grow as fast in the future because the population is ageing and this means slower growth for the labour force (in fact the number of 15 to 64 year olds is expected to shrink as a proportion of resident population over the next 25 years). To offset this, **you need to be doing things not just smarter, but *a lot* smarter.**

If this transition is not enough, consider the following:

- **We're being pushed and pulled during the transition stage.** We have deleveraging imperatives going head-to-head with low interest rates driving the reverse. The NZD is still overvalued despite a 40-year high in the terms of trade. A city rebuild is pending, which – all else being equal – will worsen the national balance sheet and not improve productivity. Leaning against this is fiscal retrenchment on current spending, which is helping to improve national savings. Housing shortages are acute in one region. A terms of trade windfall and greater connectivity into the Asia region are factors driving growth; it's always more palatable to address balance sheet issues via growth.
- **There is a time limit on the transition stage** determined by pending demographic pressure. New Zealand's demographics are altering. By 2020 there will be around 4 persons aged 15-64 for each person aged over 65, down from 5.9 in 1990. People are living longer. It is blatantly obvious the current system is unaffordable. Changes are required. The degree of change can be minimised by progress made in the transition stage (speed and quality) to unlock stronger growth potential during stage E.

We can point to the obvious factors that will influence the transition stage. **The weaker the balance sheet, the greater the deleveraging headwind** holding back near-term growth. Flexibility in areas such as the labour market and having a floating currency assist by allowing price signals and resources to adjust more readily. **Economists can point to an array of factors that determine growth.** The problem is that it's difficult to disentangle the causality, as many of the so-called growth determinants (such as investment) are key components of GDP themselves.

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For a transitioning economy, you need to address the regulatory framework and economic incentives households and businesses face to be driving the right sort of behaviours. The playing field needs to be tilted on these two counts. Sometimes this is possible (and New Zealand has done a reasonable job in this regard looking at tax change, KiwiSaver and building a more productive government sector, to name a few), in other instances (i.e. deflating the NZD) it's not possible to deliver a (strong) localised response (which is not to be confused with doing nothing: you can help with an overvalued currency by lifting Government savings and productivity). And in some areas we need to be moving faster (i.e. local government reform).

And so this stylisation is the opening gambit in the journey NZ.Inc is facing. It's a potent combination of legacy and opportunity, while addressing certain necessities and realities along the way. And we're facing a time limit. **Buckle up, it promises to be an interesting ride.**

THEME 1: MANAGING FRICTION

The upshot: While the New Zealand economy is firmly into an economic expansion, this masks huge tensions and frictions. These frictions are being driven in part by an upswing that took a long time to become embedded (it's been 5+ years since the GFC); but also reflect the complex interplay of secular forces shaping the outlook. These secular forces will be around for some time and while we'll grow it won't be as fast on average as during the pre-2008 period so frictions are here to stay. This means greater performance variability across and within industries, with the gap between good and poor businesses widening. How the interplay of secular forces are managed will have a significant bearing on the longevity of the expansion. It is simply not in New Zealand's wider interests for one or two secular thematics (such as a city rebuild or housing shortages) to dominate too much. Critical here will be the microeconomic agenda – both at the firm and policymaker level. The coming years will be notable for the significance that microeconomics plays in determining and underpinning the macroeconomic story. Microeconomics always matters; it simply matters more when the economy is navigating its way through competing structural tensions.

The New Zealand economy is firmly into an economic expansion. We have the obvious pro-cyclical drivers in the form of loose financial conditions, pent-up demand, high commodity prices, natural population growth and improving business and household confidence. However, these must be read in conjunction with much deeper positive and negative forces.

- **The national balance sheet is still weak:** net external debt at around two-thirds of GDP is world class – at the wrong end of the spectrum. The household savings rate is the big doughnut. That means limited scope for a pro-cyclical borrow-and-spend recovery. The economy still needs to deleverage; we don't need to scrimp, but income growth needs to exceed spending growth, given the realities of a poor national and household saving performance.
- **Fiscal policy is contractionary.** The NZ government is on track to deliver a surplus in 2014/15, thus more money will be taken out of the economy in taxes than the government puts back in. That's an economic headwind.
- **The NZD is a drag on activity.** The TWI is near post-float highs. While much is penned about the NZD/USD, the NZD/AUD has rocketed from significantly under-valued to significantly over-valued within a year, and we suspect it will remain high. Moreover, the 2013 rate of change, at 16 percent, is the swiftest move we have seen in any 12 month period since the 1980s, making the adjustment all the more painful.
- **The global scene may be stable, but risks of an accident are clear**, as the exceptional policy stimulus experiment is wound down. Eyes on emerging markets including China, which is New Zealand's largest trading partner.
- **Housing shortages in Auckland are acute;** residential construction still sits way under historical norms. That's a significant growth pipeline if supply-demand balance is to be restored.
- **The Christchurch rebuild will be around for a decade**, but faces challenges in producing a real return on investment as costs escalate.
- **The connectivity story with Asia is ongoing.** Soft commodity prices are elevated, China has surpassed Australia as our number one merchandise export destination, and visitor arrivals from China increased by 20 percent in 2013. There are wider opportunities in South America and wealthier parts of the Middle East, as well as the broader Asia region.

Other forces are material too, but don't make the top list. The "leaky homes" crisis is still hugely relevant. There is the lagged effect of kiwifruit Psa still being worked through. Many sectors have outstanding trade issues with China and other emerging markets that need to be worked through.

These forces are secular, meaning they will be around for some time yet.

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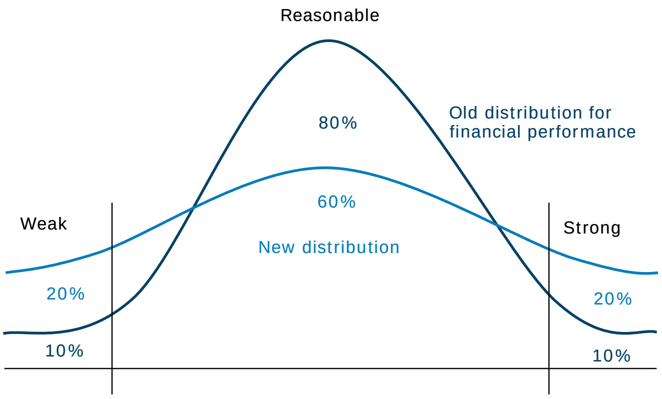
They are complementary in some facets, but opposing in others. Deleveraging is deflationary. Positive commodity income shocks and natural disasters are not. The income shock is helping New Zealand get its balance sheet back in order. This is particularly noticeable in the rural sector via income generation (a higher denominator helps lower debt and deficit-to-income metrics). Conversely, rebuilding Christchurch will involve dedicating resources to rebuilding domestic capital (i.e. housing and other infrastructure) at a time when we are supposed to be investing in other regions and sectors to address our national indebtedness and imbalances. We're already seeing the consequences of these shocks interacting with variables such as the CPI and wages with Canterbury leading the charge on both. Structural forces colliding mean more dispersion across such measures. **So not only has the economic upswing taken longer to become embedded, it has been masking these huge tensions and frictions.**

These tensions mean **conflicting economic signals and mixed messages** for businesses. The **historical "distribution"** in terms of business performance within every sector has tended to be around **10-80-10.** Ten percent are incredibly strong performers. Eighty percent perform okay, ranging from muddling through to being solid. Ten percent are constantly churned – the perennial underperformers.

The changing distribution of financial performance



This distribution has evolved more towards **20-60-20.** Twenty percent of businesses are strong. Sixty percent are muddling through or solid. Twenty percent risk being churned. We regularly see multi-tiering in terms of performance within sectors. Why the change? **Structural changes at the economy-wide level necessitate change at the core business level if firms are going to survive, let alone thrive.** Microeconomic foundations need to be strengthened, with continued emphasis on doing the basics well, but also greater willingness to adapt to suit the changing environment. Firms need to get more strategic with their future direction and highlight themselves in a more positive light, rather than just muddle through. "She'll be right" no longer applies in an increasingly connected and competitive global marketplace.

None of this is more apparent than in the retail sector. Momentum has lifted, but households are still discerning with their buying decisions. Gone are the hey-days of 5-10 percent retail sales (and credit) growth. The interplay of technology and internet shopping complicates the picture further.

An average business can look very good in a strong performing economy, but they are exposed in an environment where secular and cyclical forces collide. A larger gap between strong and weak businesses within sectors portends of a lot more consolidation to come across and within industries. Productivity performance is key, but so are the basics of any good business, namely driving every incremental piece of profitable revenue growth vis-à-vis peers and the competition.

In this environment, the onus is even more on businesses to ensure their microeconomic foundations are strong. Microeconomics always a critical role in any well-performing business so we're not talking about anything new here. However, the interaction of a complex array of secular forces simply means that the microeconomic agenda needs to be even more at the forefront of thinking.

Good policy can also help alleviate some of the tensions and frictions. They won't eliminate them, but they can moderate extremes.

The economy can ill-afford to let one secular force dominate. You never want all your eggs in one basket. Overarching forces tend to come with hooks. **Leaving Auckland and Christchurch alone – drivers of domestic-centric growth risks bludgeoning the rest of the economy with the by-product, namely aggressive OCR increases at a later stage.**

Frictions from contrasting forces will need strong microeconomic management. This means a clear and robust policy agenda. What do we mean by the microeconomic policy agenda? Consider the example of Auckland's housing shortage. The response cannot simply be a supply-centric (build more houses) response. The attack needs to be multi-pronged: land (obviously) needs to be released/re-zoned, consenting processes (and costs) streamlined, and internationally high construction costs tackled. We're seeing developments in all areas at present. However, we'd go further. Regional development initiatives need to be encouraged. Other regions need to take a more hands-on approach targeting Auckland businesses; it's not solely up to policymakers and the Government to drive things. A lot of talk focuses on

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the cost of a house in the affordability equation, but not much on the other variable; income generation. Bring in a capital gains tax. Savings-based policies need to be strengthened: KiwiSaver is semi-compulsory – we'd drop the "semi" part. Some of our social security safety net may need to be reviewed, starting with means testing NZ Superannuation and raising the retirement age. There are numerous angles to addressing New Zealand's housing issues.

We'll stop short of a complete wish-list, but there are a host of areas to look at. If the NZD is set to remain high, productivity across the tradable sector needs to be enhanced and supported. We need to ruthlessly target and minimise compliance costs and this means another leg of local Government reform. Wellington and other regions need to follow Auckland's super-city lead. Getting the right infrastructure and resources in place is critical. Some sensitive areas need to be looked at i.e. how many ports does a country of 4.5 million need? We favour across-the-board research and development concessions, as opposed to a "picking winners" style approach. Realigning the demand side of NZ.Inc also necessitates massive shifts in supply-side capacity, the root of which is the education system. More scientists, mathematicians and engineers please. Tilt the tuition fee structure to make it happen. Drive even more course specialisation into the tertiary sector.

A robust biosecurity framework needs to be in place. A number of things have focused attention on the adequacy of our biosecurity processes. These include: the impact of the Psa incursion on the kiwifruit sector; the Auditor General's report on the Ministry for Primary Industries' level of response preparedness; and recent concerns over the integrity of the processes surrounding the importation of the Palm Kernel Expeller (PKE). The same applies to our food safety framework and systems in the wake of Fonterra's issues over the past year. Recent enquires have highlighted a number of tweaks that are needed to maintain a world class system and reputation.

There have been a number of trade issues with China in the past two years or so. Some of them are self-induced and others are not. Industry and government need to work more closely together. There needs to be more specialist resource in New Zealand, but also resources embed in-market to ensure trade with our number one market operates smoothly.

Minimum environmental standards, especially for water, need codifying and implementing. This is becoming a larger source of friction between the rural sector and urbanites as time goes by. It needs to be addressed so the country can move on and the rural community has investment certainty. There has been progress from both industry and central/local government, but there is a lot of back tracking. Things are progressing at different speeds across the country, and different approaches are being taken. This has all added up to a lot of investment uncertainty. Defining and having alignment between the different parties on the country's environmental aspirations can then be used to add significant substance to the New Zealand brand story.

The list could be long and extensive, but we'll stop here.

Across a lot of areas we're seeing progress. We acknowledge this, it's encouraging. However, **our key conclusion is that the interplay of complex structural forces necessitates this progress stepping up another gear. The economy can ill-afford complacency to set in across the policy agenda.**

Economists are notorious at talking too often and too much about the big stuff and ignoring the small. We enter 2014 with a focus on the small stuff and watching microeconomic developments. Microeconomic initiatives tend to be lost in the wash amidst the wider macroeconomic stories that gather the headlines. Nonetheless, a collection of small initiatives add macroeconomic punch. None of this will be more apparent than the housing arena, which could help take some pressure off the OCR. It'll be essential if the economy is to remain on the straight and narrow as opposed to tilting in one direction. There are no quick fixes. Don't buy into the promise or mystique of magic potions in election year: they don't exist and tend to be snake oil.

THEME 2: THE SACRIFICIAL PAWN

The upshot: New Zealand faces a construction-centric growth pipeline that is bigger than *"Ben-Hur"*. There will be resourcing and supply-side tensions. A construction boom cannot be complemented by a consumption equivalent: the inflationary consequences and weakness in the national (household) balance sheet prohibit it. Restraint on the consumption side of the economy – both private and in the Government arenas – is a necessary pre-requisite for boosting productive investment, making the numbers (inflation and balance sheet wise) add up, and an economic expansion becoming durable and long-lasting.

New Zealand is facing a massive construction growth pipeline. Consider the following:

- **Christchurch.** A $40bn rebuild equivalent to 20 percent of our nationwide GDP (or more than three years of the value of nationwide work) has been put in place. With the Canterbury region accounting for around 13 percent of the nationwide

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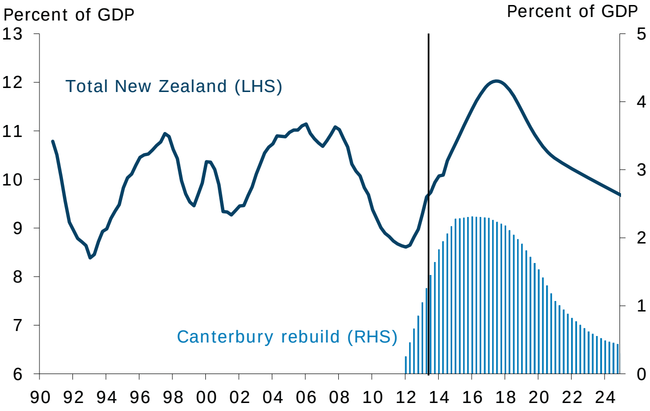
resident population and dwelling stock, this is a regionally-concentrated event. No nation in our modern history has faced as large a repair bill from a natural disaster. With a $15bn price tag to the Crown and higher insurance premiums for building owners, the rebuild will not come cheap.

- **Auckland's housing needs.** Stronger population growth in the Auckland region over the next 20 to 30 years necessitates a concerted period of house building in our most populous region. Thirteen thousand dwellings a year over the next 30 years will devote a significantly larger chunk of the nationwide residential construction sector resources – closer to half as opposed to the historical average of around one-third.
- **Leaky buildings.** Our estimates suggest a $20bn repair bill, of which around $15bn is for residential dwellings. A fraction of the repairs have been done so far. This is another hit to our structurally weak nationwide balance sheet, and with building costs on the rise, and potentially more structures susceptible to water tightness issues, there are upside risks to our estimates. While the work will generate more activity it would place further demands on a limited margin of spare capacity, with the impact on wider spending depending on who picks up the tab. There are regional facets, with more of the dwellings concentrated in the Auckland region.
- **Earthquake reinforcing remedial work.** Tougher building codes have upped the ante on improving the quality of our building stock. This is potentially very large in scope. A safer workplace carries additional costs, both in terms of funding the work and utilising the resources that could have been used to build other infrastructure such as schools, hospitals, irrigation schemes, or dairy sheds.
- **From broadband to major roading projects,** a major crown investment programme is underway. A sizeable chunk of this is construction related, with work on roads of nationwide significance (including the Kapiti Expressway, Transmission Gully and the Waterview Connection in Auckland). With a limited number of construction workers and machines to go around, the issue will be the extent to which of these projects add to capacity versus their impact on crowding out private sector demand.

With all of these demands occurring simultaneously, the construction sector will move from famine to feast in fairly short order. **Construction sector activity is expected to lift from around 10 to 12 percent of GDP over the coming three years. This might not sound like much, but it will directly account for around one third of the close to 8 percent increase in GDP over that period.** Firms in the wider economy servicing the construction industry will also indirectly benefit. Manufacturing firms aligned to the construction sector are an obvious beneficiary. The downstream consequences of the Christchurch rebuild for instance is estimated to be worth close to $20bn to the manufacturing sector (see our September 2013 *Property Focus* for further details).

Construction shares of GDP



Sources: ANZ, RBNZ, Statistics NZ

This will create obvious supply-side and resourcing frictions. Resources will need to be mobilised to alleviate demand bottlenecks. This has both regional (more to Canterbury and Auckland) and sector (more to construction) dimensions. The transition will not be seamless, and there will be a period of adjustment as skills are upgraded in needed areas, and capital and labour move.

A consumption boom typically runs hand in hand with a construction boom. The links are obvious: both are key pro-cyclical components of the economy and are interest rate sensitive; rising house prices tend to be a boon for both (encouraging more consumer spending via the perceived wealth channel and making it relatively less expensive to build rather than buy; more house building lifts the demand for consumer durables as new houses need to be kitted out).

However, there are active constraints on this historical tendency.

- **The economy has finite resources.** Our construction sector cannot meet all off these demands simultaneously. Limits on construction sector capacity suggest that the Canterbury rebuild on its own will be a multi-year undertaking, in addition to the 13,000 dwellings per annum earmarked for Auckland over the next 30 years. It ups the ante on careful prioritisation, with earthquake reconstruction at the front of the queue. Productivity performance of the construction sector needs to be lifted – paying mere lip service to the recommendations from the

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Productivity Commission report on the building sector will not suffice.

- **The inflationary genie will necessitate a policy response.** Increasing resource stretch in the construction sector will have the tendency to impact broader wage and consumer inflationary pressure, particularly when the economy is on the up, as it is now. The intensification of pricing pressure in the construction sector will see the RBNZ raise the OCR.
- **The national balance sheet still demands restraint on the consumption side.** Our net international investment position, at over 71 percent of GDP, is high in relation to other OECD countries. A good chunk of this is held by parts of the household sector, with household debt at more than 90 percent of GDP. This is the natural corollary of high house prices. As we are a nation of low saving relative to our investment needs, spending in excess of income will have to be financed overseas, and the amount of goodwill provided by overseas creditors is limited. If not, the New Zealand economic locomotive could quickly come off the rails.

For the construction boom to be accommodated, the consumption side of the economy must give way. We're not talking about moving backwards, but certainly a rate of growth that is below the broader economy. Think of it as negative jaws: the negative jaws being excess income growth over spending growth. Raise the former and the latter can lift too. Of course the flipside also applies.

We will see two obvious tensions over the coming year.

- **It's an election year, with the obvious temptation for sweeteners.** While our fiscal lolly jar has an empty rattle to it, a fiscally prudent stance will be difficult to sustain if the election race is close. There will be a strong temptation to fiscally pump-prime the economy, with the rolling out of new policy initiatives already starting.
- The flow through from the wider economy to household spending. **Debate surrounds whether households have truly gone through a structural change in behaviour or whether the restraint seen from 2009-2012 was merely cyclical and transitory.** There are cases supporting both sides of the argument. If households go on a spending spree, this will have implications for the degree of inflation pressure, national balance sheet, and inevitably the mix of monetary conditions.

We're of the view the change in household behaviour is more structural than cyclical. Implicit to this view is that household spending will be funded via current income rather than households bringing forward consumption. Yes, we acknowledge some of the fun and games in the property market and signs of pre-2008 style behaviour re-emerging in some areas. But let's not forget the continued uptake in KiwiSaver, the commonality in the political arena over the importance of fiscal surplus in the 2011 (and we suspect 2014) election – that's politicians reading the mood of the nation – and the mature debate New Zealand can now have over compulsory saving (and raising the retirement age). We doubt the 2014 election will be "long" on spending promises such is the mood of the nation. The signals are far from conclusive that we're witnessing a fundamental structural shift in behaviour, but they're encouraging nonetheless.

In some areas behaviour evolution will involve "active" management. Overheating construction and housing markets have long been an inflationary bugbear in New Zealand. The OCR is the most obvious demand-side policy tool available, and the RBNZ will not shirk from its remit to deliver low and stable inflation. Moves by the RBNZ to increase the range of policy options available to them signal they are looking to mitigate the fallout on the tradable sector. Last year, the Bank introduced speed limits on high LVR lending to directly address inflation and financial stability risks posed by the Auckland residential property market overheating (they're working). The RBNZ is unlikely to rest on its laurels, but will look to other options for taking the pressure off OCR settings.

The fiscal stance needs to remain contractionary. Returning the books to surplus is an imperative for maintaining the credibility of our policy framework and the state of our nationwide balance sheet. Moreover, prefunding of pending demographic pressures is a key necessity. The tighter the fiscal stance and greater the Government savings, the less the upwards pressure on the New Zealand dollar. Signals out of the 2014 *Budget Policy Statement* are encouraging, with government spending expected to trend down from 33 to 29 percent of GDP over the coming five years, and the fiscal stance projected to remain contractionary to the tune of 4 percent of GDP over the coming five years. However, there seems some inevitability about the 2014 *Budget* involving some election sweeteners. We're assuming they'll be funded from the existing operating allowance of $1 billion as flagged.

With many of the challenges stemming from impediments on the supply side, demand-side measures can only go so far. High construction cost inflation is a signal that more resources need to flow to the construction sector, but bottlenecks holding back performance in the sector need to be addressed. **Further initiatives in the broader policy arena would not go amiss.** A number of

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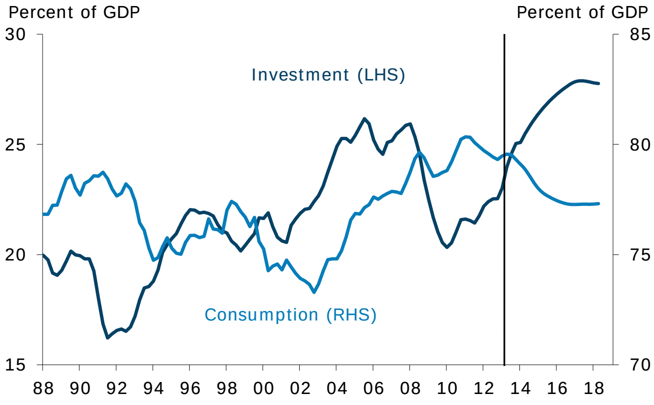
potential solutions are commonly mooted, including work at streamlining the consenting process, tweaks to the RMA, improving migration policy, and adopting global best practice construction techniques. Individually each one is unlikely to be a magic bullet, but collectively they are likely to pack some punch.

In short, there are a wide range of policy levers available. Our view is that the right combination of demand and supply-side policies has scope to achieve more than what is commonly realised. The trick is to find the right mix.

Key things to watch over the coming year include:

- **Household credit.** If this increases faster than income growth, we'll be back into that leveraging mindset. Historically low interest rates have enabled households to service higher debt levels, but we may be nearing a tipping point, particularly with mortgage interest rates set to go up. Given already high household debt positions (around 148 percent of disposable income), this would raise the vulnerability of the household sector and the economy as a whole to adverse events, both at home and abroad. Preventing such an outcome was one of the motivations behind the high-LVR lending restrictions.
- **Consumer confidence.** This has perked up, as the positive vibes felt by the business sector have flowed through to households. **A confident consumer is good for the economy.** However, spending needs to be funded out of current income and households need to be prudent.
- **The credit channel of monetary policy** (the impact the provision of lending can have on demand). The RBNZ has delivered the first warning shot in the form of high-LVR lending restrictions – a policy aimed at both borrowers and lenders.
- **The political tea-leaves.** The closer the "race", the greater the temptation for largesse.
- **Durables spending.** Traditionally linked to wealth gains and construction activity: this nexus needs to be broken. Or to put it another way, while we can have the house, we need to stop short of filling it will multiple TVs and other toys. LVR restrictions will bite here as well. +80 percent borrowing and flexi-style mortgages were not only used to buy the house, it was the play money for redecorating it post-purchase as well.
- **The housing market.** We're assuming pricing pressure will wane as demand-side measures (the OCR moving up) and a supply-side response to shortages evolves (slowly).

Total investment and consumption shares



Sources: ANZ, Statistics NZ

We're expecting credit growth to track at around 1 percent below income growth, consumer confidence and spending trends to be modest, the credit channel of monetary policy to work with (as opposed to against) monetary policy, and the fiscal stance to remain restrictive. Such **judgments are a key part of making sure our numbers "add up" and ensuring imbalances do not become problematic** (necessitating aggressive counter adjustments down the track). Stepping back, that lot **sounds a little bit holy-grailish.** However, it's the brutal reality when you throw together a weak balance sheet and an immense construction pipeline: something has to give to make it all add up, and **we're banking (or not) on the consumption side of the equation being demure.**

THEME 3: APPRECIATING THE UNAPPRECIATED

The upshot: Amongst the hurly-burly as to what is driving the New Zealand economy and helping us through the transition phase, there are the ill-acknowledged legs. Five under-appreciated legs of the story for NZ.Inc include: unlocking more growth from areas of advantage, including an abundance of natural resources; wrapping an innovation and execution strategy around New Zealand's unique points of comparative advantage; a functional political system – that amidst obvious jitters does [eventually] display more leadership than populism; society remaining receptive to change and a firm microeconomic reform agenda. A sixth – and emerging variable to watch – is productivity growth.

Talk to an economist and they'll typically point to a range of influences including asset prices, interest rates, the New Zealand dollar, commodity prices etc in terms of what is **driving the economy. That's too clever by half.**

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It is the small innocuous variables that fly under the radar that often deliver the real economic muscle (or the reciprocal). Witness for example the rapid increase of Australian tourist numbers into Queenstown. It has little to do with the NZD/AUD (competitiveness) or Australia's income (GDP), both traditional drivers of tourist numbers and spending trends. The key driver has been flight connectivity (airfare competition included) and looking forward, night flying capability (landing those jets late in the evening which will open up Queenstown to the Sydney weekend traveller) will have an equally large role to play. Sometimes we take the importance of political stability and credibility for granted. We only appreciate its significance when it disappears. Witness the various political shenanigans over 2013 in Europe, the US and Australia and what they temporarily did for growth.

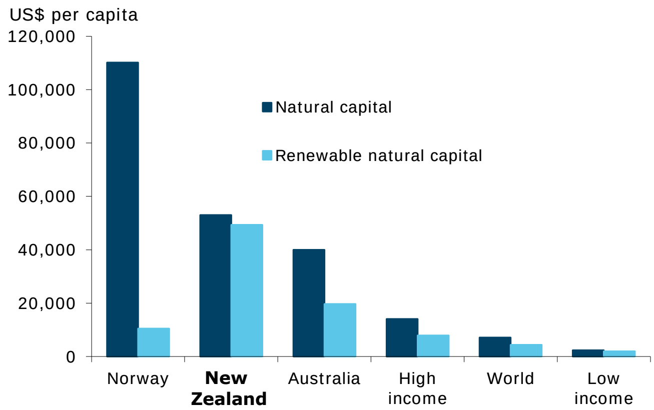
We believe there are five under-appreciated legs of the transitional and the wider growth story for New Zealand.

It's easier to transition, grow and improve your balance sheet if you have unique legs of advantage: this allows you to pull an income generating lever.

New Zealand is a resource rich nation. We rank 8th globally in the per capita natural resource wealth stakes, a few notches higher than Australia, who are often deemed the "lucky country". The only countries ranking higher export huge amounts of oil. And **in terms of renewable natural capital** (think land, timber, heritage assets, a large economic exclusive zone), **New Zealand leads the world on a per capita basis.**

Just like s**uccessful businesses need something in their offering that is "different"** (whether that be brand, relationships, or a better service proposition), **the same applies for a nation.** New Zealand has this in spades, and it's critical, **for the more you pull an income-generating lever, the less pressure there is for austerity.**

Natural capital per capita 2005

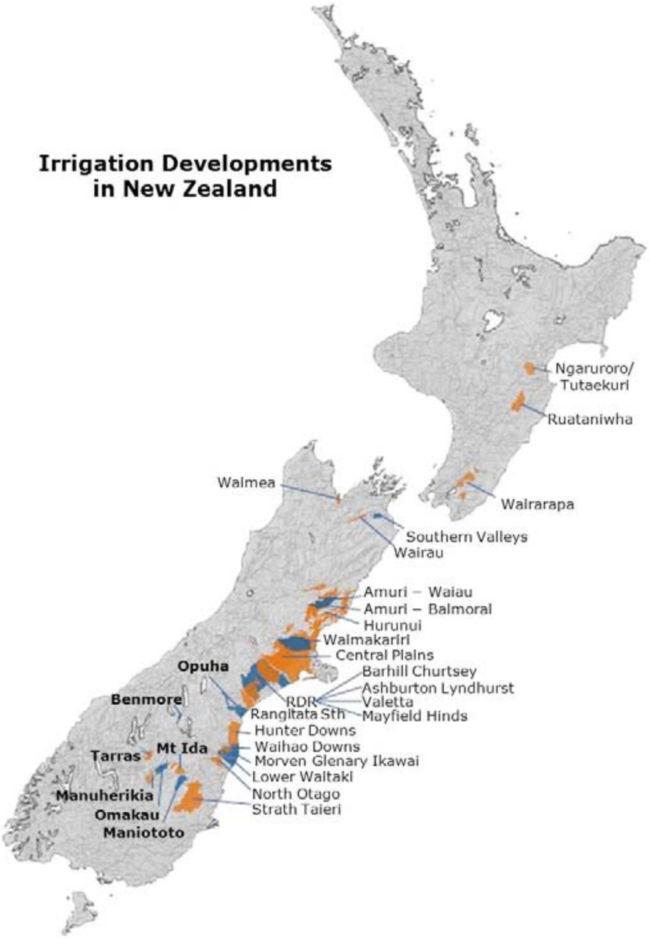


Source: The World Bank "The Changing Wealth of Nations" 2010

There can be tensions between some of these endowments. Unlocking them is not easy. You wouldn't want one area of strategic excellence, such as mining, to undermine another, such as tourism, so sensible regulatory heads are required. **Moreover, having a large natural endowment does not guarantee success for a nation.** It can invite corruption and foreign exploitation.

We're closely watching developments in a number of areas:

- **Irrigation – there are currently plans in place for 16 new water storage schemes around the country, and a further nine substantial upgrades are planned or underway for existing schemes.** In aggregate, if all the new schemes are completed this would nearly double the total irrigable land in New Zealand to 1.38 million hectares, which would equate to 12 percent of total agricultural land. This would be a tremendous boost to productivity, as irrigated farmland generates three times the production of non-irrigated land. The schemes are at various stages on the development curve, from preliminary assessment through to the initial stages of construction. Many are moving to put board and



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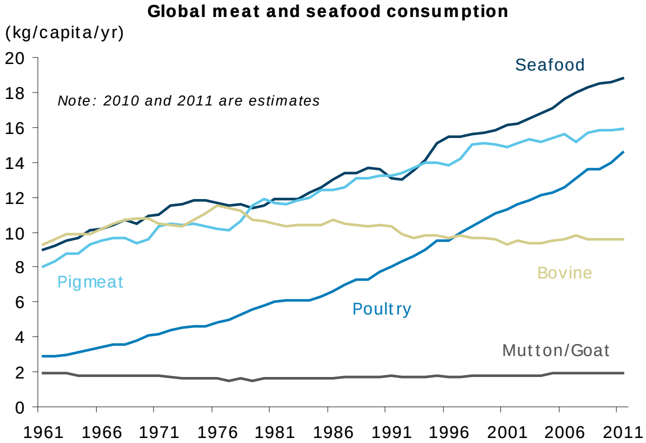
management structures in place, through to issuing investment proposals. This has a different feel to just two years ago. Many plan to be fully completed in the next 3-5 years. Combined with other on-farm improvements to farming practices and irrigation systems (i.e. greater use of pivots and piped instead of open canal distribution) this is likely to see agriculture continue to lead the productivity charge.

- **Oil exploration** – at least eight offshore petroleum exploration (or appraisal) wells will be drilled in New Zealand waters in 2014, by two drilling rigs, each costing tens of millions of dollars. These wells are targeting a range of petroleum prospects, the largest of which could contain a billion barrels of oil if successfully found to be hydrocarbon bearing. A discovery of this size has the potential to multiply (nearly 7-fold) New Zealand's oil reserves (currently ~150 million barrels). Additionally, onshore drilling in the East Coast of the North Island is taking place to assess the feasibility of developing unconventional petroleum resources. Successful development of these resources has been estimated by Government to increase GDP by around 0.2 percent for a small-scale development, to as much as 9 percent in the most ambitious region-wide development scenario. Investment continues in development work at a number of onshore fields in Taranaki and offshore at the mature Maui and Maari fields also. All up 2014 is expected to be the most active oil and gas exploration season ever, with the industry expected to spend between $600 and $750 million in 2014 and around $2.5 billion over the next three years. Beyond this exploration is expected to continue with 10 new oil and gas exploration permits awarded in December last year and another round scheduled for later in 2014.

- **Aquaculture and better use of New Zealand's economic exclusive zone.** New Zealand's economic exclusive zone is the 5th largest of all countries at 4.3 million km^2. With a land mass of 268,680 km^2 (6 percent of total economic exclusive zone) this leaves us with a lot of ocean frontage. One way to make better use of this is aquaculture. With the volume of global capture fisheries expected to remain static, because of many fishing stocks being either fully exploited (or over-exploited), there is enormous potential for aquaculture to fill the gap. Further upside to demand is large as many emerging countries have strong cultural preferences driving seafood consumption. Globally the sector has already grown 12-fold since 1980 to nearly 60 million tonnes. **This has made aquaculture the fastest-growing protein sector** and puts it on par with global beef production. So while New Zealand may be talking a big game in the dairy arena in terms of protein supply, there are other avenues to pursue.

Global meat and seafood consumption



Sources: ANZ, FAO

- **In New Zealand, aquaculture is currently a $400 million sector, but has aspirations to reach $1 billion in turnover by 2025. The sector has a three-phase plan to reach its goal and is now into the second phase.** The first phase was recently completed with the government implementing long overdue regulatory reforms. This included the removal of designated Aquaculture Management Areas, essentially opening up more area for development. There are still some issues regarding the interpretation of the law by regional councils, and gaining consent still requires consultation with all stakeholders who "share the water-space". On the whole the changes have provided more investment certainty and opportunity for the sector. Provided more space can be obtained, it will then be up to the sector to fulfill its potential. **The three largest sectors of mussel, salmon and oysters will probably achieve the lion's share of growth. These three sectors have already done the hard yards** by developing systems and technology to farm their respective species. But also, more importantly, they have developed their markets and understand what their customers want.

- **Smaller horticulture sectors are building on their human factors to further unleash New Zealand's natural factors. In the horticulture sector we often read about the big three of viticulture, kiwifruit and pipfruit, but there are many other smaller crops that fly under the radar.** There are natural factors that make it possible to grow many of these smaller crops in New Zealand in certain regions and at specific times. Often the timing is counter seasonal to many Northern Hemisphere producers, which provides a number of offshore opportunities. Specific natural factors include things such as wind

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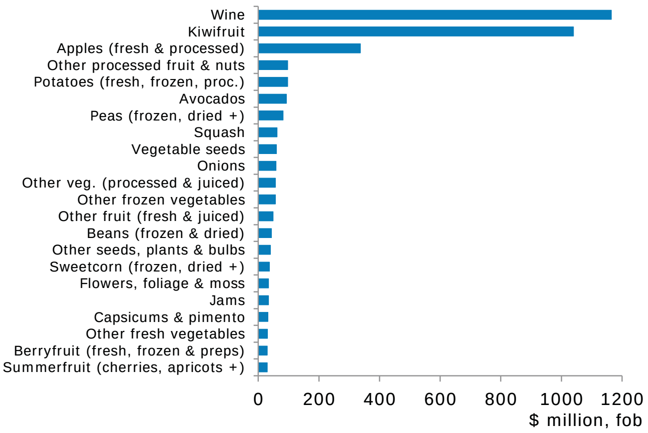
direction, growing degree days, rainfall during certain times of the year, topography, soil type etc. These have always existed, but the ability to unleash these depends on human factors, such as different varieties of a crop that are used to suit the natural factors through to expertise, management practices and other technology that goes alongside.

Horticultural exports



Sources: ANZ, Statistics NZ

- **The horticulture sector has growth aspirations to reach $10 billion in turnover by 2020, and a strategy to achieve this.** What is little understood is that this is an umbrella strategy created by Horticulture NZ and industry participants for all the crops within the sector. **Many of the smaller sectors are now developing, or already have their own goals and strategies. This is strengthening the direction of these individual sectors by creating their own goals and strategies to achieve them.** An example is the potato industry. It has recently set out targets to increase profit from productivity by $150/ha per annum over 10 years, double the value of fresh and processed based exports by 2025, and enhance the value of the domestic market by 50 percent by 2025. The focus on the export market is significant as historically the industry has been mainly domestic focused. This is to be achieved through all the normal research and development channels and then extended through to new market development programs. Overall, reading through the strategies there are a number of common elements that encompass value-add, productivity, profitability and expansion. **Many of these individual sector strategies are focused on the human and trade factors that have previously limited growth. If successfully executed, this will further unleash the natural factors that allow these crops to be grown in New Zealand in the first place. Individually these sectors may be small at present, but together they add up, and combined with faster growth, matter.**

- **Milk supply in New Zealand has already grown substantially (nearly 3-fold) over the last 20 years by using the country's natural endowments, combined with the industry's collective expertise in dairy farming and processing. With New Zealand and Fonterra now the largest dairy export player, its scale and associated expertise has created leverage and foreign investment opportunities in areas of strategic excellence. One such facet has been the development of offshore milk pools.** This has helped square the production curve for Fonterra and allows it to service customers 365 days a year. This is a critical service component for many foodservice and retail customers with dairy products in every country in demand all year round. Additionally, it is an important component in Fonterra's desire to maintain its scale and build larger foodservice and consumer businesses in dairy nutrition. What is little known is that these offshore milk pools now account for nearly a quarter of the total milk Fonterra collects and processes in a year. This is concentrated in Australia and South America and growing quickly in China. In Australia, Fonterra now processes approximately 20 percent of their total milk supply and in South America it is 10 percent (calculated across Chile, Brazil, Uruguay and Argentina's supply and includes joint venture partners) with a 25 percent share in Chile. In China they have direct ownership in farming assets producing 150 million litres each year and have plans to expand this to 1 billion litres over the next four years. While the production challenges and systems in each country are slightly different to New Zealand, the built-up expertise and associated scale that were founded on the country's natural endowments is creating exciting new investment possibilities.

- **The red meat sector still covers about 78 percent of New Zealand's total agricultural land. There is a large opportunity to close the performance gap between the top 20 percent and the rest. The recently announced Red Meat Profit Partnership is the first major step-up in investment ($64 million over seven years) to address this issue.** The aim is to change the way information and knowledge that supports best practice is developed and delivered within the sector. Creating better performance across the industry that occupies the lion share of New Zealand's agricultural land holdings is a critical element to better leveraging our natural endowments.

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- **New Zealand's landscape and climate creates a lot of natural beauty that is often used by the tourism and movie sectors. The removal of key barriers to allow better leverage of this natural beauty is critical to growing many of these sectors.** One such example is cycling tourism. Both domestically and internationally there is increasing participation in cycling activities. Over the last 5 years, 318,000 international tourists participated in cycling sports in New Zealand. Annually around 4 percent of international holiday visitors do some sort of cycling sport while visiting New Zealand. On average international tourists that participate in cycling spend $3,800 compared to the $2,500 average spend of all visitors. There is a significant high-value segment in the cycling market, with 22 percent of international cycling tourists saying they spend over $5,000 on their visit to New Zealand. **The creation of the national cycle way and individual trails suitable to a range of abilities, improving road safety, creation of appropriate support services, such as accommodation, bike hire, transport, security, as well as more marketing are all presently taking place. These investments and the removal of barriers are key to growing both domestic and international cycling tourism, which is based around New Zealand's natural beauty.**

Three years ago, progress in these areas was more theoretical than real. In fact, some – such as a cycle-way were laughed at! Today they are real prospects with building momentum. **Into 2014 we're seeing concrete progress and outright execution.** These are going to continue into the 2015 and beyond growth story.

However, New Zealand will not get rich shunting out volumes of agricultural produce like it's been doing for past decades. More thinking "outside the square" is still required. Consider the following examples:

- It rains here, so we have good access to water which can boost primary production if storage capability can be developed. By default, we should be experts in regard to irrigation infrastructure, systems, water treatment, and everything hydro.
- We pride ourselves on being clean and green so we should be leaders in green technology, renewable energy, insulation, and eco-friendly homes.
- Our primary industries are world-class in a number of areas, so we should be exploiting this expertise and knowledge by creating and marketing associated technologies, animal husbandry products, genetics, cultivars, services and pest control.
- We are a sports-mad nation punching well above our weight on a population basis at the Olympics and other international sporting events. This makes us a prime candidate as a nursery for training coaches and sports development. Leveraging our natural endowments and beauty also makes us a prime candidate for the services and expertise associated with outdoor pursuits and adventure sport, which continues to grow in popularity.
- We've a city rebuild to contend with. God forbid another city suffers the same fate, although the odds are that one will. When that happens, New Zealand should be leading the pack and be the first port of call on planning, building design and all engineering facets of rebuilding a city.

It's called wrapping an innovation strategy around your unique leverage points. We like what we are seeing across an array of areas. On the business planning side, many sectors are on to their second or third iteration of strategies to focus investment and effort in key areas to grow and make their businesses more profitable. The government and research institutes are getting involved with the likes of the work of the Massey University Riddet Institute.

On the action front there are more and more examples of investment and programs of work being launched related to specific areas of a sector's strategy. Examples include the PGP project on the Red Meat Profit Partnership. This was one of the main areas of concern identified when the Red Meat sector strategy was completed in 2011.

In the dairy sector there was the replacement of the Clean Stream Accord with the Sustainable Dairying Water Accord. The new accord outlines a number of new commitments to address the dairy sector's impact on water quality and quantity. It is more comprehensive than its predecessor, encompasses all the major dairy processors, and potentially has more teeth to address the chorus of concern on the environmental impacts of the sector.

From the Government there is more streamlining of the R&D pipeline. This has included a revamp of Crown Research Institute funding and objectives to better deliver national priorities and respond to the needs of research users, particularly business. The creation of a one-stop government department (Ministry of Science and Innovation) to better integrate policy, strategy and funding, ensuring stakeholders deal with a simpler system provides more consistency and certainty. The Government plans to introduce a new approach to growing innovative start-up technology companies. This will involve repayable government grants alongside support from new technology incubators led by the private sector.

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These and other changes show more collaboration is occurring and sectors executing specific programmes of work related to their strategic plans for growth and profitability.

Execution and strategy need to prevail over opportunity.

Conversations about New Zealand's economic future are invariably underpinned by:

- **The re-emergence of Asia as an economic power-house.**
- **The emergence of the Asian consumer and large middle class.**
- **Aggressive negotiation of free-trade agreements** that currently cover 28 percent of the global population and 35 percent of GDP, with negotiations underway with another 29 percent of the global population and 17 percent of GDP.
- **New Zealand being "long" renewable capital and much of Asia being short.** Natural biological constraints in agriculture, under-investment over the last 20+ years, urban creep and biofuel production swallowing productive land, water scarcity, a more volatile climate, and government intervention; has all added up to **some nations being increasingly reliant on food imports.** This brings social (the cost and availability of food) as well economic challenges. It also adds up to continued interest and New Zealand's supply-chain and foreign direct investment from Asia, a theme which is not going away soon.

We're coy about New Zealand having all our eggs in the Asian basket – there are material risks on the growth front. China is presented as a huge source of potential upside for New Zealand and the primary sector. However, China faces challenges re-orientating its economy. How does the economy balance an economic objective (less investment and more consumption) with a social one (more jobs), which means more investment? Will investment malfeasance and rapid credit accumulation ultimately require the piper to be paid? How does China unlock total factor productivity growth – the key to becoming a middle income economy? Can a centrally-planned economy truly outdo ones that are more based on market forces? It all adds up to a raised risk profile. We're seeing cracks in the economic story at present, and they'll no doubt deepen with global interest rates to normalise over time (refer theme 4).

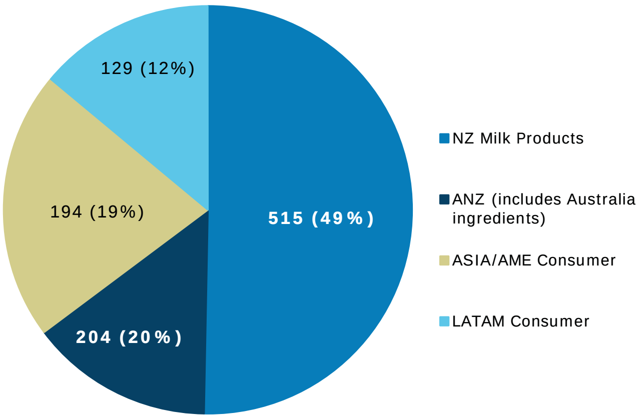
Our China economics team believes the risk of a hard landing can be managed with appropriate policy assistance, but been revising down their growth forecasts. However, they note the current risks are skewed to the downside, with a structural "L-shaped" slowdown a real prospect, without the implementation of appropriate policies in a number of areas.

We're mindful of the obvious risks. There will be twists and turns. However, New Zealand is still small. We cannot feed the world: we're targeting niches as a producer, not trying to be a mass producer. What matters most for New Zealand through the transition, and period of heightened uncertainty, will be how Chinese households fare, and the execution of business strategies by companies to target the right households and channels to market. Respect the macroeconomic picture, but the ultimate buffer to this resides in getting the microeconomic agenda right.

Talking the talk needs to translate into "walking the walk". In reality most of the major agribusiness industries, the tourism sector and others have already developed strategies around the Asian opportunity with some on to their second, third, or fourth iteration. In fact, we believe this is under-appreciated: all the agri-industries have moved well beyond identification and into the execution stage (and we believe New Zealand is well ahead of Australia in this regard). The successful refinement and execution of these strategies is the next leg on which we're looking for guidance and evidence. The problem here is that benchmarking such progress typically doesn't happen until you see it in the macroeconomic figures. We're after earlier signals than that, which is why we're eyeing all the small things at the microeconomic level.

The earlier list provides some snippets on many of the good things that different sectors and companies are presently progressing in the background. However, there have also been some challenges and slip ups.

Fonterra FY13 EBIT mix (NZ$mn)



Sources: ANZ, Fonterra annual report

Fonterra wants to process more of the milk it collects into consumer products and is busily investing accordingly. But with two food safety incidents in 2013 (one being major) this has called into question its food safety reputation and placed immense pressure on not only its brand, but many of its customers and New Zealand's brand. It's difficult to be quantitative

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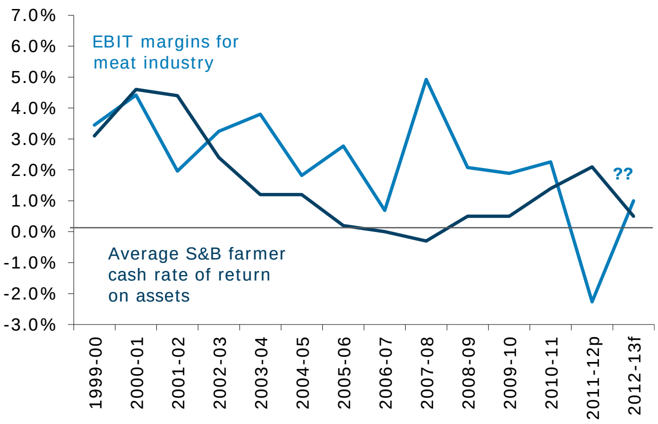
about the short and long-term financial implications, but a legal challenge for compensation by Danone of approximately NZ$500 million gives a feel for some of the more direct effects. This is equivalent to half Fonterra's value-add earnings (dividend stream) in 2012/13, 31 cents per share, or $45,000 for an average sized dairy farmer who is 100 percent share backed. The prospect of a long drawn out court case could not only be expensive, but also has additional risks for its brand. **Only time will tell how significant the total impact is.** Increased scrutiny from media, customers and trade partner's means the company needs to be whiter than white, otherwise its ability to deliver on its strategy will be severely limited.

Profitability metrics for Meat Industry



Sources: ANZ, Beef + Lamb NZ, Meat Company Financials, NZX.

Another example of painfully slow progress is reform of the red meat processing sector. Collectively meat processors lost nearly $200 million in 2011/12 and most only just managed to get back into the black in 2012/13. The prospect of lower slaughter numbers in 2013/14 and stock rebuilding following the drought are again going to apply pressure to earnings and weaker balance sheets in 2013/14. Addressing overcapacity, especially for sheepmeat, and better alignment between farmers and processors, is critical to addressing poor profitability, creating greater supply chain efficiencies and ensuring NZ meat farmers capture their fair share of the retail value. **The talk has not been matched by action on this one** and it feels like a death by a thousand cuts. **The election of new board members that stood on amalgamation platform to the two co-operatives in the industry late last year, likely pressure from financiers, and other industry conversations suggests change is getting closer. What type of change though, remains to be seen.**

Industry-specific issues have not been the only challenges. Trade issues with our largest partner China and biosecurity are challenges the government and industry have been grappling with. Biosecurity remains a lightning rod for many sectors after some costly incursions such as Psa in kiwifruit, varroa mite in honey bees and psyllid in tomatoes and potatoes to name just a few. With the Ministry for Primary Industries introducing Government Industry Agreements to create structures under which the Government and an industry can work together to identify priority biosecurity risks; make consensus decisions on how to respond to threats; and share the cost of responses, there is plenty to work on to ensure we have robust systems in place.

On the trade front with China the rapid increase in exports seems to have caught everyone by surprise. This has caused a number of issues, with it hard to think of a sector that has not had an issue, as opposed to one who has. Some of the issues have been self-induced, others not so (i.e. the emergence of non-tariff barriers), but with many of them you have got the feeling that under-resourcing, lack of understanding on different business practices and cultural issues have played a big part.

One such example has been the banning of green runner (sheep and lamb intestines) exports to China. You might ask why one would care, but the annual value of these exports is about $160 million, with a potential loss of at least 40 percent from an inability to sell to China – so not small change at $7 per sheep. No one really seems to know why the trade has stopped. Various theories include political, environmental, biosecurity, disease risk, waste and the Ministry for Primary Industries hasn't said much on when trade might be reinstated. There may be a perfectly logical explanation for the ban, but surely the processors have a right to know why. If there is no logical reason, it is the responsibility of the government to take the issue up with Chinese authorities and let New Zealand processors know what steps are being taken to reinstate access.

The political framework needs to be, and is, functional: leadership needs to trump populism.

New Zealanders tend to take their lack of corruption and well-functioning political system as a given. But it matters. And while "democracy is the worst form of Government except all those other forms that have been tried from time to time" in that it rewards short-term thinking, we are encouraged by the consistency being shown across the entire political spectrum towards fiscal savings and rebalancing the economy. Moreover, New Zealand has a political framework that is reasonably adaptive and receptive to change in a relative sense. Of course, MMP has presented its own challenges. If you want evidence of political fragmentation and institutions that are conducive to gridlock, look no further than the US and

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Europe. Our system is not perfect, but it's far better than most. For an example of how political fracas influence and undermine an economy, look no further than Australia. Politicians don't need to be rock-stars, just do the basics well. It's a dynamic we can often take for granted.

At one level we like what we see in the policy arena. Both the mainstream political parties have commonalities on major policy areas: rebalancing, driving savings, curtailing debt accumulation and running surpluses. It's unusual for an opposition party to go out with bold policy planks such as a capital gains tax and lifting the retirement age (normally a key to winning an election is to say nothing); and we like both policies. The entire Government sector is working more collaboratively around specified "Better Public Service" result areas (e.g. reducing long-term welfare dependence, or supporting vulnerable children), and is becoming much more outcome-focused (it's what you achieve with distributing the money) over inputs-oriented (distributing the money). It's common sense stuff, but implicitly adds more teeth to the Fiscal Responsibility Act. Both the mainstream political parties now broadly agree when it comes to oil exploration. We're seeing the red and blue hue try to outdo one another when it comes to education initiatives.

We also have some concerns. The regulatory wand is waving in a more aggressively and fickle manner. Boardroom discussions (and some offshore chatter) now question the political scene. The likes of nationalising the energy sector, mooted changes to the Reserve Bank Act and reintroducing national awards are steps back not forward (and that is being very, very polite about it). Few mention the side effects of relaxing the inflation target including higher interest rates on average over the cycle. Or the added risk premium to the economy in general for interfering in the independence of monetary policy. **It all adds a layer of uncertainty.**

There are costs associated with uncertainty. The existence of uncertainty can be enough to cause businesses to hold off investing today and instead wait until tomorrow to decide whether to invest. Businesses find that it is in their interest to delay investment decisions when uncertainty is high. Unfortunately, all this waiting means too little capital formation and too little capital formation means the economy has less capacity to grow. Work undertaken by ANZ in 2006 examined the role of uncertainty on investment (Regulation, the Role of the Referee, 2006). We found a long-run relationship between investment, output, the relative price of existing and new capital, and uncertainty. The linkages between investment, output and relative prices are well known, whereas the relationship with uncertainty is not. We found that uncertainty shocks had a strong adverse impact on growth for about three quarters. The longer-run impact was smaller, but still negative. A gradual rise in uncertainty in the decade up to 2006 was estimated to have carried a cumulative investment cost of $2 billion of forgone investment, or more than 1.5 percent of GDP at the time. We believe uncertainty is one variable adding to Australia's challenges at present.

And so the scene is set for the 2014 election. **We're agnostic on the result, but the one thing we don't want to see is political fragmentation and a hodge-podge leadership model that leaves us beholden to small groups where populism trumps leadership and uncertainty inhibits growth.**

Society needs to remain receptive to change.

An economy is a super-tanker: it takes time to turn. Leadership can only take you so far – habits have to change on the ground. Some habits – such as NZ's fixation with housing – need modification.

Our economic performance, after all, reflects the decisions of 4½ million individuals, whether that's their borrowing, spending, or voting decisions. Japan's lost decade epitomises a refusal to bite the bullet. Europe is witnessing the same. Despite signs of pre-2008 style behaviour in some areas (residential property and more recently the rural scene), it still appears that the critical mass in New Zealand is now tilting towards necessary structural change. Witness the continued uptake of KiwiSaver despite the smaller carrots now on offer; the focus on fiscal responsibility in the 2011 election; a refreshingly non-hysterical discussion of the possibility of raising the retirement age beyond the age of 65; and the savings debate turning more towards compulsion.

Such signals don't guarantee that society is willing to do the hard yards, but it's reassuring that things are moving in the right direction. However, we're also seeing evidence of old style behaviour and the belief that house prices only go up, though signs of this flowing through into the broader economy are mixed. There appears to be a lack of clear "consensus" in some sensitive areas (asset sales) which polarises the political arena and stymies progress. Ultimately we believe such tensions will be overcome, but we'll be tracking such debates with interest as fundamental flagbearers for New Zealand's future prospects.

One dynamic that struck us in 2013 was the angst over changes to the snapper quota: 50,000 submissions! Now no disrespect to those keen on their fishing, but amidst some pretty significant welfare reform, asset sales, global wobbles, housing affordability issues, tensions associated with rebuilding a city, f**or one of the most emotionally sensitive issues to be fish-centric, tells you something about the general attitude to change for society: we're pretty receptive.**

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The Government has also done a pretty clever job packaging up policy responses. Time and time again we've seen independent enquiries into issues and ex-post recommendations. These include welfare, housing affordability and improving child health outcomes. The recommendations receive the big tick, and because they've come from an independent committee (or should we say semi-independent, because members are chosen by the Government of the day) it removes some of the political sensitivity over the topic.

We need to continue the process of microeconomic reform to lift the supply-side capacity of economy.

Microeconomic issues are often overlooked when assessing the macroeconomy, but the economy is the summation of its parts. It is crucial to get the right incentives in place. New Zealand has already done a lot of the heavy lifting in terms of getting a system that is world class. We rank at the upper end of the OECD in terms of literacy, attainment of secondary and tertiary education (though there are real issues over gaps between the top and bottom students), transparency of our institutions, and law and order. Access to childcare has vastly improved, half of the population has now enrolled in KiwiSaver, and reform of the RMA has helped address infrastructure bottlenecks. However, we've got some clear challenges in key socio-economic groupings too.

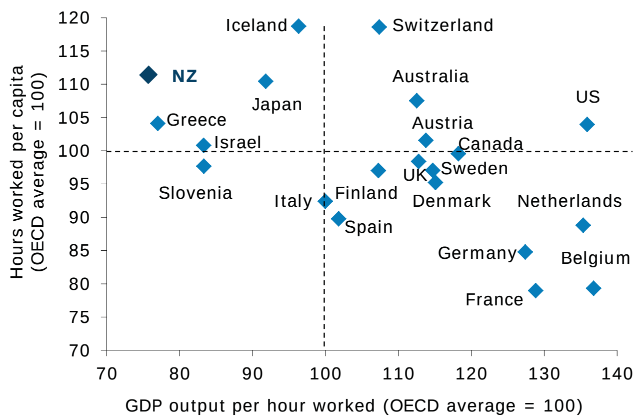
Incremental improvements can still be made to overcome the tyranny of distance from markets. Tax policy is a biggie here (we'd raise GST, bring in a capital gains tax and cut income tax rates further), as well as welfare policy design, eye the regulatory burden, property rights, balancing public and private interests, and avoiding corruption and rent-seeking behaviour (moulding one's economic activity around maximising returns from distortionary policies, rather than true economic profit).

These factors do not deliver nirvana. Nothing does. They also come with complications. Investor confidence and belief in the wider New Zealand economic story is one factor inflating the currency beyond levels dictated by local fundamentals today. In short, investors are banking on the story being delivered. The challenge for New Zealand is to deliver in the face of an elevated currency. Amongst the hurly-burly of what to do about the currency (intervene, cut interest rates, capital controls) only one idea has any credence: an obsession with lifting competitiveness, and this will require give and take across all levels of the economy from central government, local government to businesses, and unions. At present, constituents from each of these groups appear to be in a round room looking for four corners.

The productivity story is poor according to official data, but this is at odds with what we are seeing on the ground. We're backing the latter.

The official figures tell a woeful story about New Zealand's productivity performance. We work long hours, with per capita hours worked the third-highest in the OECD. Not quite as hard working as the Swiss, but right up there with the Japanese. However, the income produced per hour worked is world class at the wrong end of the spectrum. In fact it is worse than Greece. Enough said.

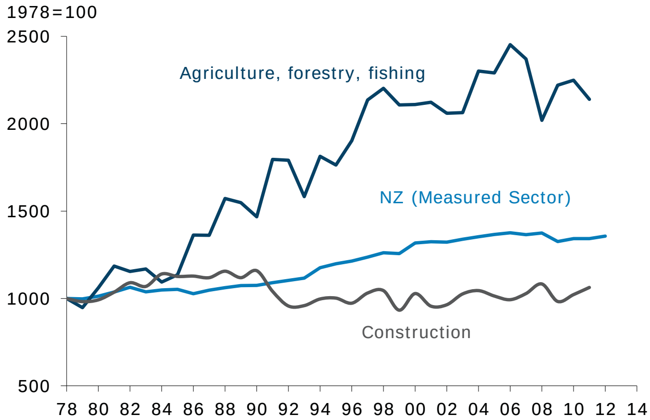
NZ's work/life balance & wealth creation vs the rest



Sources: ANZ, OECD

Productivity is a variable that is very slow to turn. This is due to inflexibilities in labour and product markets, our smaller labour force, capital holdings to invest, the time it takes to adapt skills and fill areas of skill shortages, and getting to grips with new technologies and techniques. It can take many years before the full fruits of change can be realised – the internet boom may have been in the 1990s, but advances in mobile phone technology continue today. It is a function of an array of things: research and development, commercialisation of R&D to increase revenue, or reduce costs; the training and retention of

Multi-factor Productivity
New Zealand



Sources: ANZ, Statistics NZ

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key expertise that enhance a service proposition; the effective transfer of best practice techniques overseas to our shores – we do not always need to reinvent the wheel.

The primary sector has traditionally led the charge on the productivity front in New Zealand. Its total factor productivity (TFP) growth has been 1.9 percent per annum over the last 34 years. This was more than double that of the rest of the economy, for which comparable figures are available. TFP growth in the agricultural sector has averaged around 2.3 percent per annum over this period, one of the best performing sectors over the last few decades.

Agricultural productivity gains were particularly strong after deregulation in the mid-1980s, averaging 4.0 percent per annum over a 17-year stretch. On the farm this can be seen in the breeding ewe that now has twins or triplets instead of a single, or the different varieties and yields of kiwifruit, grapes and pipfruit. All these gains have significantly improved the competitiveness of the primary sectors over this period and kept them as the engine room of the New Zealand economy.

We've seen virtually static TFP growth rates for the construction sector over this period (+0.2 percent pa since 1978) making it one of the weaker performers, with average labour productivity growth in this sector about one-third of that of the 2 percent rate experienced by the measured sector. Not surprising perhaps that the construction sector is an inflationary hot-spot, with unit labour cost growth in this sector nearly twice that of the wider economy since the start of the millennium.

While things have stagnated in recent times you only need to go on a farm tour, visit a processing/packaging site, or attend the national or local field days to get a feel for the next wave of innovation and productivity growth. Recent innovations include using drones to monitor livestock, robotic milking plants, mobile milking platforms, renewable energy innovations to power farm equipment, cloud accounting that combines physical performance and financial information to inform on-farm decision making, livestock traceability technology being used to monitor performance, continued investment in new grass cultivars and animal genetics, artificial insemination of dairy cows with single sex semen, a mechanical fruit picking machines for kiwifruit, and the list could go on.

But it isn't just on the farm. There have been many off-farm productivity gains. One example is new separation and extraction technologies to create new milk protein ingredients such as PowerProtein™ 515WPC – a breakthrough ingredient with unique textural properties for food bars. PowerProtein™ 515WPC is a highly-functional dairy protein that can be incorporated into different bar components such as binders, caramels, nougats, and dough layers to deliver high -quality protein with great taste and texture. The list could go on here also with the 10 year average annual compound growth of processed foods at 15 percent. Within this stellar growth rate, highly sophisticated nutraceuticals and other innovative food products, such as the example above have grown at an even faster clip. This reflects the increasingly porous nature of the distinction between food as nutrition and food as health. Food as health is huge in Chinese and many Asian cultures.

The "next wave" is being matched by a fundamentally different attitude across the business sector in general (and across elements of the Government). Few businesses in New Zealand have the same operational structure today that they did pre-GFC (the same cannot be said for Australia who we suspect faces some sizable challenges on the productivity front). Efficiencies are being etched out and it's occurring in a constant fashion.

The first leg was addressing cost-side largesse that comes with economic good times in the lead-up to the GFC and recession of 2008. Our fabled period of grumpy growth over the 2010-2012 really set firms on a strong drive for efficiency gains. In our view firms are now settling into a continuum of change, in which they continue to look for incremental efficiencies. Why this is not flowing into the official statistics is puzzling. We suspect it's a question of both measurement and timing, as the anecdotes don't match the official data. Indeed, the ability of the New Zealand export sector to cope with the NZD/USD around 80 cents for a sustained period pays tribute to an underlying productivity story.

These changes are slow to feed into official data, but they're occurring nonetheless. It's an unheralded example of New Zealand's economic renaissance. When the productivity parameters are on the improve and the broader macroeconomic story come together, revenue gains go straight to the bottom line and it's like an economy hits a tipping point. Suddenly "kicking tyres" becomes "doing deals". New Zealand appeared to hit this tipping point in 2013.

Challenges remain. We're geographically distant and have limited scale to drive efficiencies. A nation of 4.5 million people naturally gravitates towards a few large players in each industry as opposed to the "pure" competitive model.

Despite the challenges, all the high notes seem to be hit in regard to driving a more productive economy: the business sector is focused, the policy platform reasonable, the Government sector is more

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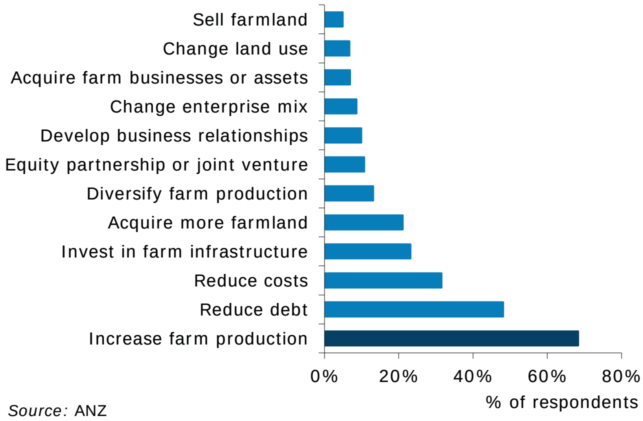
outputs-orientated, we have reasonable political unity (in a relative sense compared to other nations) and necessary infrastructure investment is being made (including broadband). New Zealand finds favour across the OECD, IMF and rating agencies in terms of the economic framework itself. We rank highly across a number of recent surveys in terms of our competitiveness and ease of doing business. NZ ranked 18th on the World Economic Forum's 2013/14 Global Competitiveness Index and 3rd on the World Bank survey for the ease in doing business.

So what is missing? Better data measurement would help, with GDP unrepresented in our view. However, productivity is another supertanker and slow to turn. The basics may have been put in place though there are clearly some missing legs. A non-exhaustive list includes:

- **We need to be thinking outside the square.** How many people would point to eyeglasses as being transformational in terms of productivity performance. They have been. We could lift productivity across the economy by going back to 5 day a week shopping. We'd still purchase, but the input costs to the business sector would be far lower. Of course our busy lives demand such flexibility so shopping hours will not change. Why is it we have to reapply for some things (most notably in the Government sector) whereas a bank automatically sends out expired credit cards? The elixirs of stronger productivity performance are not always obvious.
- **The three Bs attitude (we seek the boat, the bach and BMW) needs to change.**
- **We need to grow our concentration in high-value-added industries or the value-added component from low-value-added industries.**
- **Capital and investment intensity needs to lift.** There is no shortage of capital itself: it's the efficiency of it that's the issue.
- **Success needs to be better recognised and rewarded.** You get that by lower taxes and not higher ones. But the issue also rests strongly with attitudes.
- **A stronger shift away from regulation itself and to enforcement.** Regulation is the biggest issue facing small businesses (*ANZ Small Business Microscope*, December quarter 2013). There is a role for regulation, but poor regulations creates distortions and uncertainty (refer page 16 for the negative impact of uncertainty on growth). Growth in financial sector regulation did not stop a ponzi scheme funds management business going bust.
- **The regulatory framework and incentive structures must be better than average. A good economic framework is not enough given the tyrannies of distance and scale.** Some tough issues need addressing. The New Zealand Treasury needs to be taking a stronger leadership and articulation role prescribing where New Zealand is headed. This means being involved and taking a stance on tough policy issues even if the view is counter to the sitting Governments. A fight doesn't need to be picked – there would only be one winner – but there needs to be more independent thought into the public arena.
- **We need to be better at connecting the dots across industries and sectors.**

Are we seeing showstoppers? No. Yet we are seeing subtle movements. Witness the success of Xero and frenzy around boutique IT companies: a high-value-add IT industry is on the ascent (and Wellington needs it!). **On the farm there has been a notable shift to farming for profit and reinvestment instead of expansion solely through land acquisition. Examining the *ANZ Privately-Owned Business Barometer* results shows** "Acquire more farmland" ranks fifth as an area agribusinesses are looking to invest in. Top of the list for activities being considered to improve financial performance is an increase in farm production, followed by reducing debt and costs, as well as investing in farm infrastructure. All of these investments are aimed at boosting cash performance, productivity, and improving the resilience of a farm's bottom line to an economic shock. Three of the four activities are specifically focused on improving productivity.

Activities being considered to improve farm financial performance



Source: ANZ

There's not just a focus on productivity in the agribusiness community either. The results from the ANZ survey of commercial businesses showed 25 percent of respondents said they would benefit from specialist expertise, or information that would improve productivity. This ranked second behind accessing capital to expand business, or finance equipment, which is also an activity aimed at boosting efficiencies.

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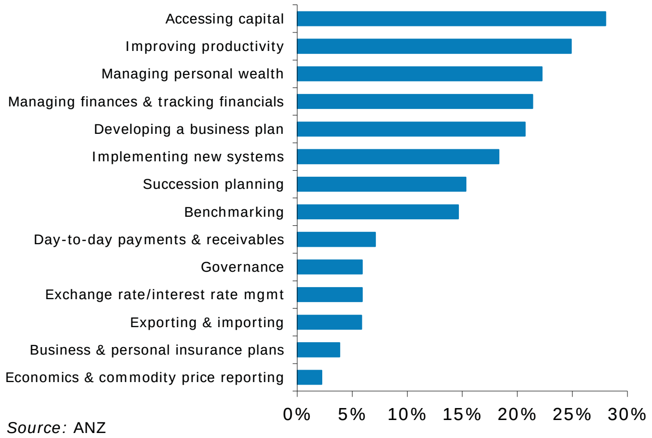
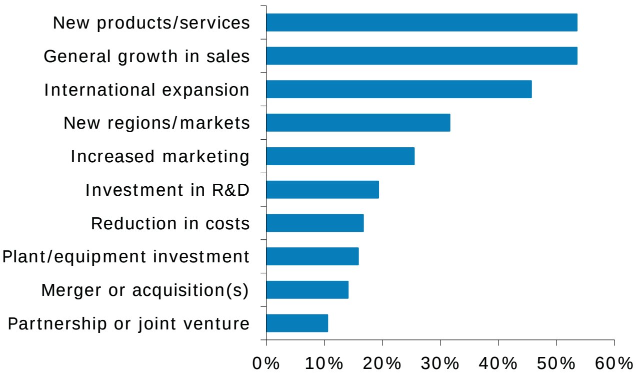
Specialist expertise, or information you would benefit from in your business



Source: ANZ

There was strong acknowledgment that adding new products/services, opening up new markets and increased investment in marketing, research and development and plant/equipment will be some of the most important factors in contributing to business performance over the next 3-5 years. So it seems the business community is clearly focused on how the bar can be raised in a number of areas that improve productivity.

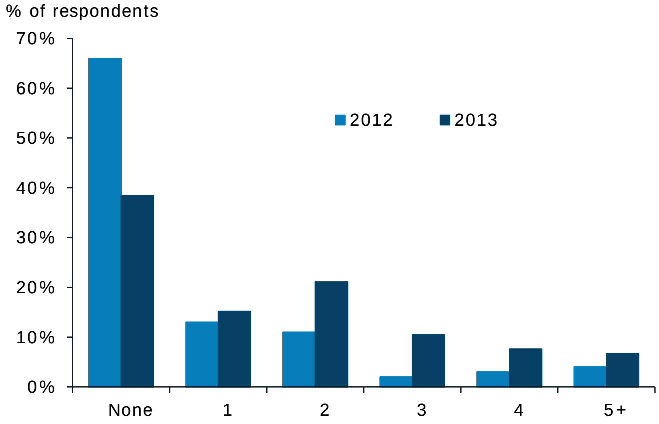
Factors that will contribute most to business performance (next 3-5 years)
Commercial Businesses



Source: ANZ

Additionally with the evolving focus on profit, larger businesses and more sophistication within operations there is more focus on people investment and the different roles people and specialists play within a business. **Perhaps the most important investment any business can make to boost productivity is in its principal asset – people.** In the ANZ agribusiness barometer results there is an increasing awareness of the benefits of formal boards, informal boards and consultants to provide insight.

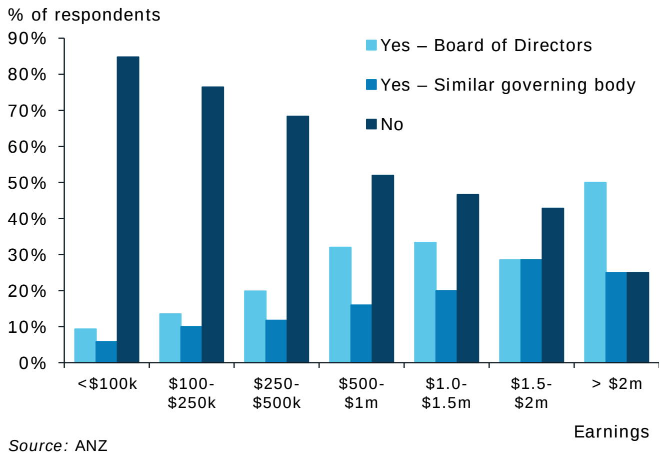
Number of Independent Directors on Board (Agri-businesses)



Source: ANZ

Over 30 percent of agribusiness respondents in 2013 noted the use of a board of directors, or similar governing body. This was well up on the previous year. The thirst for outside expertise in governance was highlighted by an increasing number of independent directors being included on boards. Of the respondents who said they had a board of directors, 38 percent said they have no independent directors, which was nearly half of the year before (66 percent). Of the 62 percent who did have independent directors, nearly 50 percent had more than one independent director.

Farm Earnings/EFS vs Governance Boards



Source: ANZ

Some sort of board structure is becoming increasingly commonplace in larger agribusinesses that have more complex ownership and operational structures. This is highlighted by a very strong correlation between the turnover of an agribusiness and the use of some sort of board structure. In the more than $2 million earnings category, 75 percent of respondents use some sort of board structure, compared with less than a third of respondents when earnings are $500,000 and below.

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Basic standards (expectations) have been introduced into the education sector and better information is being produced to assess progress. Australian newspapers and media are now taking an interest in New Zealand's policy platform, and commentators are being drawn across to speak about it! We detailed an array of examples on pages 12 and 13 where industries are working far more co-operatively today than previously. The connectivity linkages between public and private enterprise are better. A host of local authorities are engaging in dialogue over merger: they may be slow to pull the trigger, but the dialogue and appetite is clear.

We've seen the establishment of the Productivity Commission to take an economy-wide look at productivity related issues. They're throwing up some interesting work which is being acted upon. So far we've seen completed enquiries into local government regulation, housing affordability, international freight services. Enquiries into regulatory institutions and practices and boosting services sector productivity are underway.

Such dynamics are subjective and anecdotal. But hard data is the plural of anecdote. When it comes to assessing prospects for productivity growth across the economy we're simply taking a glass half-full approach. Saying New Zealand's productivity growth is the same today as it was a few years ago just doesn't pass the smell test.

Looking forward, an obvious risk for the economy as the economic expansion broadens is that the foot gets taken off the accelerator. Economies can follow the cycle we call the CROC where Calamity is followed by Response, Opportunity, Complacency and back to Calamity, and the spiral is in motion. We're now seeing the fruits of opportunity as the economy expands at a solid clip. With that comes the risk of rolling into complacency and calamity.

THEME 4: TAPER TANTRUMS

The upshot: Asset prices benefitted immensely from a fall in the risk-free rate (lower long-term yields), in effect underpinning price rises in all asset classes. With US Federal Reserve ("Fed") tapering now in the bag, the market's focus has shifted away from the minutiae of "will they/won't they" and is instead now focussed on data and the endgame – namely more normal policy settings. The Fed has made it clear that policy is not on a pre-set course. However, tapering is the first step in a long journey that will ultimately involve rate rises and the risk-free rate moving up. For bond markets, this means higher interest rates and forward guidance aside, it'll be a challenge to "manage" the ascent. Over time a higher risk-free rate must turn asset valuations away from the provision of liquidity and towards traditional fundamentals. There will be wobbles. Those who leveraged up during the period of low interest rates – notably some emerging market economies with poor market based signals – will come under the spotlight as they are now. Higher US yields will also underpin "Reversification" and a stronger USD, thereby taking heat out of the NZD/USD over time – though we're not talking a massive depreciation. The focus for currency markets will shift away from current account deficits towards relative growth prospects and leverage.

The US Federal Reserve's decision to "taper" the pace of asset purchases in December was significant. Not only does it mark the first direction change since the GFC (tapering cannot strictly be considered to be tightening, as it is a reduction in the pace of stimulus, but it is a change in direction), but **shifts the focus away from the decision to taper towards the data flow and the endgame**. Prior to tapering, markets swung wildly as the will they/won't they debate raged. Now the decision is less binary and more fluid, leaving markets free to debate the timing of the first Fed Funds rate increase.

Reaction to the tapering decision so far has been reasonably muted. This is not surprising. QE3 was an open-ended programme, so it was natural that complacency crept in. Just like the odds on a horse race swing wildly before the race, so too did the odds of tapering. But once the race gets underway, one stops focussing on the odds and on the race itself. The same goes for tapering and QE. Unless we see a policy backtrack, we thus expect to see significantly less volatility around Fed meetings than we did in 2013. **We are mindful that while most of the focus is on Fed tapering, the BOJ's QE programme is ongoing, and the ECB has hinted at further stimulus.** This further muddies the waters for markets.

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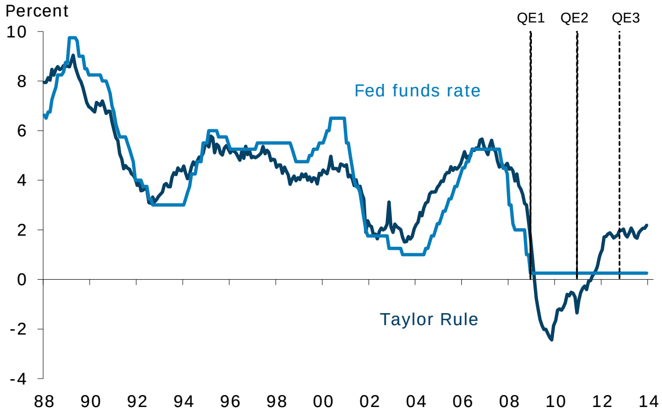
Looking beyond Europe, Japan and the UK, how US Fed policy evolves is nonetheless critical. **Incoming Fed Chair Janet Yellen has been a proponent of the "optimal path" approach, which seeks to minimise deviations of inflation and unemployment from their long-run objectives (of 2 percent and 6 percent respectively).** In a speech in late 2012, Yellen noted that this approach suggested that the Fed Funds rate would stay close to zero until early 2016. This more accommodative policy path was assumed to generate a faster fall in unemployment than otherwise, with inflation slightly above target. By contrast, under the popular Taylor rule approach, the Fed Funds rate would rise sooner, unemployment would remain above target for a more protracted period, but inflation would not be substantially closer to the target. **In sum, the optimal policy path delivers better economic outcomes as it results in a much faster return to full employment at minimal cost to inflation.**

Fed funds rate vs Taylor Rule



Sources: ANZ, FOMC, CBO, Bloomberg

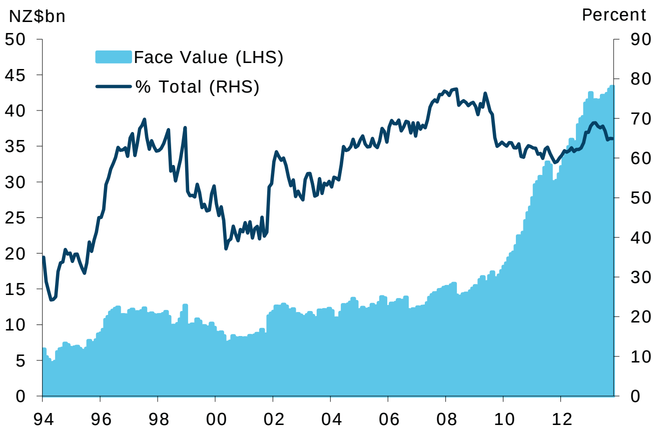
But whereas in late 2012 the US unemployment rate was close to 8 percent and thus some way away from the Fed's 6.5 percent initial target, it is now at 6.7 percent. **The Fed has reiterated that "a highly accommodative stance of monetary policy will remain appropriate for a considerable time after the asset purchase program ends and the economic recovery strengthens".** Unless it changes its 6.5 percent unemployment rate threshold the risk is the market starts to fast track the assumed tapering timetable. This threshold therefore almost certainly has to change, or another variable needs to be nominated. One option would be the so-called U-6 measure of the unemployed, those marginally attached to the workforce, and those working part-time who would prefer to be working full time. This measure is much higher than its 2003 peak, whereas the unemployment rate is closer to its peak. If this measure is pursued in the spirit of the optimal path, perhaps the Fed Funds rate will indeed remain low for an extended period.

But the optimal path approach also entails a more rapid rise in the Fed Funds rate at the back end of the projections. This has the potential to catch markets unaware, just like being lulled into a dependence on QE did. For now, the Fed is happy to be deliberately behind the curve. While inflation is low that's a position the Fed can afford to take. If inflation starts to rise, either naturally, or in response to the gradually improving labour market, this looks set to be the next bump in the road. The upshot: don't get too complacent if the tempo of the data continues to improve, no matter how soothing the Fed's words are.

The Fed Funds rate will thus eventually go higher. Our Taylor Rule estimate for the Fed Funds rate stands at around 2.2 percent, with recommendations from the rule having consistently been above the Fed Funds rate since late 2011. Because the optimal policy path approach puts more emphasis on unemployment and less on inflation when the inflation rate is low, we need to discount this somewhat. Nonetheless our analysis underscores the notion that when the Fed Funds rate does go higher, there will be some catching up to do.

One of the more dramatic consequences of QE has been diversification away from the core and into the periphery (including New Zealand) as markets searched for yield. This is evident in NZGS offshore ownership statistics, which show a surge in the value of holdings. While much of this is likely to be permanent (we saw a pause in buying, rather than selling when the NZD dropped in the 2013 taper tantrum), the constant buy flows implied by these statistics have helped prop up the NZD. In coming years, US bond yields and the USD are set to rise, and NZGS bond issuance is set to slow, reducing this as a source of upward pressure on the NZD.

NZGS Held by Non-Residents



Sources: ANZ, RBNZ

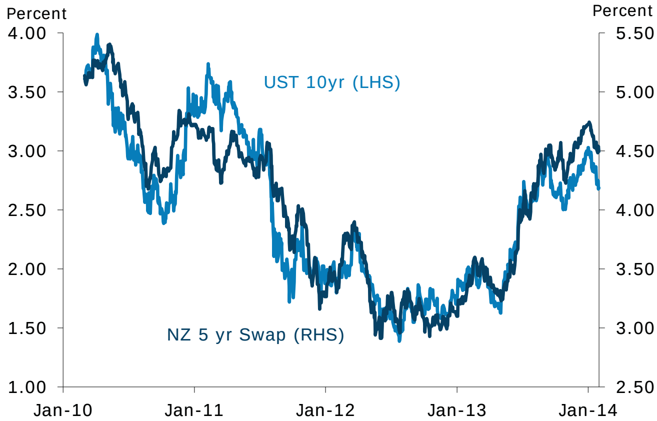
In New Zealand then, tapering will impact the NZD, but it will have a greater impact on bonds, particularly given the close correlation between US 10yr Treasury yields and NZ swap yields. We

FEATURE ARTICLE: KEY THEMES OF 2014

expect US 10yr bond yields to rise to 3.5 percent by the end of this year and to 4 percent by the end of 2015.

A lift in US yields is not a harmless externality – higher US long-end rates mean higher NZ long-end rates, which would take pressure off the RBNZ to raise rates (particularly given that many corporates borrow further out on the yield curve). All else equal, this would, in turn, lead to a steeper than usual yield curve here unless there is a corresponding sharp fall in the NZD. In short, what happens in the US matters a great deal here, for both policy and the long end.

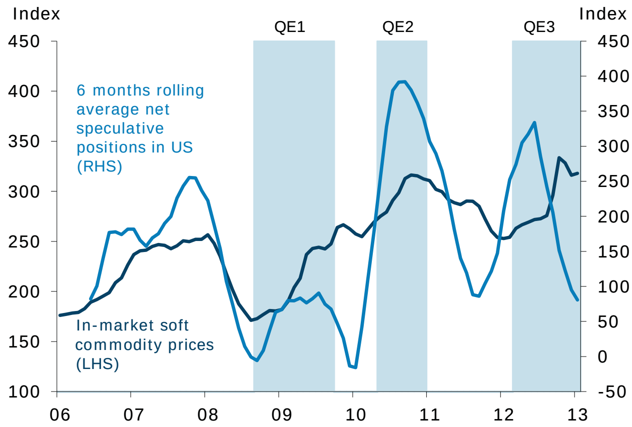
UST 10yr vs NZ 5yr Swap rate



Sources: ANZ, Bloomberg

For New Zealand, we also need to be mindful of the impact QE has had on commodity prices. As we discussed at length in the July 2013 issue of our *Agri Focus,* speculative activity has tended to increase through each phase of QE, exacerbating upswings in commodity prices. The risk then is that we see commodities soften as QE is unwound.

Excess liquidity flow into agricultural markets



Sources: ANZ, Bloomberg, CFTC

Broadly speaking, it is also difficult to overlook the simple idea that a rise in the global benchmark risk-free rate (i.e. the US 10yr Treasury bond yield) will have knock-on impacts. QE was all about getting long term interest rates down, and putting credibility behind forward guidance indicating that policy would remain easy for an extended period. The Fed's intention from the start was to support asset prices, particularly equities and housing, in a bid to kick-start the wealth effect (or at least to eliminate the effect of a massive drop in wealth on consumer behaviour). But QE went on for so long that markets look to have become somewhat addicted to the excess liquidity, often shrugging off fundamentals. How often have we seen a bad economic indicator result in lower interest rates and higher equities? Bad news becomes good news courtesy of the anticipated liquidity injection or expected maintenance of policy support. Even peripheral European bond spreads came in. Although this was in part due to the ECB putting safety nets in place, we doubt markets would have been so kind to what were, frankly, insolvent sovereigns, had the opportunity cost of capital not been so low. There's not just a warning here for Europe's sovereigns, but for all markets as they adjust to focussing on fundamentals as opposed to liquidity.

In developed markets where QE has occurred, we are also mindful of tensions between monetary and fiscal policy. Fiscal solvency in part depends on low interest rates and/or abundant liquidity. Monetary policy has suppressed yields, improving solvency and buying time for Governments to enact reform programmes. Reform programmes have been slow to take hold: why reform if the need to address solvency is no longer acute because markets are giving you a free ride? Monetary policy is independent, but this independence is the luxury of the government of the day. It's not a central bank's job to underpin fiscally-profligate governments. Our Taylor rule analysis "says" that policy rates should already be moving up in the US. This is not overly contentious given the tone of recent US data.

This analysis also shows that policy rates need to rise in Europe too, with interest rate recommendations for our ECB and BOE Taylor Rules (0.7 and 1.6 percent respectively) above current policy settings (0.25 and 0.5 percent). Like that of the US Federal Reserve, the ECB's balance sheet is bloated with assets acquired through QE (or OMT in the case of the ECB). While effective in stemming the rise in interest rates, these purchases have blunted market forces.

Just as in the US, at some stage the ECB will likely be forced to phase out its emergency programmes, and when it does, and ultimately starts lifting its main policy rate, there will inevitably be winners (countries like Germany, who can handle higher interest rates) and losers (likely the periphery). ECB "tightening" may be years away, but the more the Fed tapers and as the BOE (and possibly the Bank

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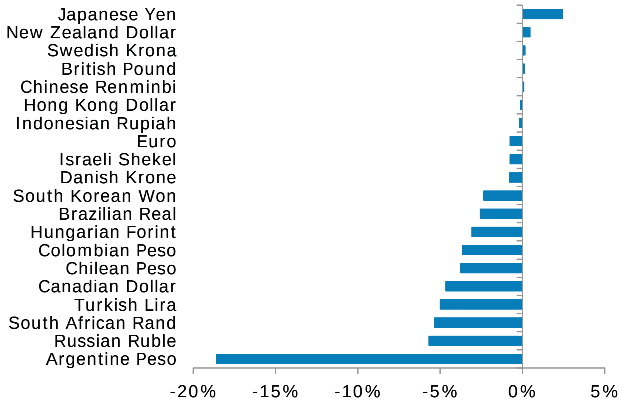
of Japan) start to transition away from QE and back to conventional policy formulation, unless the ECB deepens its quantitative programme more pressure will come on peripheral borrowers. Global bond yields are closely linked, and it is nonsense to think that European bond yields can resist a rise in US bond yields, unless of course, the ECB eases further. And that faces internal challenges across Europe too for validation with all member countries not on the same wavelength over what the ECB should be focused on.

In Asia, tapering is likely to have more of an impact on FX markets. We do expect Emerging Asian growth to pick up in 2014, but for Asian currencies though, the promise of stronger growth is not enough. We have not seen better data in Asia yet. PMI readings in the major advanced economies have rebounded, but those in the major emerging market economies remain subdued. Asian export data has been mixed or disappointing. Furthermore, the synchronised G3 upswing may not uniformly manifest itself in the Asian production and export figures in the near-term due to the looming Lunar New Year holiday period, lagged currency impacts to date and changing sensitivities to underlying shifts in the global drivers of growth. We thus expect Asian currencies to struggle in the face of Fed tapering.

Capital outflows from emerging markets (EM) were a major focus of last year after the Fed first flagged tapering in 2013. **To date, the outflows have only reversed a small proportion of the strong inflows seen since 2009, although these flows could intensify if current EM wobbles deepen.** The big portfolio moves have actually occurred in developed markets, which received strong inflows on the back of improvements in their growth outlook. The risk then, is that we see a further shift in capital flows away from Emerging Asia towards developed markets as the growth premium gets priced out (in line with our "Reversification" thematic). The outflow of capital will put depreciation pressure on Asian currencies.

While the US Federal Reserve has been at pains to point out that tapering is not tightening, markets must eventually start to price in Fed rate hikes. Higher US bond yields mean the cost of capital in Emerging Asia will start to rise. We believe this will increasingly put the focus on leverage this time, and not merely on current accounts. Indeed, debt levels in Emerging Asia have risen in the post-GFC period, with private sector debt rising from 115 percent of GDP in 2007 to close to 160 percent at present. While a large portion of the increase occurred in China, the debt ratio (excluding China) is elevated and close to levels seen prior to the 1997 Asian Financial Crisis. Investment is now close to 50 percent of GDP in China. Poor market based signals mean resource malfeasance has invariably taken place (China's shadow banking sector is under the spotlight) and the piper will invariably be paid. Domestic fundamentals were ignored when QE was abundant and interest rates low. They now matter in an environment of tapering and asset prices and risk sentiment will need to reflect the new reality

Top and bottom major currency performers
Year to date



Sources: ANZ, Bloomberg

In recent weeks there have been various flare-ups in emerging markets. The weakest performing currencies since the start of the year reads like a sort of "who's-who" of former emerging market darlings. We've seen political issues in Thailand, currency devaluations in Argentina and Turkey, and talk of a liquidity squeeze in Russia. These are all negative developments, and reflective of some of the stresses and tensions that exist. At this stage there is no evidence of a **strong common unifying theme between them all as there has been in earlier episodes** (like 1997). While it is not immediately obvious that recent wobbles are directly related to tapering, rising leverage has always been a concern, and the prospect of higher US interest is unsettling. As a generalisation, peripheral spreads have been narrowing, although they have lifted in recent days. Markets are notorious for reaching "tipping points": nothing is a problem until the tipping point is reached and then issues quickly mushroom at an exponential rate. Rising interest rates, capital flight and rising risk aversion would exacerbate the issue. In fact, if risk aversion starts to get too extreme, what the catalyst for it was will soon become irrelevant. What will be relevant is who has the money and who needs the money, and we would expect leverage to be under extreme scrutiny.

Of course, a big difference for Emerging Asia this time around compared to 1997, the region as a whole is running current account surpluses, and FX reserves are much more substantial. However, market fixation on leverage will nonetheless mean that economies that have increased their debt levels in recent years will come under more scrutiny. Indonesia (and to a

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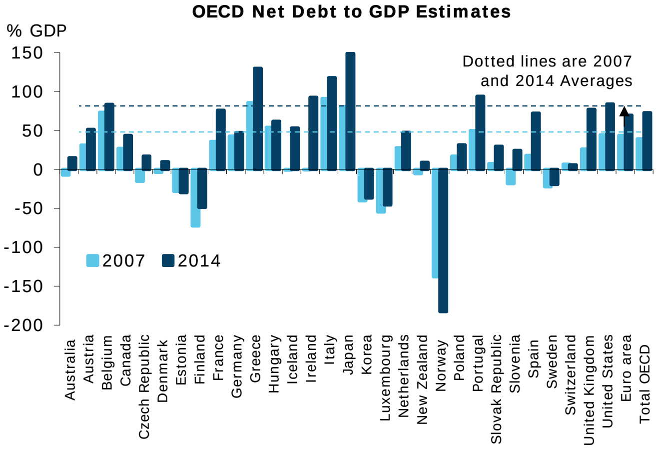
lesser extent, India) have been a focus for markets for some time. Both have succumbed to bouts of currency selling in the past year. But we also wonder whether greater attention will be paid to the likes of Korea and Singapore, where private sector debt to GDP are 200 percent and 133 percent respectively. Strong current account surpluses helped the Korean won and Singapore dollar stay resilient last year, but it may not be so easy this year now that interest rates (the biggest foe of leverage) are on the rise.

THEME 5: SOVEREIGN RISK

The upshot: The global economy has stabilised but deep-rooted challenges remain, particularly in the fiscal arena. Our sovereign risk analysis, which encapsulates both negative (i.e. debt) and positive attributes (i.e. flexibility) across 38 countries, remains European-centric at the problem end. Over the coming year, Italy and France will be the countries to watch, as will the evolution of bond yields. The issue is not the debt burdens themselves, but rather a lack of economic flexibility to drive growth, which, along with keeping a lid on financing costs, is a necessary condition for fiscal solvency. While problematic and challenging for some nations, leaving markets prone to wobbles, we do not believe it will be enough to derail the global economy in 2014.

OECD Net Debt to GDP Estimates



Sources: ANZ, IMF, Bloomberg

The global economy has stabilised, and indeed shown signs of improvement for the best part of 6-9 months now. But some deep-rooted challenges remain. Harsh austerity, labour market reform and internal devaluation saw unemployment lift to depression-like levels across much of Europe's periphery. This will cap the speed limit for potential growth into the longer term. Rising debt-servicing costs also crimp the cash available for spending in other areas. Unemployment in the Eurozone has risen to record highs of 12 percent. Much of Europe's periphery remained in recession in 2013 – though recent numbers are more encouraging, and debt ratios continue to rise on account of the denominator effect (lower nominal growth). Indeed, net debt in the OECD region increased to 73 percent of GDP in 2013 (from 39 percent in 2007).

Sovereign risk has been a recurring theme for us since 2010. Regular readers will recall that we developed an indicator almost four years ago to assess sovereign vulnerability in an objective manner, and sovereign risk has been one of our key themes at the start of each year since. From the outset we acknowledged, and still do, that we do not have the resources of a credit rating agency. However, we do have access to plenty of data, enabling us to assess a host of countries on the basis of two broad criteria. First, we look at "bad" or "worry" variables – things like government debt, the fiscal balance, the current account, net external debt and the unemployment rate. Including variables beyond fiscal metrics such as the current account and external position means the term "sovereign risk" really personifies the risk of the nation as a whole as opposed to merely the government in isolation.

We also recognised that there would be offsets, and looked at things like GDP per capita, population, the existence of a floating exchange rate, political stability, competitiveness etc. These variables are critical as they signify a degree of flexibility within the economic system: this flexibility can buy you a lot of time to work through issues. Another way to think about this is simple business parlance: a business with a lot of debt can be struggling, but the coup de grâce is ultimately delivered when the revenue line tips over. The same applies for a nation. The metric here is GDP. The death spiral beckons when debt is rising and GDP is contracting. By comparing one set of criteria against the other, we arrived at a "net" score giving a simple metric of sovereign vulnerability.

To recap on our methodology, we collect comparable statistics across 38 countries, comprised of the OECD and the major Asian economies. Where possible, we collect data from the same source for consistency. Negative unfavourable scores are added to positive favourable scores to arrive at an overall vulnerability score, with the most vulnerable countries having the lowest (generally negative) overall scores.

Our analysis reveals that over the past year, the overall picture has not changed significantly. Indeed, the annual "refresh" of our sovereign risk ranking framework throws up the "usual suspects" at the top (Norway, Switzerland and Australia) and bottom ends of our rankings. But we also find that the good are getting better, the bad are getting worse, and perhaps more alarmingly, a few large countries have slipped a little too far for comfort.

Look, for example at Italy, France and the so-called "PIGS". When we first ran our extended analysis

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including Asia in 2010, Italy was ranked 8th worst and France 6th worst. Now they rank 5th and 4th worst respectively. Of note, Ireland (a minnow) has exited the bottom four and been replaced by France, Europe's second-biggest economy. This is where we see the biggest risk – not so much in outright terms, for a US default (though unimaginable) would clearly be worse – but more in rate-of-change terms. As the table below shows, the hurdle for the US running a surplus is much lower than it is for France or Italy.

Country	Net debt % GDP	Primary budget balance required to keep net debt stable	OECD 2014 Forecast Primary Balance	Gap
Australia	12.9	0.1	-1.9	2.0
France	73.4	1.0	-1.4	2.3
Germany	49.0	-0.1	1.6	-1.7
Italy	116.7	3.3	2.5	0.8
New Zealand	7.8	0.5	-0.4	1.0
United Kingdom	73.9	-0.2	-3.1	2.9
United States	81.8	-0.8	-2.9	2.0

Yet markets seem to be keen to avoid thinking too deeply about this, preferring to focus on the various backstops and safety nets. But what if one breaks, or confidence disappears? Like a car crash, there is half a chance of avoiding catastrophe if everyone is moving slowly. But if everyone is travelling faster than the speed limit (or in the case of European sovereigns – the Stability and Growth Pact debt limit) it's harder to take evasive action. This is one reason why we remain somewhat concerned about sovereign risk: the windows may have been cleaned, and new management is in place in some premises, but the business has not yet been successfully turned around. **For our part, we will be watching France, Italy, bond yields, and growth forecasts carefully.**

The good news for New Zealand is that it has moved up another place (again), and now ranks 8th best (or 8th least vulnerable) out of the 38 countries in our analysis. This is largely thanks to the significant (and counter to the trend) improvement in NZ's fiscal position, lower unemployment and improved GDP per capita standings. A sound fiscal position is not the be all and end all, but it does help shape perceptions and is one reason why we expect bond yields to be under less pressure relative to our offshore counterparts. It also matters for the exchange rate, as perceptions of creditworthiness will shape investment allocation decisions. In New Zealand's case, positive fiscal data goes a long way to offset our worst-in-class external debt ranking. This doesn't get New Zealand off the hook though. A poor external debt position remains problematic and will remain a structural noose for years to come.

Overall Rank	Country	Overall Score	S&P Credit Rating
1	Norway	43%	AAA
2	Switzerland	27%	AAA
3	Australia	14%	AAA
4	Denmark	13%	AAA
5	Singapore	9%	AAA
6	Sweden	9%	AAA
7	Taiwan	8%	AA-
8	NZ	8%	AA
9	Canada	7%	AAA
10	Luxembourg	6%	AAA
11	Korea	1%	A+
12	USA	0%	AA+
13	China	-2%	AA-
14	Germany	-3%	AAA
15	Czech Rep	-3%	AA-
16	Poland	-5%	A-
17	Japan	-5%	AA-
18	Hong Kong	-8%	AAA
19	Austria	-10%	AA+
20	Iceland	-10%	BBB-
21	Netherlands	-11%	AA+
22	Finland	-13%	AAA
23	Malaysia	-14%	A-
24	UK	-15%	AAA
25	Vietnam	-17%	BB-
26	Philippines	-17%	BBB-
27	India	-17%	BBB-
28	Hungary	-18%	BB
29	Thailand	-22%	BBB+
30	Slovakia	-24%	A
31	Ireland	-24%	BBB+
32	Indonesia	-26%	BB+
33	Belgium	-26%	AA
34	Italy	-26%	BBB
35	France	-30%	AA
36	Portugal	-38%	BB
37	Spain	-39%	BBB-
38	Greece	-62%	B-

Implications:

- **Our sovereign debt analysis highlights the importance of growth, a necessary condition for fiscal solvency.** To use the US as an example, real GDP increased 2 percent in 2013 and is forecast to grow at closer to 3 percent in 2014. The associated lift in tax revenues has contributed to the budget deficit narrowing to 4 percent of GDP (from more than 10 percent in 2009). This has

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seen the US net debt ratio stabilise, evidence that growing your economy can improve your sovereign credit metrics via that denominator effect. In contrast, activity across much of Europe stagnated in 2013, which has seen debt ratios continue to rise. Higher debt-servicing costs also crimp the cash available for spending in other areas, contributing to record levels of unemployment in the Eurozone.

- **Safety nets will be tested. We expect to see some hiccups in 2014, but we don't think it'll be enough to derail the global recovery.** Europe's periphery is not out of the woods just yet, with the region only slowly resurfacing from several years of recession. Debt ratios continue to rise. Investors will not be forgiving to laggards whose fiscal metrics continue to deteriorate. Much of the European periphery and some parts of Emerging Market Asia remain one shock away from crisis. Flare-ups seem likely, and this will remain the case until long-term debt sustainably is achieved. This could prove to be a very long work out for some countries.

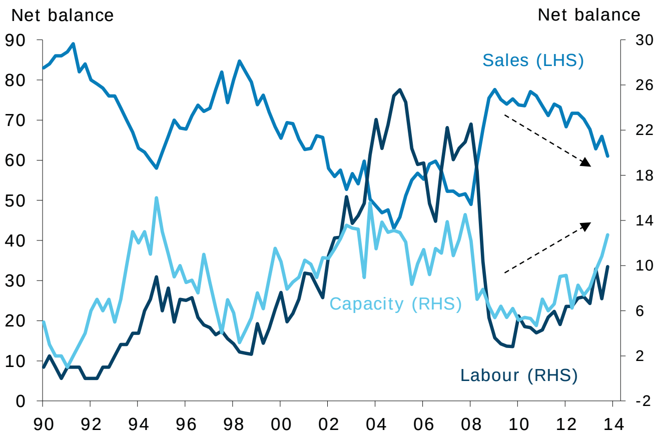
THEME 6: THE LONGEVITY OF THE EXPANSION: INFLATION AND SUPPLY-SIDE CAPACITY WATCH

The upshot: Economists and commentators tend to focus on the demand side of the growth equation. That story is locked in. The emerging issue will be one of supply-side capacity and meeting that demand. With the economy expanding nicely, attention is evolving to the inevitable lift in inflation pressures and necessary policy response. Inflation pressures will build over 2014 and 2015, though we're not picking the inflation genie to get let out of the bottle. Key judgements we are making include: a continued lift in New Zealand's underlying productivity performance, suppressing deflationary forces from abroad continuing despite expectations of elevation across soft commodity prices, the RBNZ moving earlier in the economic expansion to stymie inflationary hot-spots (including the use of ancillary policy instruments), marginal assistance from a reasonable microeconomic agenda which takes the edge off some inflationary hot-spots (notably housing), and fiscal policy remaining restrictive.

The demand side of the equation for NZ.Inc looks to be a gimme. While we can point to the obvious risks in the form of Europe's sovereign challenges, wobbles in Australia, China's growth shift and tapering tantrums, it would take a massive shock to derail an economy such as New Zealand, which is benefitting from significant localised points of stimulus.

Our emerging worry is not demand; it's meeting it and how inflation evolves over the coming years. Spare resource capacity is slowly being eaten into. Large businesses now report skilled labour as their second-biggest issue *(ANZ Small Business Microscope)*. Supply-side factor constraints (materials, labour and capital) within the NZIER's QSBO are becoming more noted factor constraints.

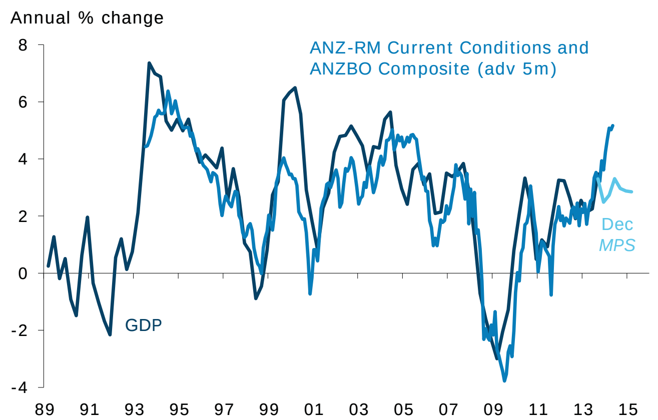
Factor constraints



Sources: ANZ, Statistics NZ, NZIER

In fact the inflation picture is starting to look one-sided. A quick glance over our key proprietary gauges and upside risks for the inflation picture abounds. This stems mainly from a stronger than expected starting point for economic activity and a pretty solid outlook going forward. All amidst an economy with a ho-hum speed limit of just over 2 percent.

GDP vs Confidence Composite vs *MPS*



Sources: ANZ, Roy Morgan, Statistics NZ, Westpac McDermott Miller

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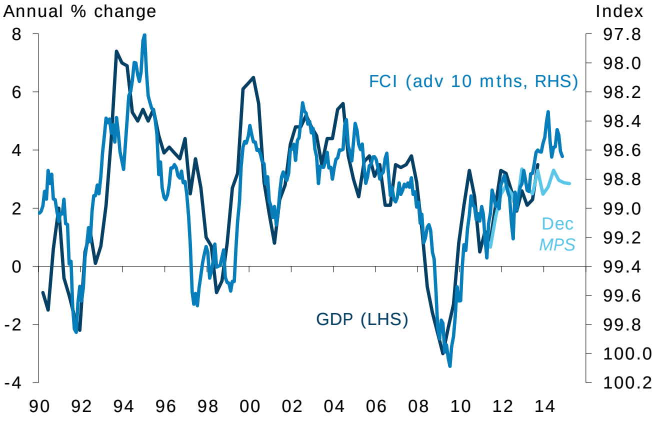
NZ GDP vs Financial Conditions Index vs *MPS*



Sources: ANZ, RBNZ, Statistics NZ

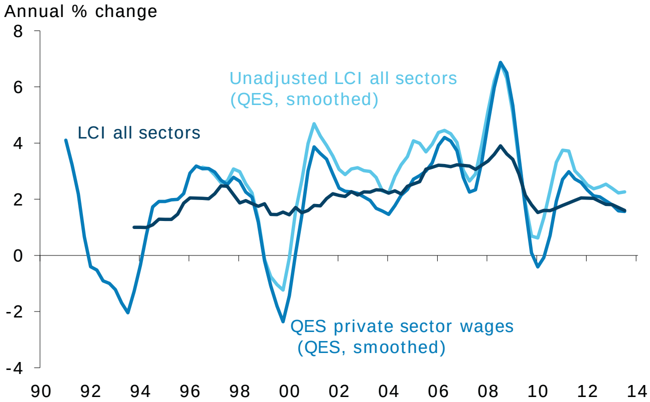
For sure, pricing intention measures remain benign, the NZD high and inflation expectations low. We're seeing little inflationary pressure around the globe. However, other drivers of the inflation picture are pointing up – and sharply. The unemployment rate is falling, and this means eventual upwards pressure on wages and in the absence of better productivity growth, unit labour costs. The disinflationary impact of the elevated NZD on tradable CPI prices appears to be waning. Soft commodity prices are through the stratosphere. Spare capacity across the economy is being eaten up. We've some notable localised inflationary issues: a natural disaster and housing shortages. One-offs (higher government tobacco excise, higher charges for insurance as a consequence of the Canterbury earthquakes) add to the inflation profile. Our monthly inflation gauge is rising from lows. **As night follows day and day follows night, this all adds up to rising inflation and if history decides to repeat (or rhyme), the OCR is moving up sharply.**

We fully expect inflation pressures to lift, though to stop short of the inflation genie being released from the bottle. Key assumptions we are making in regard to the profile for inflation include:

- **New Zealand's productivity performance continues to lift.** Better productivity performance is an unheralded part of the recovery story for NZ.Inc. It's likewise going to be a critical ingredient influencing the longevity of the economic expansion. Looking forward, further gains in productivity will be critical if the traditional nexus between higher growth and rising inflation is to be tamed somewhat. Lifting the efficiency of the construction sector is a key priority, with the dynamism and efficiency of the sector in the provision of NZ's housing set for a major test over the next few years. Continued improvements in other sectors are needed to arrest our poor historical record – our economy-wide labour productivity has averaged around 1 percent per annum over the last 20 years as opposed to closer to 2 percent for the better performing OECD economies. We're expecting and require an uplift.

Unit labour costs

QES based estimates of labour productivity (ex-agriculture)



Sources: ANZ, Statistics NZ

- **Suppressing deflationary forces from abroad continue, though soft commodity prices remain elevated.** Wholesale dairy product prices are set to moderate from record highs in the middle of the year. Although the flow through from wholesale to retail for dairy products hasn't occurred during this upward cycle with Fonterra not passing on all of the increase. The same principle may well apply on the way down. Red meat inflation will pick up as supply tightens with reasonable offshore demand. This will probably be offset to some degree by softer white meat prices, though high domestic feed grain prices and animal welfare changes continue to pressure producer margins. Fruit and vegetable prices will remain at the mercy of the weather. Global food inflation looks to be stabilising after falling in the second half of 2013. Some large Northern Hemisphere crops were the main driver. All up, it looks like there will be some food inflation over 2014, but it won't be rampant.
- **Technology continues to play a key role suppressing inflation.** Lower costs for consumer durables given continued gains to technology, and greater use of the internet to reduce search costs and keep a lid on retail inflation have been influential factors in keeping inflation low.
- **The microeconomic policy agenda assists at the margin.** Focal points here are the likes of the Government's procurement of construction materials, the announced enquiry into construction costs (with a 30 percent difference noted on average with costs in Australia). Moves to increase competition in the sector, to promote the easier adoption of skills, expertise, labour and building products would not go amiss.

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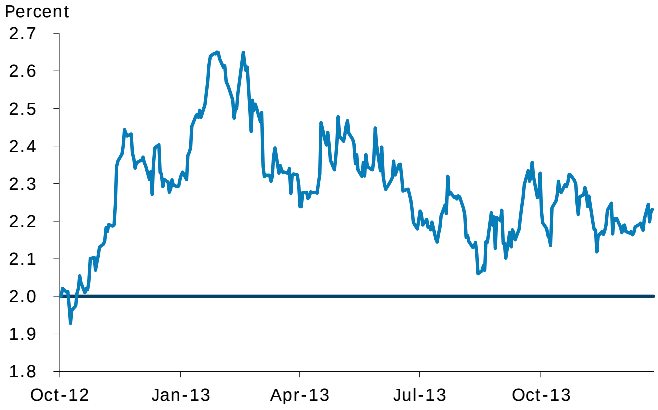
- **The RBNZ moves earlier in the economic expansion to ward off inflationary pressure.** Track the last two economic / inflation cycles and the "error" on the behalf of the RBNZ has been moving too late in the cycle. We doubt they'll go for a three-peat. Watch for the Governor to cement his inflation-fighting credentials early and if necessary, turn to other ancillary policy instruments. The rural sector is staring down the barrel of a policy response if the rural property market and rural credit growth takes off.
- **The RBNZ will implicitly target credit growth (keeping it at or below the rate of nominal GDP) and this will suppress the potential for credit-fuelled wealth gains driving the property market and wealth-related spending.**

This combination will take some heat out of the inflation profile, thereby implicitly elongating the economic expansion. But we're still looking at an upward trajectory for inflation.

The big variable to watch is the profile for productivity, and implicitly unit labour costs. If we are wrong, and New Zealand's productivity performance over the past decade repeats, then all bets are off on the profile for inflation.

NZ Breakeven Inflation Rate
(derived from NZ 10yr Linkers)



Sources: ANZ, Bloomberg

Breakeven inflation rates derived from the NZ inflation-indexed bond market are yet to detect any discernible lift in the market's expectations for future implied inflation. Indeed, since early 2013, breakeven inflation rates have proven resilient to the upward drift in inflation expectation survey readings and lift in other inflation indicators. The implied breakeven inflation rate on the NZGBi Sep-2025 bond is currently marked at around 2.2 percent, slightly below inflation expectations survey readings of 2.3-2.4 percent. So for now, markets seem to be hedging their bets.

THE MONTH IN REVIEW

SUMMARY

Pasture growth has varied across the regions over the past two months. Generally it has been windier than normal, which has depleted soil moisture and slowed pasture production. Rain has been unevenly distributed. However, every time a real pinch has started to be felt, some rain seems to have been delivered. Milk production is on track to hit a new record. Lamb production forecasts have been raised after a bigger than expected lamb crop (+1.2m head). Early indications for the 2014 grain crops are showing average to slightly above yields. The 2014 vintage is expected to be very large and up on last year.

Much of the North Island and top of the South received good rainfall in late November, which setup most during December. Of late, Northland, through to the Waikato, and Central North Island down to Taihape, have become dry with little substantial rain since late-2013. Higher pasture covers from the good spring and early summer have provided a buffer, but have started to disappear in recent times. On the whole, the South Island has had a pretty good run. Parts of Canterbury and central and coastal Otago were drier in December, but rain in late-2013 through to mid-January has helped the situation.

Early indications for the 2014 grain harvests are showing average to slightly above yields across the main regions and crops. Early barley harvested so far in Canterbury has had higher screenings than in 2013, and generally average yields. These have been lower than the previous two years though, which were particularly good harvests. Maize crops in the North Island are generally looking very good and at this point very high yields are expected.

DAIRY

The official statistics for year-to-date (Jun-Nov) milk production show a 5.5 percent y/y increase so far. Recently the year-on-year growth rate has slowed as pasture conditions have normalised and the Waikato has become a bit drier. However, the annual growth rate is likely to exceed this with strong gains expected over the last quarter of the season. This is mainly due to farmers having to dry off their herds earlier than normal last year, because of the widespread drought. **Fonterra recently revised up their full season production forecast to 6.5 percent y/y. We continue to expect similar annual growth.**

MEAT AND FIBRE

The 2013 lamb crop came in better than first thought after the good winter/spring conditions allowed a quick recovery from the drought. This improved ewe condition more quickly than initially thought. Combined with good lambing conditions and lower conception rates this led to very low lamb wastage in the main producing regions. **Overall, Beef + Lamb NZ's survey pointed toward a 2013 lamb crop of 25.53m head. This was down 1.3m head (-4.7 percent) on the previous year and is the second-lowest in nearly 60 years, with only 2010/11 at a lower level.** However, this was vastly better than earlier expectations, which had been for a drop of 2.5m head, or 9.4 percent y/y.

The better (less negative) result has increased production forecasts for the 2013/14 year. While expectations had earlier been increased from a fall below 18.5m head as the 30 June stock number survey only showed a 1 percent decline in breeding ewe numbers despite mutton slaughter (+22 percent) signalling a larger decline. **With an extra 1.2m head it is likely lamb production will now be between 19-19.5m head. This would be very similar to the 2010/11 season.** Export production over the first quarter of the season is currently up 4.2 percent y/y. The North Island is steady, but the South Island is up 9 percent. It seems the increase in the South Island has been mainly driven by old season lambs with the 30 June stock number survey showing higher hogget numbers in Canterbury and Otago, as well as the majority of the increase occurring earlier in the quarter.

On the beef production front the official 2013/14 forecast is for a 2.6 percent decrease in export slaughter to 2.23m head. Year-to-date production over the first quarter is tracking this, **but the pull-back could be more than currently forecast.** This is due to more recoil from last year's 10 percent increase, a higher number of possible dairy conversions on the cards, a larger number of budget cows and dairy heifers are likely to be retained because of high prices, some restocking by North Island dairy farmers following the drought and the slow start for bull slaughter.

HORTICULTURE AND VITICULTURE

After a very good Sauvignon Blanc flowering period and reasonable temperatures since then in Marlborough – it is highly likely the 2014 vintage will be materially larger than 2013. As there are few new and maturing plantings coming into production the large crop is all driven by yield. With enhanced industry confidence – many vineyards set up in winter 2013 for a larger crop and combined with excellent early summer conditions this has driven high bunch numbers and weights. Prudent crop management is now an imperative. It will be critical for the industry that the speculative fruit harvest is not significant and in general, growers and wine companies seem to be taking sound action to ensure it isn't.

RURAL PROPERTY MARKET

SUMMARY

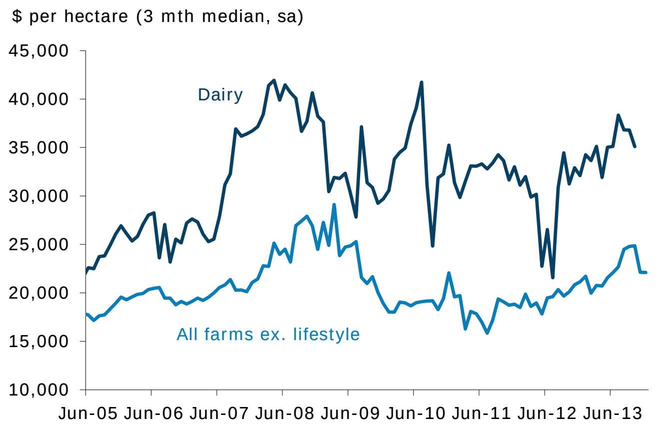
The rural property market looks like it has hit fifth gear in recent times. Turnover across all property types, except horticulture, has surged above 10-year averages. Total turnover in the 3-month period ended December was back to pre-GFC levels and nearly 20 percent above the 10-year average. Average pricing while coming off the peaks of the spring period has a definite strengthening trend that stretches back 18 months. The average sale price is now 5 percent above last year. The charge is being led by existing dairy farms, land suitable for future conversion and dairy support blocks. Most other property types have seen more modest gains in price. Recently there have been some reports of buyer resistance in the traditionally more expensive regions of the Waikato, Taranaki and Canterbury. This is leading some to search for better deals outside these regions.

Total turnover for the 3-month period to December moved up to 117 percent of the 10-year average, to sit at its highest level since August 2008. Higher turnover rates indicate that the supply of quality properties hasn't been as big an issue as first thought. **The average all-farm price was $22,100/ha (+5 percent y/y).** The obvious driver since the drought for the strengthening trend in prices has been the better farm-gate prices. While dairying is the most obvious beneficiary, many of the other sectors have also seen a steady improvement in farm-gate prices. The good recovery from the drought, which seems to have been very well managed by the majority, has also been influential in boosting confidence. Combined with other supportive factors such as low interest rates and aggressive lending competition, this has turned confidence into conviction for many.

FARM SALES BY FARM TYPE

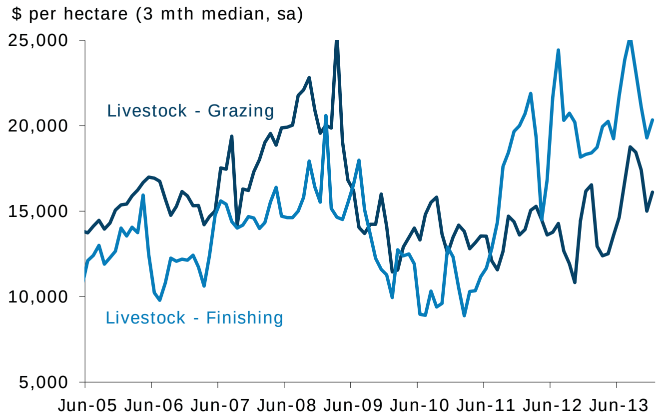
3-Month Seasonally Adjusted		Current Period	Previous Period	Last Year	10-Year Average	Chg. P/P	Chg. Y/Y	Chg. P/10yr
Dairy	Number of Sales	107	113	55	72	↓	↑	↑
	Median Price ($ per ha)	35,100	36,800	31,200	30,100	↓	↑	↑
Livestock – Finishing	Number of Sales	124	122	74	65	↑	↑	↑
	Median Price ($ per ha)	20,300	19,300	18,300	14,200	↑	↑	↑
Livestock – Grazing	Number of Sales	240	195	179	224	↑	↑	↑
	Median Price ($ per ha)	16,100	15,000	16,000	15,200	↑	↑	↑
Horticulture	Number of Sales	34	37	33	47	↓	↑	↓
	Median Price ($ per ha)	144,700	147,400	88,800	146,700	↓	↑	↓
Arable	Number of Sales	27	26	19	19	↑	↑	↑
	Median Price ($ per ha)	24,100	26,000	25,000	26,300	↓	↓	↓
All Farms ex. Lifestyle	Number of Sales	539	491	379	461	↑	↑	↑
	Median Price ($ per ha)	22,100	22,100	21,100	20,100	↔	↑	↑
Lifestyle	Number of Sales	1,599	1,630	1,593	1,578	↓	↑	↑
	Median Price	508,000	506,000	478,000	421,000	↑	↑	↑

Farm Sales, Median Price



Sources: ANZ, REINZ

Farm Sales, Median Price



Sources: ANZ, REINZ

RURAL PROPERTY MARKET

The key question remains: are property prices entering speculative territory? Recent anecdotal evidence of some buyer resistance to higher prices in the traditionally more expensive regions suggests this could be the case. **To assess the question it is useful to look at where recent land sales sit on traditional valuation metrics.** In the rural property market prices range hugely, depending on factors such as location, soil type, rainfall, topography, quality of facilities/improvements, access to water/irrigation, and so on. We are also mindful that history is a partial measure at best: rural land has seldom traded in line with conventional cash-flow valuation measures. This means only broad generalisations on valuation metrics can be made, but they are useful to gauge general behaviours.

Given dairy sales are leading the charge this is the focus of our assessment. **For dairying properties the average price (seasonally adjusted) seems to have crept up to sit around the $37,000/ha mark since July 2013.** This represents a step up from the $32,000-$35,000/ha band that has been the norm since the events of 2008. **The land price paid per kg MS produced has broken through the $40/kg mark and averaged nearly $41.5/kg over this period.** This is a 12 percent lift on the post-GFC average of $37/ha. Looking back through history the $40/kg mark has been an important psychological level.

Whether this price is fair comes down to the outlook for the milk payout. The land price multiple to the milk payout has averaged 4.95 since July 2013. This is well below the 20-year average of 6.3. But this metric uses this year's farm-gate forecast of $8.40/kg MS (100 percent share backed). Given this is a record high, it seems unlikely to be the long-term average going forward. **If you assume a milk payout of $7.25/kg MS** (our current forecast for next season) and use the long-run average land price multiple to milk payout of 6.3, **this implies scope for average land values to head toward the $41,000/ha, or $45.7/kg milk produced mark over the coming year.** That is, this metric suggests no current land price overvaluation.

However, these measures are perhaps a little misleading, as they only include the revenue and productivity sides of the equation. **Today there are higher costs**, which impact on margins and profitability. Additionally, there are higher capital requirements for shares, cows and other inputs. **A better valuation measure to capture all these dynamics is the cash rate of return.** Dairying cash rates of return are likely to average 8-10 percent this year. This is the highest level since the early 2000s and well up on the 10-year average of 5 percent. If we normalise the cash rate of return to the long-term average of 5 percent, by changing the land value component of the equation and using an average milk payout of $7.25/kg MS this implies **land values have scope to move up by $3,000/ha, or 9 percent on the 2012/13 season.** The recent move up of $3,500/ha implies the market is making a similar assessment. **However, it also suggests land values could have started to enter overheated territory when assessed against historical returns.**

The spill-over effects of the larger milk payout into dairy support and arable land prices (especially with the move to more intensive dairying systems) **are more difficult to assess.** Finishing and arable land prices have had a strengthening trend since mid-2012. **Prices for both though have moderated in recent months after earlier breaking out of their 2-year ranges in the winter and spring period. Turnover has picked up substantially for both in recent months. This appears to be giving buyers a few more options. The large majority of sales are in the traditional dairying areas, or those growing quickly.** Finishing activity levels have been the strongest of all property types with total turnover in recent periods nearly double the 10-year average.

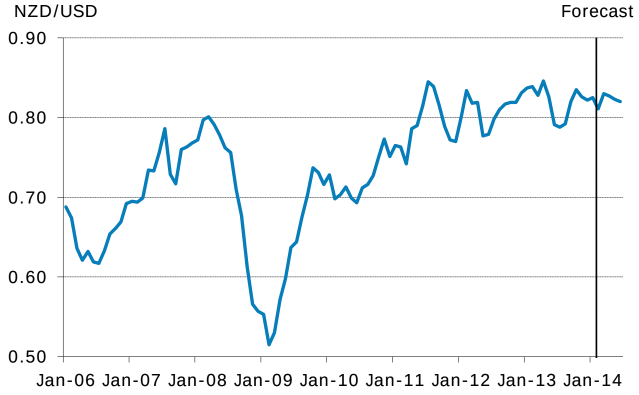
Looking back at average cash rates of return on B+LNZ Class 7 & 8 farms (finishing/arable) reveals a 10-year average of just 2 percent. On Class 8 farms the value of the land has been around the $22,400/ha mark, and returns 1.9 percent, over the past couple of years. Therefore, **recent prices don't seem too out of whack with history, but do imply rising expectations for dairy grazing and cash crop prices, as well as more conversions.** A move substantially higher with already slim rates of return seems unlikely – or at least unwarranted. **Average monthly arable prices got as high as $28,000-$30,000/ha in the winter and spring period, but have moderated back to $25,000/ha in recent periods.** This is still a 9 percent increase from the prior two year average of $23,000/ha. Turnover is now nearly 50 percent above the 10-year average and at its highest level since prior to the GFC.

Elsewhere **the monthly turnover of grazing properties has pushed up to the 10-year average, but average prices have moved back to a $15,000-$16,000/ha range.** In mid-2013, average prices hit levels not seen since the period prior to the GFC. **In the horticultural sector confidence continues to rise.** Turnover has remained robust over the last six months, running at nearly 80 percent of the 10-year average and the average sale price has continued to gravitate upwards. With Psa less prevalent over the last year, G3 grafting showing reasonable tolerance to Psa, and solid orchard-gate prices anticipated, confidence and demand for kiwifruit orchards has lifted. In the viticulture space large wine companies continue to look to secure supply and make strategic purchases of brands.

ECONOMIC INDICATORS

EXCHANGE RATES	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
NZD/USD	0.825	0.828	0.837	↓	↓
NZD/EUR	0.607	0.607	0.630	↔	↓
NZD/GBP	0.503	0.510	0.523	↓	↓
NZD/AUD	0.930	0.895	0.797	↑	↑
NZD/JPY	86.50	83.50	74.33	↑	↑
NZD/TWI	78.30	76.64	75.21	↑	↑

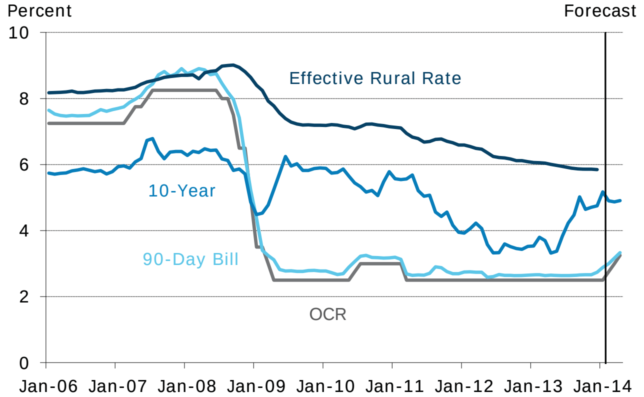
NZD Buys USD



Sources: ANZ, Bloomberg

NZ INTEREST RATES	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
Official Cash Rate	2.50	2.50	2.50	↔	↔
90 Day Bill Rate	3.08	2.69	2.66	↑	↑
1 yr	3.40	3.11	2.51	↑	↑
2 yr	3.82	3.30	2.53	↑	↑
3 yr	3.95	3.62	2.64	↑	↑
5 yr	4.65	4.16	2.56	↑	↑
10 yr	5.17	4.70	3.53	↑	↑
Effective Rural Rate	5.85	5.86	6.09	↓	↓
Agricultural Debt ($b)	51.85	52.01	50.13	↓	↑

Key NZ Interest Rates



Sources: ANZ, RBNZ

New Zealand's uniquely positive growth prospects are expected to keep the NZD elevated through much of 2014. To be sure, we do expect the NZD to eventually succumb to our "reversification" thematic (the gradual unwinding of diversification flows from the core to the periphery that characterised 2011 and 2012). **However, with the RBNZ set to lift the OCR well ahead of any other major central banks, NZ commodity prices still elevated, and best-in-class growth in prospect, we expect the NZD to demonstrate real resilience through H1. As H2 progresses, reversification is expected to take a greater hold and this will provide downward pressure on the NZD/USD.**

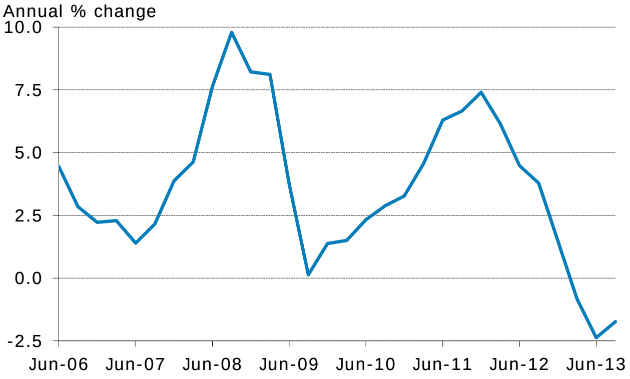
While we cannot forget global factors, the power of the domestic story is shown in the way the NZD has behaved through recent EM wobbles. Early jitters saw all so-called "risk" currencies drift lower, but the NZD was one of the best performers, thanks in our view to domestic factors. Ordinarily, some facets of the domestic story (commodity prices for example) are globally rooted. However, aspects like the Canterbury rebuild are almost entirely domestic in nature, and are unlikely to be derailed by global jitters. Similarly, the case for a rise in interest rates to cool inflation is largely a domestic story, with domestic (non-tradable) inflation currently running at 2.9 percent y/y, well above the mid-point of the RBNZ's target band. Rate normalisation is thus needed no matter what's going on globally, and unless we see the global outlook deteriorate sharply, expectations of rate rises will keep the NZD elevated.

While the RBNZ's elected to leave the OCR unchanged in January, the Bank's comment that it "expects to start this adjustment [returning interest rates to more-normal levels] soon" was as clear a warning of a March OCR hike as the Bank could possibly have provided. As we have long argued, interest rates need to rise, and barring a catastrophe, March is when things will kick off. Much of this is already priced into markets, so the reality is that actual hikes will not come as a surprise. We expect the RBNZ to lift the OCR four times (by 0.25 percent per time) in 2014, starting in March with follow up hikes in April and June, then a pause, and another hike in December. As the OCR goes higher, the yield curve will flatten. Long-end interest rates are biased higher, in line with global rates, but with the US Federal Reserve at least a year from lifting interest rates, the rise will be gradual, and there is ample scope for NZ rates to narrow against US rates as yields drift higher.

ECONOMIC INDICATORS

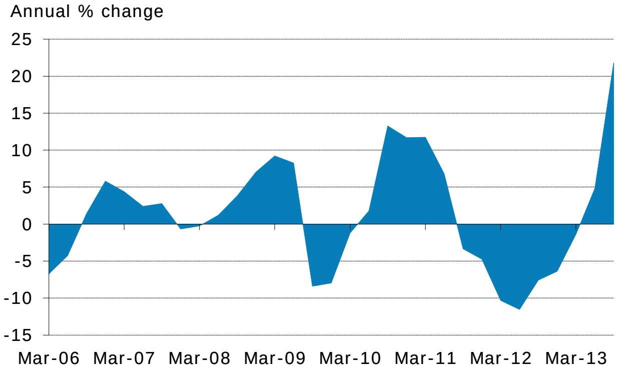
INFLATION GAUGES					
Annual % change	**Current Qtr**	**Last Qtr**	**Last Year**	**Chg. Q/Q**	**Chg. Y/Y**
Consumer Price Index	1.6	1.4	0.9	↑	↑
Farm Input	-1.7	-2.4	3.8	↑	↓
Net Imp. Margins PPI	21.8	4.8	-7.6	↑	↑

Farm Input Inflation Gauge



Sources: ANZ, Statistics NZ

Net Implied Margins PPI
Ag/Forestry/Fishing (Outputs - Inputs)



Sources: ANZ, Statistics NZ

The turning point for the cost of farm inputs came at the start of the 2013/14 season with the Agri farm cost index in September registering its first quarterly increase (+0.7 percent) since the end of the 2011/12 season. Cost pressures are expected to continue to build over 2014. This will whittle away some of the year's better farm-gate prices, but more importantly, is likely to set a higher cost structure in place for 2014/15. **A higher cost base in 2014/15 of course carries risks if farm-gate prices have a dramatic readjustment.** This is not our central scenario. We would just note volatility in soft commodity prices has doubled since 2006, and none of the drivers for the increase in volatility have changed.

The two drivers of the expected acceleration in on-farm cost pressures are a lift in the economy's general inflation, and spill-over effects from this year's record milk price into service providers' pricing intentions, and eventually, prices. With the NZ economy hitting expansion mode the economy's spare capacity will continue to be soaked up over coming quarters, and as this happens, inflation pressures will rise. **We expect to see headline inflation increase toward 2.3 percent y/y by the end of the 2014/15 season (up from 1.6 percent at present).** This will spill over into general cost pressures for all farm types.

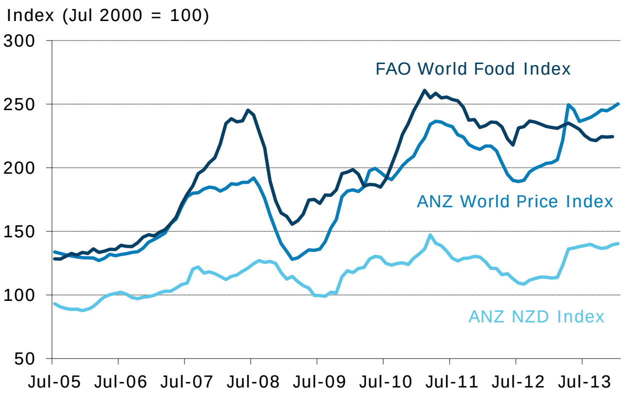
A spend-up by the dairy sector has potential to add fuel to the fire. Thus far most of the pressure over the 2013/14 season has been limited to productive dairy inputs. However, there are likely to be spill-over effects into other services and inputs as the 2014/15 season nears and confidence grows of another good payout. This will affect all farmers/growers as there are many inputs that are used by all. **Increases in the OCR will come into focus with 65 percent of rural loans on shorter-date terms. In total we expect 125bps of hikes over the next 18 months. This means the effective rural interest rate could be 75-100bps higher in 2014/15.** For the average dairy farmer with debt of $21/MS this could translate into an extra cost of $0.15-0.20/MS.

Annual PPI margins surged by 22 percent in the September quarter, largely due to a 55 percent lift for dairying. Equally encouraging, though, was that all the other sectors – apart from fishing and aquaculture – also experienced a lift in margins. The surge in dairying margins was due to the record milk powder prices in recent quarters lifting dairy outputs by 54 percent y/y. Apart from the sheep and beef sector, all the other sectors also experienced a lift in output prices. Horticulture, viticulture, forestry and other livestock farming output prices were all up by nearly 6 percent y/y.

KEY COMMODITIES: OVERALL INDEX AND DAIRY

SOFT COMMODITY PRICE INDICES	Current Month	Last Month	Last Year	Chg. M/M	Chg. Y/Y
ANZ NZ Index	140	140	113	↔	↑
ANZ World Index	250	247	204	↑	↑
FAO World Food Index	224	223	232	↑	↓

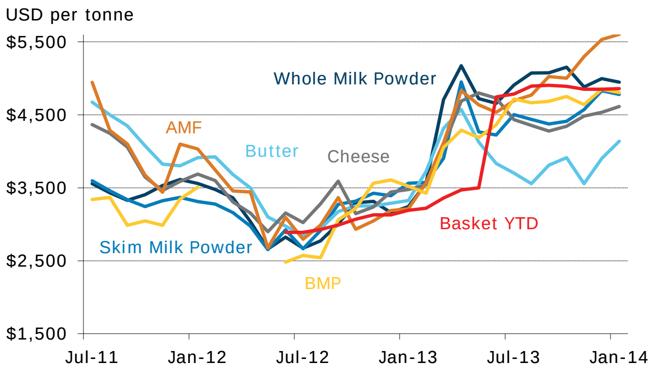
Soft Commodity Price Indices



Sources: ANZ, FAO

OCEANIA DAIRY PRICE INDICATORS USD per tonne	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Milk Price YTD ($ per MS)	8.37	8.27	5.50	↑	↑
Milk Price Forecast ($ per MS)	8.30	8.30	5.50	↑	↑
Whole Milk Powder	4,946	5,010	3,244	↓	↑
Skim Milk Powder	4,778	4,604	3,562	↑	↑
Butter	4,137	3,790	3,325	↑	↑
Anhydrous Milk Fat	5,603	5,277	3,211	↑	↑
Butter Milk Powder	4,804	4,746	3,523	↑	↑
Cheese	4,613	4,453	3,477	↑	↑
Basket YTD	4,860	4,863	3,190	↓	↑

Dairy Products - NZ Export Market Prices



Sources: ANZ, GlobalDairyTrade, USDA

The FAO index finished 2013 back 1.6 percent on the previous year. On an annual basis this was the least amount of movement seen in global soft commodity markets in nearly 20 years. Since 2006 it hasn't been uncharacteristic to see swings of plus or minus 20 to 30 percent in the FAO index. **However, while it looked a quieter year for price movements there were still large price movements in the sub-sectors, which offset one another.** Dairy experienced the largest increase (+25 percent) and oils (-14 percent) and sugar (-18 percent) the biggest declines. **Since 2006 many of the sub-sector groups have tended to move in tandem, but this wasn't the case in 2013. The divergences suggests as economic prospects have improved, and financial market volatility declined, soft commodity markets have begun to trade more on their own fundamentals and less on other macro-economic drivers.** For NZ producers this gives a clearer price signal for long-term investment decisions.

The Fonterra milk price and dividend forecast update in December was a watershed moment with the rule book thrown out the window. Some compromises have been made between the milk price and dividend. **A theoretical milk price of $9/kg MS versus the forecast $8.30/kg MS is a gap of $0.70/kg MS. Across annual production of 1,556 million MS this implies the cooperative is short of $1.09 billion to pay the theoretical milk price. Yet a dividend of $0.10 per share and EBIT earnings of $500-$600 million are still forecast in 2013/14.** It seems earnings from the NZ milk products business has been cut to zero, whereas earnings from the other consumer/value add businesses have been retained to pay out through dividends. From the information provided so far it's not entirely clear though and it will be interesting to see how the final results are published.

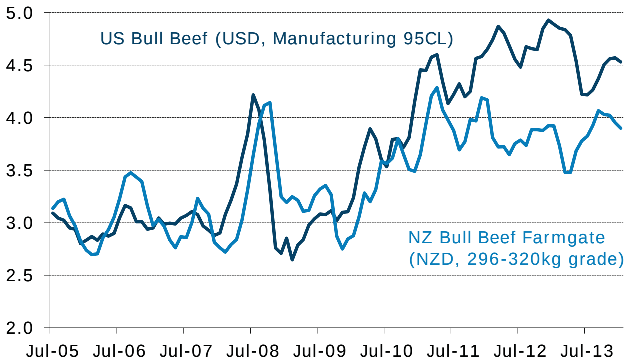
The focus is beginning to turn to what might be in store for the 2014/15 season. China's import demand for WMP to substitute for lower domestic fluid milk doesn't appear to be tailing off despite a record domestic farm-gate price and reported stabilisation in milk flows. In 2013 China brought nearly 620,000 tonnes of milk powder, a 53 percent increase on 2012. New Zealand supplied 91 percent of this. All-in-all a downward price adjustment is likely to come in Q2 2014 when NZ dairy farmers look to extend lactation for as long as possible and Northern Hemisphere production peaks, meaning more milk is able to be diverted into milk powders and other exportable goods instead of liquid milk at this point. But given tight global stocks and good Chinese demand, only a modest adjustment seems likely. **This means an opening milk price around the low $7/kg MS mark is becoming a real possibility.** Combined with this year's record $8.40/kg MS, such a result would ensure strong farm-gate cash flow well into 2015.

KEY COMMODITIES: BEEF AND LAMB

BEEF PRICE INDICATORS					
$ per kg	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Bull Beef[1]	3.90	4.00	3.92	↓	↓
NZ Steer[1]	4.08	4.21	3.89	↓	↑
NZ Heifer[1]	3.50	3.63	3.31	↓	↑
NZ Cow[1]	2.80	2.87	2.91	↓	↓
US Bull Beef[2]	4.53	4.54	4.89	↓	↓
US Manu Cow[3]	4.37	4.31	4.64	↑	↓
Steer Primal Cuts	7.26	7.23	6.54	↑	↑
Hides[4]	72.7	72.9	57.2	↓	↑
By-Products[4]	52.9	50.3	45.0	↑	↑

[1] (NZD, 296-320kg Grade Bull & Steer), (NZD, 195-220kg Grade Heifer) (NZD, 160-195kg Grade Cow)
[2] USD, Manufacturing 95 CL [3] USD Manufacturing 90 CL [4] USD$ per Hide

Beef Indicator Prices

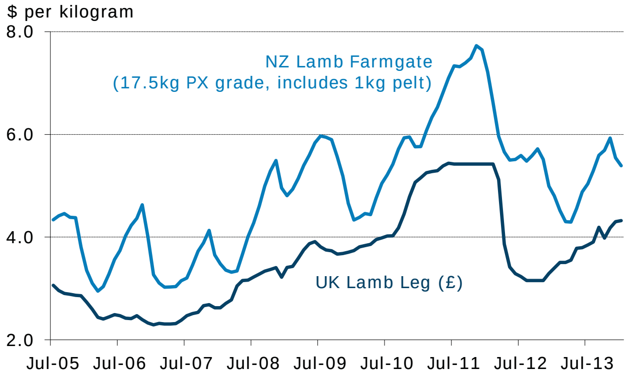


Sources: ANZ, Agrifax

LAMB PRICE INDICATORS					
$ per kg	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Lamb[1] (NZD)	5.39	5.72	4.80	↓	↑
UK Lamb Leg (£)	4.32	4.15	3.40	↑	↑
Rack US (USD)	16.4	16.0	18.0	↑	↓
Flaps (USD)	5.54	5.56	4.61	↓	↑
Skins[2]	7.98	7.94	5.30	↑	↑

[1] 17.5kg PX grade, including 1kg pelt [2] USD per skin

Lamb Indicator Prices



Sources: ANZ, Agrifax

While beef markets didn't set the world on fire in 2013 the next 12-18 months look more promising. **In the US domestic lean beef prices have rocketed up, reaching all-time highs for January and sitting 25 percent above the 5-year average. As yet import prices have not moved higher**, but it seems only a matter of time. US beef and dairy cow supply is expected to continue to contract into the autumn as record high beef calf values and some of the best feed/ milk ratios on record see herd rebuilding pickup. **With domestic US supply to tighten further, import demand for lean beef is expected to be buoyant. Import supply could also be tighter than expected over the first six months of 2014.** Lower cow supply from New Zealand is expected as dairy farmers rebuild herd in the North Island and there is an increase in new conversions this coming spring. Australian beef supply is also forecast to decline by 9% y/y in 2014. The only offset will be an increase in South American exports, especially from Brazil.

Outside the US the forecast drop in Australian beef supply should help relieve Asian markets. However, the counter might be better market access for the US into Korea and Japan, which is likely to continue to erode market share for secondary cuts. Outside the traditional Asian market, **NZ exporters are cautiously optimistic on China and Indonesia.** Import demand is expected to remain strong due to their own tight domestic supplies, high retail prices and increased food safety standards. This is expected to provide more competition for limited Oceania supply, especially for manufacturing beef as foodservice demand expands. This should benefit NZ farmers especially with better market access compared to many other countries.

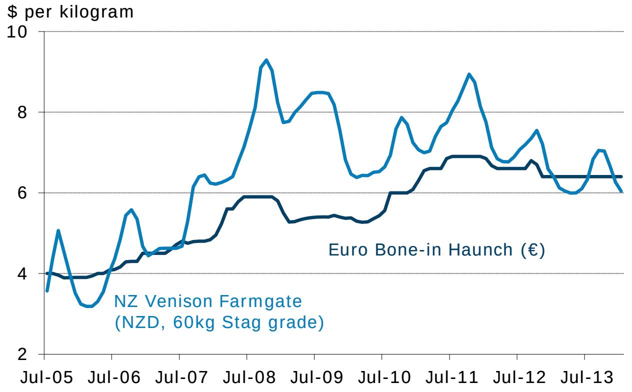
Overall lamb supply across NZ, the UK and Australia is expected to be back 4 percent in the 2013/14 season. This is less than initially thought and means the global supply situation for the rest of the season will not be as tight as previously thought. However, it doesn't seem like this will matter too much for prices with increased inter-market competition between Europe and China. In the UK, frozen lamb leg prices are almost 30 percent higher than 12 months ago and demand seems to be holding up, with retail purchases of legs up a massive 32 percent. Additionally demand across most other cuts has improved as the price competitiveness of lamb versus other proteins has lifted. While retail prices in China now seem to be pushing the boundaries more, channels to consumers with higher disposable incomes have opened up. As such there is growing demand for higher value cuts. Wealthier households incomes are at a level where price isn't the primary determinate of purchasing patterns. This seems to be the next leg of the story. How these channels and markets are developed by the industry will have important implications for long-term farm-gate prices.

KEY COMMODITIES: VENISON AND WOOL

VENISON PRICE INDICATORS					
$ per kg	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Stag[1]	6.04	6.65	6.40	↓	↓
NZ Hind[1]	5.93	6.55	6.29	↓	↓
Euro Bone-in Haunch (€)	6.40	6.40	6.40	↔	↔
Boneless Shoulder (€)	4.70	4.70	5.44	↔	↓
Loin (€)	14.02	13.99	16.28	↑	↓

[1] (60kg Stag AP grade), (50kg Hind AP grade)

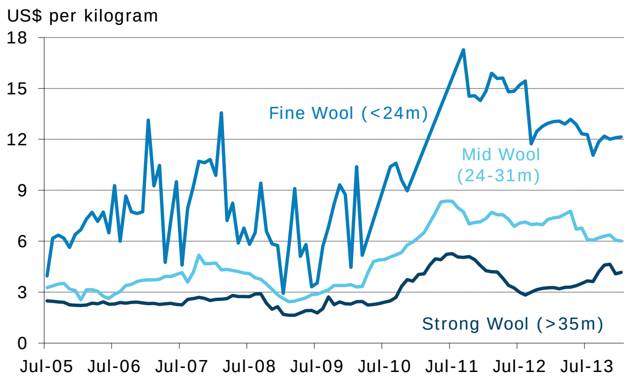
Venison Indicator Prices



Sources: ANZ, Agrifax

CLEAN WOOL INDICATOR PRICES					
$ per kg	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Fine Wool (>24m)	14.71	14.61	15.58	↑	↓
NZ Mid Wool (24-31m)	7.28	7.54	8.81	↓	↓
NZ Strong Wool (>32m)	5.04	5.36	3.90	↓	↑
USD Fine Wool (>24m)	12.14	12.09	13.04	↑	↓
USD Mid Wool (24-31m)	6.01	6.24	7.37	↓	↓
USD Strong Wool (>32m)	4.16	4.43	3.26	↓	↑

Wool Indicator Prices (Clean)



Sources: ANZ, Beef + Lamb NZ, Wool Services International

In-market prices for venison have recently stabilised at lower values. Over the past year chilled volumes were back by 10 percent and values by 6 percent. This was one reason for lower returns. **The second aspect was frozen product sales were slower during the European autumn, mostly due to warmer weather, but also due to stronger competition from other European game producers.** Other game meats have increased both their quality and quantity over the last two seasons and this has eaten into the premium NZ venison can command. **With both factors taking a toll, this reduced in-market frozen pricing by 15-20 percent depending on the cut.** Increased competition from alternate game meats in Europe provides a new dynamic from the last several years. **The industry's success in developing new markets and marketing initiatives to position venison as a better proposition will influence how much prices recover.** Improvement in retail prices for alternate proteins in Europe are expected to provide some support even though venison is a niche meat and demand is still very seasonal.

The direction of the NZD/EUR will also have a large bearing on farm-gate prices over the next two years. **We have forecast a lower NZD/EUR, and combined with slightly lower supply, and stable in-market prices, an improvement in farm-gate returns are expected over the coming year.**

Auction prices for strong wool have had a wild ride over the past several months. There was a snap back in prices in late 2013 on buyer anticipation of higher seasonal supply, but this proved to be short lived as the realisation that seasonal supply wouldn't be that high prompted buyers back into action. Wool prices also became less competitive with polyester and cotton over the first half of 2013/14. In fact the wool-to-Cotlook 'A' price ratio blew out to 2.5 in November after managing to get back to its long-run average of 1.65 at the end the 2012/13 season. The last peak was 2.2 in December 2011, when cotton prices adjusted lower before wool prices did.

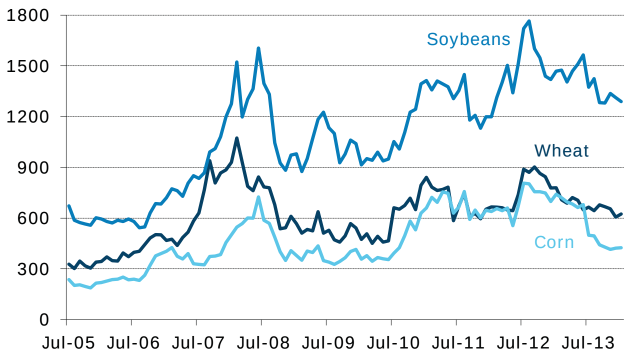
It seems tighter supply of crossbred wool from the major exporters, low inventory levels, a continued uptick in US demand for carpets and growth in domestic Chinese demand will outweigh weakness in demand elsewhere and lower substitute fibre prices in 2014. Combined with the better prices achieved in the first half of 2013/14 we have lifted our season average strong wool price to $3.75 per kg (greasy). This is a 30 percent increase on 2012/13.

KEY COMMODITIES: GRAINS

GRAIN & OILSEED PRICE INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
NZ Milling Wheat[1]	422	419	412	↑	↑
NZ Feed Wheat[1]	396	393	358	↑	↑
NZ Feed Barley[1]	401	403	351	↓	↑
Palm Kernel Expeller[1]	316	313	291	↑	↑
US Wheat[2]	6.2	6.4	7.8	↓	↓
US Soybeans[2]	12.9	13.1	14.7	↓	↓
US Corn[2]	4.3	4.2	7.4	↑	↓
Australian Hard Wheat[1]	380	396	441	↓	↓

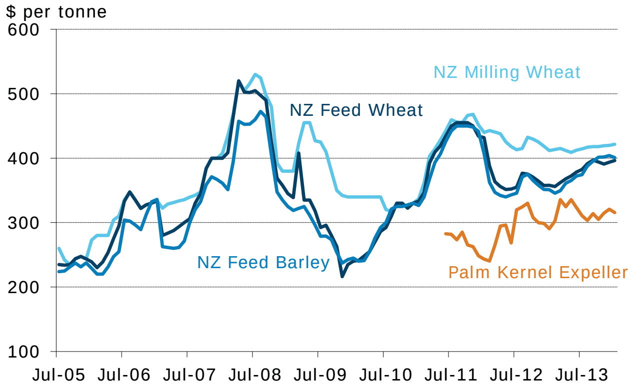
[1] NZD per tonne
[2] USD per bushel

CBOT Future Grain & Oilseed Indicator Prices



Sources: ANZ, Bloomberg

Key NZ Grain Prices



Sources: ANZ, Agrifax

The size of 2014 grain harvest will be key for price direction into the winter. Going by the feed wheat plantings intentions in the AIMI survey, the area to be harvested in 2014 is expected to be up 17 percent on 2013. The vast majority of these plantings were made in the 2013 autumn/winter period. The total area of feed barley planted and to be harvested is expected to be very similar to previous years, though little change in the AIMI planting intentions for barley contradicts industry reports of higher-than-normal seed sales in the spring period. **All up if the 2014 harvest achieves yields similar to the last three years this would increase feed wheat production by 18 percent y/y and see barley production decline by 3 percent y/y. In total, feed grain production lifts by 7 percent y/y.** As it stands, most consider it highly likely that all of the 2013 barley harvest will be sold by the time the bulk of the 2014 harvest arrives. For feed wheat it is expected there will be little unsold grain in soils come harvest time and about half the amount of the year before in sold grain. **With a robust demand backdrop, especially from the dairy sector; not a lot of 2013 grain left in soils; and only a modest lift expected in the 2014 harvest it seems the only downside pressure for prices is cheap imports.** On this front imports can still be made at very competitive prices versus current domestic prices.

Global grain markets will face 2014 from a better supply position than in recent years, keeping prices under pressure. A record Canadian crop has helped swing the global wheat market into its first surplus since 2010. A rebound in US corn yields, another increase in China's corn production, and lower demand from the US ethanol sector, is set to see the largest buildup in global corn stocks since 2005. However, given grain prices were the worst performing soft commodity over the last half of 2013, the more favourable supply environment is already priced in. We view the price correction as having run its course, with grain prices already likely to have found a new base. **With the lows already in place, price risks are skewed to the upside, given the level of stocks (though improving) are such that the market still remains vulnerable to any weather-induced supply shocks in key producing countries.**

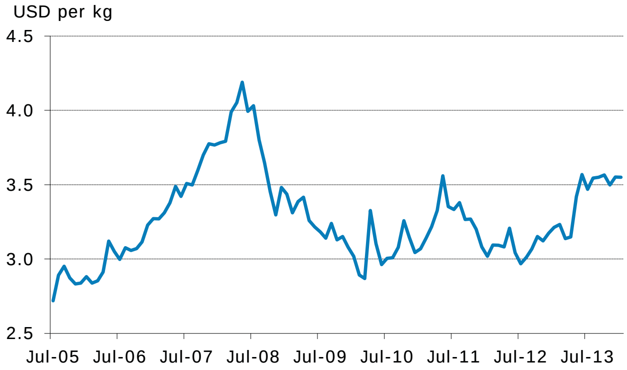
Elsewhere the maize grain harvest is expected to be a bumper one with plenty of healthy-looking crops and plantings increasing by almost 12 percent over the 2013 harvest. The increase in plantings was in response to the strong demand for 2014 contracts, with the vast majority of the crop expected to be already sold on pre-harvest contracts.

KEY COMMODITIES: HORTICULTURE

HORTICULTURE PRICE INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
Kiwifruit (USD per kg)	3.6	3.5	3.2	↑	↑
Apples (Weighted Index)	265	265	247	↔	↑
Average Wine Price[1]	5.9	5.7	5.9	↑	↓
Packaged White Wine[1]	6.8	6.5	6.8	↑	↓
Packaged Red Wine[1]	10.1	9.7	10.3	↑	↓
Bulk wine[1]	3.2	3.2	2.7	↔	↑

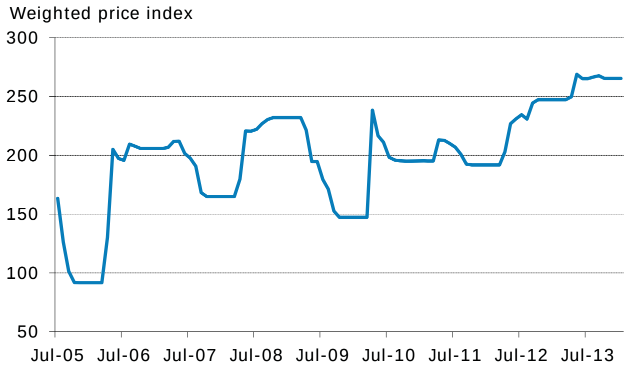
[1] USD per litre

Kiwifruit Indicator Price



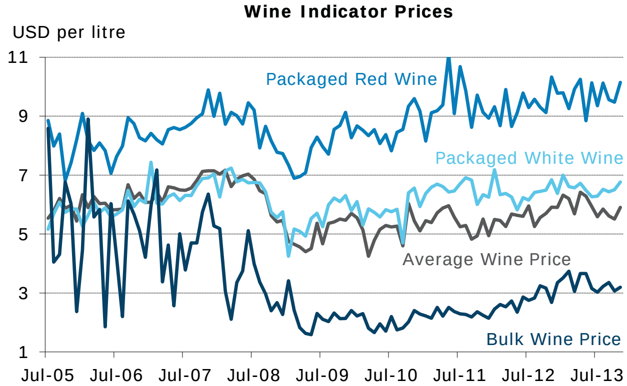
Sources: ANZ, Zentrale Markt- und Preisberichtstelle

Apple Indicator Price Index



Sources: ANZ, Zentrale Markt- und Preisberichtstelle

Wine Indicator Prices



Sources: ANZ, NZ Winegrowers

There was a further lift in kiwifruit returns in December. This was driven by strong end of season sales and lower than anticipated fruit loss. **Green orchard gate returns were lifted to $5.12/tray. This is a $0.50/tray (+11 percent) lift on the previous year. Combined with a yield of 8,163 trays/ha this lifts orchard gate revenue by 10 percent to $41,800/ha.** The increase comprises a total fruit and service payments increase of $0.32/tray in the face of a higher effective exchange rate and a smaller-size profile. It was another exceptional season for low fruit loss with onshore fruit losses decreasing from 2.88 percent to 1.47 percent, which increased returns by $0.10/tray. Post-harvest costs have continued to be reduced, resulting in an extra $0.11/tray. They are now down $0.34/tray (-10 percent) since the 2011 crop.

Returns around the $5/tray mark are expected for the 2014 crop. There could be some upside with early estimates that Chilean production could be back by more than 30 percent after severe frosts. But kiwifruit will need to maintain its competitiveness against other summerfruit. **Long-term with smaller volumes of Green to be produced it will be about optimising returns.** This is expected to see higher market penetration into China, Japan and South-East Asia, which will provide a handbrake on price increases, but equally it will provide more price tension for Europe if they want to secure supply. This is expected to see returns lift to around the $5.25/tray mark in 2015.

Gold orchard gate returns were lifted to $12.39/tray. This is a $1.94/tray (+18.5 percent) lift on the previous year. Expectations for Gold orchard-gate returns are more difficult to forecast. An increase in supply will impact on the market mix at the margin, and combined with more marketing activity revenue, will be reduced. Stabilisation in costs and fruit losses are expected, but the main downside is the higher NZD, especially against the JPY as long-term currency hedging rolls off. **This is expected to see 2014 Gold3 orchard-gate returns pull back toward the $10-11/tray range. Long-term Zespri still believe returns will move back to the $7.50/tray mark as supply increases toward the 50-60 million tray range. While the growth path for supply remains uncertain it is likely to undershoot.**

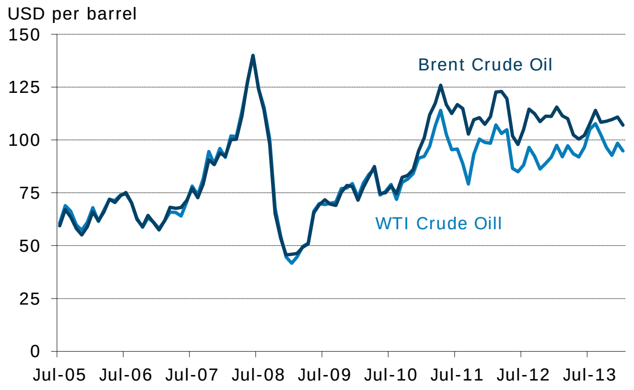
Pipfruit growers had one of their most successful exporting seasons ever. Average FOB prices were NZ$27.7/TCE, which was a 20 percent y/y increase. It is thought with the bigger crop average costs per TCE shouldn't have been increased too much. This would mean virtually all the extra NZ$4.7/TCE earned from exports should flow through to profits. Over the last few years profits have been nonexistent to a maximum of approximately NZ$3/TCE.

KEY COMMODITIES: OIL, FREIGHT AND FERTILISER

OTHER COST INDICATORS	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
WTI Oil[1]	95	96	97	↓	↓
Brent Oil[1]	107	110	116	↓	↓
Ocean Freight[2]	1,618	1,867	760	↓	↑

[1] USD per barrel, grade WTI
[2] Baltic Dry Index

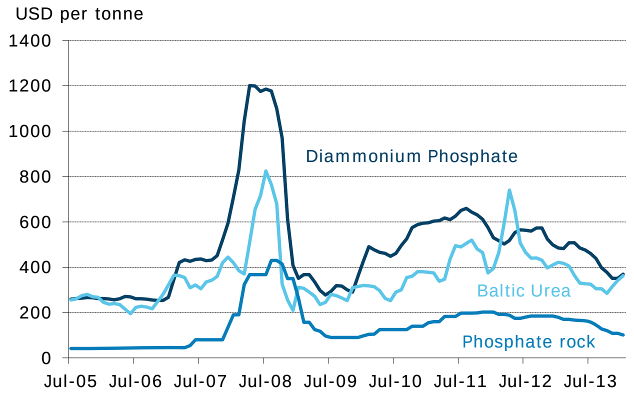
Crude Oil Indicator Prices



Sources: ANZ, Bloomberg

FERTILISER PRICE INDICATORS USD per tonne	Current Month	3 Mth Trend	Last Year	Chg. M/3M	Chg. Y/Y
DAP (USD)	369	360	485	↑	↓
Urea (USD)	363	314	422	↑	↓
Phosphate Rock (USD)	101	113	179	↓	↓
Farm-gate DAP (NZD)	826	846	NA	↓	NA
Farm-gate Urea (NZD)	615	635	NA	↓	NA
Farm-gate Super phosphate (NZD)	327	334	NA	↓	NA

Indicative International Fertiliser Prices



Sources: ANZ, Bloomberg

We expect oil prices to rise 3-4 percent in 2014, mainly supported by better demand conditions. Energy markets tend to benefit most from a lift in developed market growth, which we're forecasting for 2014. We have seen this dynamic play out in 2013, with oil outperforming other commodity markets as US economic activity regularly surprising on the upside – and this on the backdrop of booming US shale oil production and corresponding rises in stockpiles. We think a similar outcome will play out in 2014. We expect WTI to marginally outperform Brent and as a result expect the wide (unsustainable) spread between the two benchmarks to contract to USD8/bbl by the end of 2014 (currently USD12/bbl).

Chinese oil demand should improve in 2014 as overall growth stabilises. That said, the rising base effect and commissioning of new oil refinery capacity will warrant an increase in crude oil imports by default. Strategic stockpiling will be an ongoing dynamic as new storage facilities become available. Easy-to-access domestic oil supply is also diminishing, meaning a greater reliance on imports.

Both Brent and WTI markets have had a mixed start to the year. Market chatter around further tapering measures in the US held WTI prices down early, before prices edged higher on declining US crude inventories and increases in fuel demand. We expect the link between better US economic conditions to continue with stronger prices forecast in the second half of the year. **Brent prices have been equally choppy**, fluctuating between signs of improved global economic growth and the prospect of excess supply driven by Libya and Iran. Whilst we acknowledge the downside risk presented by increased Libyan output and Iran making steps towards a return to global supply, we feel the speculation of a major supply glut is overdone.

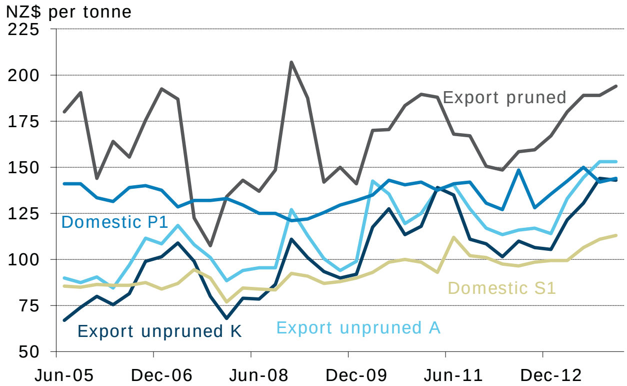
Farm-gate prices for the main fertiliser types followed international prices down late last year. International Urea prices had dropped by 17 percent over the course of the year and phosphate prices were back 30-40 percent. **Combined with the high NZD lower farm-gate prices were inevitable. There were price drops across all the main fertiliser types.**

International urea prices have bounced higher in recent months and phosphate prices have stabilised. It seem prices have now reached their floor due to a tightening in supply and some key importers beginning some restocking after living hand-to-mouth for a long period.

KEY COMMODITIES: FORESTRY

OTHER COST INDICATORS					
	Current Quarter	3 Period Trend	Last Year	Chg. P/3P	Chg. Y/Y
Export: (NZ$ per JAS m3 f.o.b.)					
Pruned	194	186	167	↑	↑
Unpruned A Grade	153	144	114	↑	↑
Unpruned K Grade	143	132	106	↑	↑
Pulp	137	118	91	↑	↑
Domestic: (NZ$ per tonne delivered at mill)					
P1	144	145	136	↓	↑
P2	124	123	117	↑	↑
S1	113	106	100	↑	↑
S2	102	100	94	↑	↑
Pulp	50	49	51	↑	↓

NZ Forestry Indicator Prices



Sources: ANZ, MPI

There were record log exports during 2013, in both volume and value terms. Demand in China is driving very high prices and excellent returns for logs heading overseas. This has also dragged up domestic prices for industrial and utility grades, while structural and framing logs are in high demand for the Canterbury rebuild and the growing Auckland housing market. **The outlook for the first half of 2014 is very positive with a continuation of both factors expected.**

Export log prices have hit record levels for some log types in recent months. With domestic log prices also rising, the Agrifax Log Price Indicator hit record levels in January, eclipsing the previous record set in 2011. Recent price rises have come from further pressure for supply in China, where on-port inventories have shrunk, despite a high rate of imports. New-build house prices in China increased 10 percent in 2013, a record rate, which is the driving force behind the increased lumber consumption. Steady declines in supply from Russia and Chinese domestic supply being reduced due to greater conservation efforts has resulted in increased volumes being sourced from the Pacific Northwest and New Zealand. Additionally US housing construction has begun to recover and this is creating pricing tension for lumber and logs, with prices rising rapidly for supplies from the Pacific Northwest.

Pruned export log prices ended 2013 at $194/m3, this was the highest level since 2003. The other unpruned (Grade A and K) grades were unchanged on the quarter, but finished the year 35 percent higher than they started and are at their highest level ever. Domestic grade prices didn't experience the same lift throughout 2013 increasing between 6-12 percent. However, with consent issuance picking up there is expected to be more pricing pressure throughout 2014

BORROWING STRATEGY

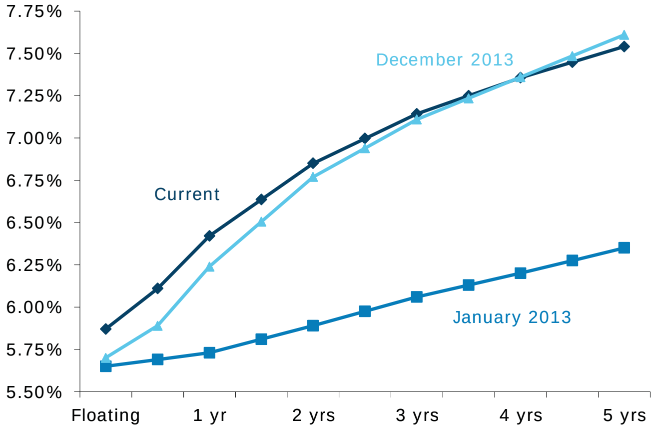
SUMMARY

While indicative short-term rural fixed lending rates have moved a touch higher, long-term rates have moved lower, "flattening" the lending curve. Fixing for longer is thus cheaper. Although the "horse has bolted" for those wishing to fix ahead of upcoming OCR increases, there is still likely to be some benefit in fixing for terms like 3 years. This is because while it is more expensive to fix now than it was a year ago, if the RBNZ lifts the OCR by 1 percent this year as we expect, term rates are likely to rise more rapidly than implied by breakevens. This opportunity has been afforded to borrowers thanks largely to lower global interest rates.

OUR VIEW

Indicative fixed lending rates have not changed substantially, but we have seen the borrowing curve "flatten" as short-end rates move up and long-end rates move down. While the change has been subtle, **a flatter yield curve does make fixing more palatable both in terms of reducing the "step up" to fix, and by lowering forward breakevens.**

Indicative Rural Lending Rates



Sources: ANZ, Bloomberg

By comparison to a year ago, interest rates are sharply higher – by almost 1.2 percent in the 5-year term. In that regard, as we have noted in past editions, the "horse has bolted". Fixing was a lot cheaper a year ago, as was our preference at that time. However there is also "no point crying over spilt milk". Any decision to fix has to be a forward-looking one, and while a borrower may rue the decision not to fix a year ago, if interest rates are still projected to rise more rapidly than breakevens, then there is a case for fixing.

So, what's changed compared to December, when we saw limited value in fixing for more than a year? In short, two things have. For one, **we now expect the RBNZ to get at least three rate hikes out of the way before the election**, and five over the next 12 months (March, April and June, followed by a pause, then two back-to-back hikes in December this year and January next year). That's a slightly more front-loaded profile than we originally envisaged, and reflects the better outlook and signs of more intense inflation pressures.

Secondly, **the flatter borrowing curve has lowered breakevens.** For example, whereas in December our breakevens showed the 1-year rate would have to move from 6.24 percent to 7.30 percent a year later (i.e. a rise of 1.06 percent) in order to make fixing for 2 years worthwhile, breakeven analysis now shows that the 1-year rate needs to rise from 6.41 percent to 7.19 percent in a year's time. That's not just a smaller rise, but it is to a lower end-point (7.19 percent versus 7.30 percent). Yet if anything, we believe the case for the RBNZ to lift rates is more powerful now than it was in December. Accordingly, although it would clearly have been better to have fixed a year ago, there is still value in fixing for a term like three years now.

To be sure, we don't see a great deal of benefit to be had in fixing, as breakevens are close to our forecasts. But for many borrowers, the decision is often tipped by the additional certainty that fixing brings. So even with fixed terms costing about the same as shorter terms over the long term, if certainty is something borrowers want, fixing may be more palatable.

Of course, the RBNZ did not lift the OCR in January. But this should be cold comfort to borrowers. This is because the Bank strongly hinted at a rate hike in March, noting that "returning interest rates to more-normal levels" is expected to "start soon".

Rural Lending Rates (incl. typical margin)		Breakeven rates			
Term	**Current**	**in 6mths**	**in 1yr**	**in 2 yrs**	**in 3 yrs**
Floating	5.70%				
6 months	6.09%	6.73%	6.99%	7.52%	7.86%
1 year	6.41%	6.86%	7.19%	7.67%	7.97%
2 years	6.80%	7.16%	7.43%	7.82%	8.12%
3 years	7.09%	7.39%	7.61%	7.97%	
4 years	7.31%	7.57%	7.77%		
5 years	7.50%				

EDUCATION CORNER: NZ'S CHANGING TRADE PATTERNS

SUMMARY

New Zealand's main export markets have changed rapidly in the last six years. The change has been mainly driven by the rise of China, which overtook Australia as our largest export destination in November 2013 (A position Australia had held since 1989). On a sector basis China is the now the largest earner for 11 out of 21 of our major primary sectors. For the remaining 10 sectors it ranks either second, or third for all but one. While the China story has been widely publicised, there has also been strong growth in exports to ASEAN and wealthier Middle East countries. Our more traditional markets such as Australia, the US and Europe remain important for specific sectors and higher grade/quality products though. While the rapid growth to non-traditional markets has brought opportunity, as trade matures a deeper understanding of the regulatory framework, business practices and local culture which affects consumer trends, tastes and customer service requirements are needed to continue to drive growth. At the moment New Zealand still has a way to go to develop a critical mass of institutional knowledge and expertise in these fields as it relates to many of these markets.

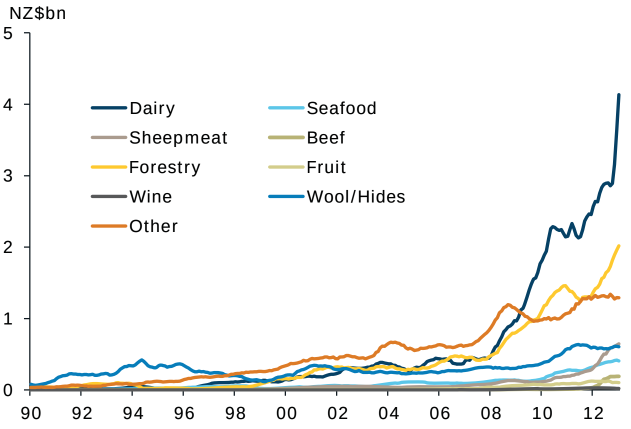
THE RAPID RISE OF CHINA

The release of the November merchandise trade statistics at the end of last year was a watershed moment, with Australia relinquishing the mantle to China of being our largest export market. Australia had held this position ever since August 1989. Prior to this it was jointly held by Japan and (to a lesser degree) the USA, who in turn wrestled it away from the United Kingdom in the early 1980s. The rise in China's prominence has been widely signalled, but the pace of its climb to pole position as our number one export destination has really surprised.

In the twelve months to November 2013, exports to China totalled $9.4bn, just shy of a fifth of our total export receipts of $47.4bn. The value of exports sent to China have risen nearly $1.5bn compared with a year earlier, with the most dramatic increases being measured for milk powder ($1,200m), logs ($221m), butter ($57m) and sheepmeat ($50m).

China's share of NZ's total merchandise trade averaged only 2.2 percent over the 1990s, doubling to 5 percent a decade later. It hit a double-digit share of overall export receipts in May 2010, and is a shade away from doubling this (currently 20 percent) 3½ years later.

NZ Exports to China, 12 month running total



Sources: ANZ, Statistics NZ

On a sector basis, China is the largest earner for 11 out of 21 of the major primary sectors. For the remaining 10 sectors, China ranks as either the second or third largest market for all but one (cheese). The wool industry, then forestry, skins, and seafood, have the largest exposures to China. The fastest-growing exposures over the last two years have been for meat, seafood, skins, and horticultural products.

While the spike higher in international soft commodity prices back in 2006/07 was seen as the start of a new paradigm, all the forecasts on how rapidly the change might occur have been blown out of the water. Every time there's a sense we might be reaching a plateau, there seems to be a new catalyst of growth. Many companies are now actively discussing what proportion of earnings should be exposed to China. It will be interesting whether the money on the table, or strategic market placement decision, holds sway. This is likely to be influenced by individual sector dynamics.

The lift in exports to China has been driven by a range of factors. These have included:

1. **A growing population, larger middle class, urbanisation and higher personal incomes. Combined with the modernisation of the food supply chain and increasing presence of modern retail outlets and quick-service chains this has led to a more westernised diet and higher calorie intakes.**
2. **Improved infrastructure, especially the cool chain and more refrigerators in homes.** This has increased the market penetration of NZ's perishable exports by improving shelf-life and the ability to transport and store products throughout a larger area of China.

EDUCATION CORNER: NZ'S CHANGING TRADE PATTERNS

3. **Tight domestic supplies and associated rising retail prices for certain goods, such as dairy and red meat. This has supported a general increase in soft commodity imports.** The tight domestic supplies have often been driven by disease issues, low profitability for small/backyard producers and regulatory changes to the food system causing consolidation and higher compliance costs.
4. **Consumer concerns over food safety with China's domestic supplies and the government's stricter control over food safety.** This has boosted sourcing from multinational retailers and food service companies expanding their footprints and the general underlying demand for imported food products.
5. **NZ's free trade agreement lowering trade barriers and tariffs** for a range of exports boosting our competitiveness against other countries and domestic supply.

For many sectors it all started with a rush of secondary and lower grade/quality products making their way to China and other emerging markets. But once confidence and experience was acquired, along with increasing market penetration into new marketing channels (such as food service), higher grade/quality products began to be sold also. While this represents a new opportunity it means a deeper understanding of the regulatory framework, business practices and local culture which affects consumer trends, tastes and customer service requirements is needed. This could provide slower incremental growth as New Zealand still has a way to go to develop a critical mass of institutional knowledge and expertise in these fields as it relates to China and the broader Asian theatre. As we have said before, China is quite different to our own marketplace and most of our traditional ones. Cracking this will take longer and require different approaches to traditional investment and ownership models.

THE RISE OF ASEAN AND OTHERS

While the lift in Chinese exports has been widely publicised, it hasn't been an isolated case. Many ASEAN countries and others in the Pacific-Asia region have risen to prominence at

NZ'S EXPORTS TO ASEAN NATIONS FOR THE 12 MONTHS ENDED NOVEMBER 2013 (NZ$M)

	Global Total	ASEAN Total	ASEAN as % of NZ	Brunei	Cambodia	Indonesia	Laos	Malaysia	Myanmar	Philippines	Singapore	Thailand	Vietnam
Sheepmeat	2,710	57	2%					39		1	12	4	1
Beef	2,100	152	7%		1	43		30		31	35	10	3
Other Meat	454	20	4%			4		5		3	5	2	
Milk Powder	8,184	1,595	19%		1	292		368	14	266	265	223	165
Butter	2,129	360	17%	2		77		54	2	77	35	38	75
Cheese	1,421	179	13%			59		32		54	10	15	8
Whey/Casein	1,861	172	9%			51		20		24	64	12	2
Kiwifruit	871	42	5%			9		12		2	10	7	2
Apples	505	90	18%		1	7		13		1	15	45	8
Other Fruit/Vege	842	69	8%			8		34		2	12	12	1
Wine	1,233	24	2%			1		2		1	18	2	1
Wool	768	14	2%			1		5				7	1
Skins/Hides	599	26	4%			5						8	12
Logs	2,346	6	0%									4	2
Sawn Timber	1,106	159	14%			19		15		34	5	30	57
Fibreboard/Plywood	334	44	13%			21		5		9		1	7
Whey/Casein	617	160	26%			117		17		4		15	6
Fish/Seafood	1,428	91	6%	1		3		8		14	27	27	10
Crude Oil	1,749	177	10%								177		
Aluminium	989	11	1%			5		1			2	2	1
Remainder	15,180	1,270	8%	3	3	160	1	255	3	214	310	196	125
TOTAL	**47,426**	**4,720**	**10%**	**7**	**6**	**883**	**1**	**916**	**20**	**738**	**1,002**	**661**	**486**

EDUCATION CORNER: NZ'S CHANGING TRADE PATTERNS

the expense of our traditional export markets. In fact six out of these ten ASEAN countries now appear in New Zealand's top 20 export destinations (see table on page 49). They include the larger and wealthier countries too as the six countries account for 96 percent of ASEAN GDP and 86 percent of the total population. Back in 1990 only 3 out of the 10 ASEAN countries today made it into our top 20 export destinations.

The Association of Southeast Asian Nations (ASEAN) consists of Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. The organisation was formed to accelerate economic growth among member countries. To a certain degree this growth has been driven by many of the same factors that led to an increase in NZ's exports to China. However, each local market has its own regulatory regime, business customs and cultural factors, influencing how business is conducted, through to their preferences and tastes.

ASEAN nations account for 10 percent of New Zealand's total merchandise exports. The ASEAN bloc is over-represented (shares greater than 10 percent) in the exports of milk powder, butter, cheese, apples, sawn timber, fibreboard, and whey.

New Zealand's trade with ASEAN nations has grown by $295m (6.7 percent) in the past 12 months, accounting for a quarter of the $1,181m (2.6 percent) increase to all nations. The largest increases were measured in milk powder to Singapore, Malaysia and the Philippines, crude oil to Singapore, and butter and whey to Indonesia.

The value of exports sent to Singapore ranks 7th, up from 14th position in 1990. Milk powder is the largest-value commodity exported to Singapore, accounting for over a quarter of all merchandise exports. Singapore is our largest market for tallow and our second-largest market for crude oil.

Milk powder accounts for 40 percent of exports sent to Malaysia and they are now our third-largest market for milk powder behind China and the United Arab Emirates. Malaysia is also our second-largest export market for onions and scrap metal.

Indonesia is our tenth-largest export market, but has ranked as high as eighth in the past four years. Milk powder makes up a third of all exports sent there. It is our second-largest export market for wood pulp and sugar.

Dairy products make up the top four items sent to the Philippines. Milk powder is the largest individual commodity, accounting for 36 percent of our total trade with them. Exports of butter, cheese and ice cream add up to a further 29 percent. The Philippines are our largest single market for ice cream, with $61m exported there.

Milk powder accounts for a third of our exports to Thailand. Apples are the second highest-value product exported there, and it ranks as our fifth-largest market overall for this product, and our top market within Asia. Ice cream and butter ranked third and fourth, with Thailand our second largest market for ice cream.

Vietnam just makes it onto our table of the 20 largest export markets, but has been the fastest moving (up from 100th position) over the last 20 odd years, when milk powder was virtually the sole export. Nowadays the principal exports also include butter, sawn timber and fur skins, with the latter being New Zealand's largest export market.

Rounding out the Asia-Pacific region in the top 20 are Taiwan, Hong Kong and India.

Milk powder is the largest export sent to Hong Kong, accounting for 16 percent of all exports. Export of malt extract is half this value, accounting for 8 percent of all exports. Hong Kong is our second-largest market for live horses, miscellaneous seafood and tanned hides. The Hong Kong market is closely associated with the Chinese market. Many of these exports are likely to be to importers buying product that is then on-sold to mainland China.

Taiwan is our 11th-largest export market. Milk powder is the largest individual commodity exported to Taiwan, accounting for 23 percent of all exports sent there. Beef is the second-largest export, accounting for 15 percent of exports, and malt extract half of this with a 7 percent share of total exports to Taiwan.

India is our 14th-largest export market, up from 25th ranking in 1990. The largest export sent to India is "confidential items", which is a description used to temporarily suppress commercially-sensitive information. Looking back at past years where the data suppression has been lifted and correctly re-classified, it can be deduced that coal is the main export sent to India as a "confidential item". Logs are the second most-valuable export, followed by respirators/breathing apparatus.

The main exports to India are a lot less focused on primary goods compared with the other surrounding markets. Currently there are many impediments for New Zealand's primary exports to India that include:

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1. A number of trade barriers and very high import tariffs that exist for many products;
2. Still low average incomes;
3. Poorly-developed cool chain and other infrastructure needed for the distribution and storage of perishable products; and
4. Government intervention and regulation in a range of soft commodity markets that favour domestic produce over imports.

Despite the development of the India food industry probably lagging 10+ years behind the likes of China, New Zealand's primary sector still seems to have become more adept and savvy in targeting niches within large markets such as India.

THE RISE OF THE WEALTHIER MIDDLE EASTERN MARKETS

We've seen some recent inroads in export growth to the Middle East. The United Arab Emirates (UAE) and Saudi Arabia are our 16th and 18th largest export markets. Also keep an eye on Egypt and Nigeria. Both are just out of the top 20, but have experienced a rapid rise up the rankings to 24th and 28th position, respectively.

Milk powder represents just over 62 percent of exports sent to the UAE, with butter accounting for a further 8 percent. Milk powder is also our largest export to Saudi Arabia, but it only makes up 36 percent of all exports sent there. Butter and sheepmeat are the next largest shares, each accounting for 14 percent.

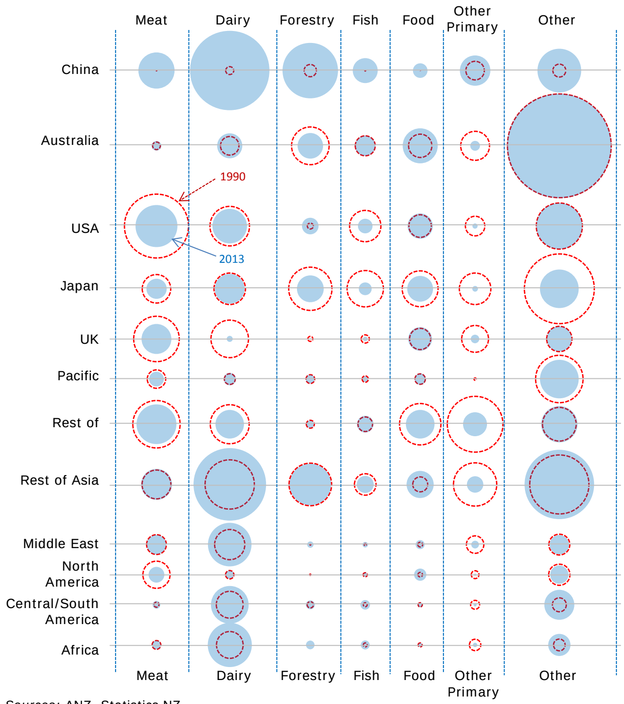
Dairy products account for the top four NZ exports to Egypt. Butter is the largest, at 42 percent, followed by milk powder on 35 percent. Cheese and whey account for 9 and 6 percent respectively. Exports to Nigeria amounted to $306m in the latest 12 months, making it our 28th-largest export market behind 27th-ranked France. Ten years earlier it only ranked in 51st position. Milk powder accounts for 53 percent of exports, followed by malt extract on 22 percent.

The specific targeting of the wealthier Middle East markets again highlights New Zealand businesses becoming more adept and savvy in targeting discerning customers. While many of the top exports are largely in commodity form, there is a growing proportion of value-add/branded food products. As diets become more westernised, and consumers wealthier, a greater share of food will be purchased less on price and more on other attributes such as taste, texture, functionality, brand, food safety etc.

THE DECLINING IMPORTANCE OF OUR TRADITIONAL MARKETS

We have constructed a chart to highlight the redistribution of exports away from our traditional markets (UK, USA and Europe) and towards the Asian and Middle East marketplaces. The graph below depicts the percentage distribution of merchandise exports across our key markets in 1990, drawn as hollow red dashed hoops. Overlaid are the equivalent relative proportions, as reported in the 12 months to November 2013, represented by blue solid discs.

NZ's Changing Export Distribution, 1990 versus 2013



Sources: ANZ, Statistics NZ

The greatest change to New Zealand's profile has occurred in the top left-hand corner, with the explosion of exports of meat, dairy, forestry and seafood to China.

Our export profile to Australia hasn't changed dramatically, with only a minor decrease in forestry exports offset by a lift in processed food exports. Several of New Zealand's exports to Australia are not exported to many other nations, resulting in a relatively broad-based basket of goods exported compared to most other nations we trade with. **Crude oil is our highest-value export sent to Australia**, with exports in the latest 12 months valued at $1.5bn, accounting for nearly 17 percent of all exports sent to Australia. This proportion is up from 11 percent in 1990. Gold is our second-highest value export ($810m) sent across the Tasman, up from 3 percent of exports in 1990 to nearly 9 percent

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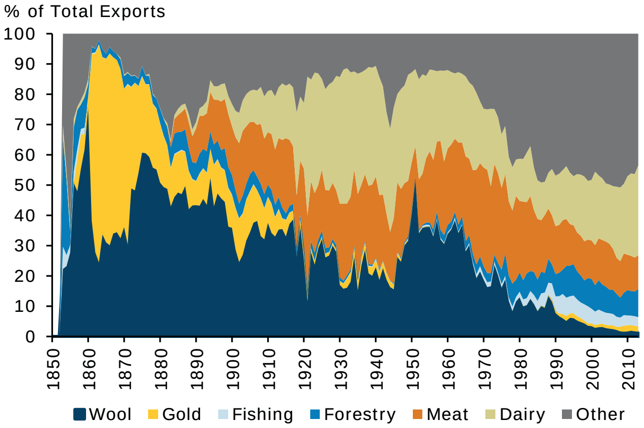
in the latest 12 months. Machinery is our third-ranked export ($450m), followed neck-and-neck by wine ($378m) and electronic components ($377m). Sawn timber, food products and apparel account for the next largest exports sent to Australia.

The reduction in exports to the United States over the past 23 years has predominantly been via a reduction in meat and seafood exports. The nominal value of beef exports sent to the United States in the latest 12 month span ($914m) had only increased 17 percent from what was sent 23 years ago ($782m). Meanwhile total exports have more than doubled, from $1,988m to $4,087m – resulting in the share of beef exports dropping from 40 percent to 22 percent. Similarly, seafood exports to the USA have dropped from over 10 percent of total exports in 1990 to 3½ percent in the latest twelve months. On the other side of the ledger, whey and wine exports to the United States have lifted from next to nothing in 1990 to 7¼ percent each in the latest 12 months.

Sheepmeat exports to the United Kingdom have held a constant share. In 1990 they accounted for 37 percent of total exports sent to the UK, while 23 years later the proportion was 38 percent. **The biggest lift in the distribution of exports to the UK has been for wine exports**, which increased from 1 percent of total exports, to a fifth of all exports in the latest 12 months, with a value of $278m. **The big losers in the export profile of goods sent to the United Kingdom over the past 23 years have been wool and butter.** Wool exports now account for just over 3 percent, down from nearly 10 percent in 1990. The reduction in butter exports has been more extreme, falling from 21½ percent of total exports in 1990 down to only a ¼ of a percent. In nominal amounts this is a slump from $241m in 1990 to just over $2m now.

Long-term perspective of NZ's export profile



Sources: ANZ, Statistics NZ, NZIER.

New Zealand's export of primary goods was founded on the shipping of primary goods to the UK. In 1882 the first refrigerated shipment of lamb carcasses was sent to London. The introduction of refrigeration helped to transform the New Zealand economy (and continues to in many emerging countries), and the wealth of the nation grew exponentially.

From a trade policy perspective, two important trends emerged. New Zealand's export orientation rapidly swung towards the middle class consumers of South-Eastern England. New Zealand's comparative advantages became concentrated in animal products for this single market (meat, wool and dairy). Furthermore, the prices New Zealand received were often set by inter-governmental agreement at high levels as a result of the two World Wars. Our living standards rose to be the third-highest amongst nations. They remained there for over 70 years, until the early 1950s when the end of the World War II coincided with a new period of globalisation, opening up of markets and the end of guaranteed export prices.

Germany is our eighth-largest export market, having been as high as our fifth-largest export market over the past 25 years. Sheepmeat is the largest export commodity making up a quarter of total exports sent to Germany. Kiwifruit is the second-largest export sent to Germany, although Germany is used as the gateway for fruit exported to Europe. Germany is our largest market for venison. This stems from the country's historical obsession with game hunting and Germany's increased appetite for game meat over the hunting season.

Rounding out our traditional markets in the top 15 are Korea and Japan.

Korea is New Zealand's fifth-largest export market, a ranking it has held for the past 2½ years. Since 1989 Korea has steadily ranked between 5th and 7th position. Our largest export to Korea is logs, which accounts for over a fifth of all exports sent there. Korea is our largest market for scrap metal and our second-largest market for logs, aluminium and deer velvet.

Japan's share of New Zealand exports has shrunk across all sub-groups, as the nation struggles against headwinds of a patchy domestic economy exacerbated by the turmoil of the recent GFC. In 1990 Japan was our largest market for aluminium, cheese, seafood, fibreboard/plywood, fresh vegetables, flowers, chemicals, and iron ore. In the 12 months to November 2013, this list has dwindled to just a handful, but still included aluminium, cheese and fibreboard/plywood. In

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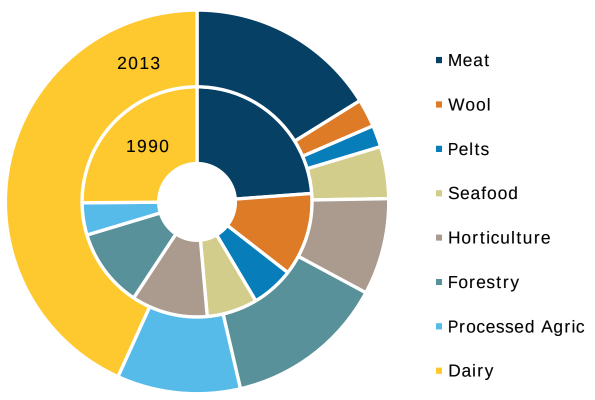
addition, kiwifruit has been added to the list as NZ's largest market. Aluminium accounts for 16 percent of exports sent to Japan, down from 22 percent in 1990. The proportion of exports from cheese, kiwifruit and fibreboard/plywood, casein and beef has increased, with cheese recording the greatest lift, up from 3½ percent of total exports to Japan in 1990, to 11¼ percent in 2013.

GROWTH BY SECTOR

Distribution of NZ's primary exports, 1990 vs 2013



Sources: ANZ, Statistics NZ

Looking at the difference in exports between 1990 and the most recent 12 months reveals that the dairy sub-group has recorded the most dramatic rise. Back in 1990, dairy exports accounted for just over 16½ percent of all exports ($2.6bn of a total of $15.8bn). By 2013 this figure had leapt to just below 30 percent ($14.1bn out of a total of $47.4bn). **Processed agricultural products, underpinned by a jump in wine exports, recorded the second-largest lift in export share, lifting from 3 to 7 percent.** Forestry exports increased from 7¼ percent in 1990 to 9¼ percent in the most recent 12 months. **Wool has recorded the largest reduction in export share**, falling from nearly 8 percent in 1990 to just 1½ percent in 2013. Exports of meat products slipped from just below 16 percent 23 years ago to 11 percent in 2013. The export share of pelts and hides dropped from 4 percent to 1¼ percent. Seafood exports eased from just over 4½ percent in 1990 to 3 percent in 2013. Lastly, horticultural products narrowed from 7 percent in 1990 to 5½ percent in 2013.

QUIRKY CORNER

The country that has registered the greatest move up New Zealand's export rankings over the past ten years has been Cameroon, lifting from 163rd ranking ($0.3m of exports) in 2003 to 76th ranking in 2013 ($24.5m of exports). This has been underpinned by the dairy sub-group. Looking across the other sub-groups, the largest move up the rankings (from a very low ranking in all cases) has been registered by:

Sub group	Country	Current ranking	Total exports
Meat	Turkey	49	$6.3m
Dairy	Cameroon	65	$14.4m
Wool	Morocco	30	$1.2m
Pelts	UAE	28	$0.2m
Horticulture	Brazil	39	$3.3m
Forestry	Ecuador	31	$2.1m
Seafood	Brazil	35	$3.7m

On the flip-side, the country registering the greatest move down New Zealand's export rankings over the past ten years has been Cayman Islands, dropping from 70th ranking ($18.3m of exports) in 2003 to 169th ranking in 2013 ($0.6m of exports). This was due to luxury yacht exports drying up. Looking across the sub-groups, the largest move down the rankings (with export receipts evaporating to nothing) has been registered by:

Sub group	Country	Current ranking	Total exports
Meat	Venezuela	87	$0.1m
Dairy	Estonia	63	$4.4m
Wool	Ireland	46	$0.4m
Pelts	Brazil	29	$0.1m
Horticulture	Syria	68	$0.2m
Forestry	Panama	52	$0.1m
Seafood	Venezuela	63	$0.2m

By commodity

It will come as no surprise that dairy products experienced the largest growth in total exports since 1990. It grew from $2.6bn in 1990 to $5.8bn in 2000 (a 120 percent increase over the 1990s. Dairy exports nearly doubled again in the next ten years with total receipts lifting to $11.2bn by 2010. Since then dairy exports have risen to $14.1bn, resulting in a cumulative rise of 436 percent over the past 23 years. This rapid acceleration reflects the formation of Fonterra, which has coincided with a 32 percent increase in cow numbers and productivity growth of 19 percent.

Looking at the detail over the remaining commodities reveals that Malt extract was the commodity to record the greatest percentage increase between 1990 and 2013. Exports grew from $1.6m in 1990 to $742m in 2013, a 454-fold increase (which averages out

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to 20 percent each year for the past 23 years).The next largest increases were: Miscellaneous cereal preparations (72-fold increase), Sauces/soups (62-fold), Wine (54-fold), Whey (46-fold) and Honey (35-fold).

At the other end of the spectrum, Art/antiques recorded the greatest percentage decrease in exports, dropping from $339m in 1990 to $46m in 2013 (a fall of 86 percent). The next largest decline were: Cork/straw (-73 percent), Fertilizer (-64 percent), Deer velvet (-48 percent), Aircraft (-47 percent) and Wool (-37 percent).

By country

There has been a four-fold increase in exports to the ASEAN bloc between 1990 and 2013. Not surprisingly dairy product made the largest contribution to this increase, lifting from $319m to $1,594m, a 418 percent increase. However, the greatest percentage increase has been in exports of wine, which lifted from $0.1m to $24.4m. Not bad, considering the high proportion of the population that don't drink alcohol!

For the following countries we only export one commodity (milk powder): Swaziland, Lesotho, Rwanda, Dominica, Gambia, Saint Helena, and Turkmenistan. **Australia is our most diverse export market, with 96 out of 98 commodities exported.** The exceptions are negligible amounts (less than $100k) of exports of potatoes and tallow. **The next most diverse countries regarding the range of our exports consigned is China** (90 out of 98 commodities), USA (87), Malaysia (87), Hong Kong (86) and Fiji (83).

China is our largest export market for 14 of the 98 commodities we export: Milk Powder, Logs, Sheepmeat, Wool, Crayfish, Butter, Malt Extract, Pet Food, Raw Hides, Wood Pulp, Miscellaneous Dairy Products, Live Animals, Iron Ore, Copper-Nickel and Deer Velvet. **This is up on previous years, but still a long way short of Australia, which has 50 items in its list, including:** Oil, Gold, Wine, Lumber, Apparel, Food preparations and Beverages, to name but a few. Other countries to top the export list by commodity are: USA (Beef, Whey, Apples, Mussels, Cork/Straw, Agricultural machinery, Aircraft, Medical equipment) Germany (Venison, Grains), Japan (Aluminium, Cheese, Flowers, Kiwifruit, Fibreboard, Chemicals), Fiji (Potatoes, Boats), Netherlands (Onions, Seeds), the Philippines (Ice cream), Italy (Tanned hides), Vietnam (Leather), UK (Honey), Singapore (Tallow), Korea (Scrap metal), Papua New Guinea (Salt) and New Caledonia (Fertilizer).

RELATIVE RANKING OF NEW ZEALAND'S EXPORT MARKETS, 2013 VERSUS 1990

	TOTAL	Meat	Dairy	Wool	Pelts	Horticulture	Processed Agric	Forestry	Seafood
China	1 (20)	2 (83)	1 (32)	1 (8)	2 (18)	6 (70)	3 (7)	1 (6)	1 (36)
Australia	2 (1)	16 (26)	8 (10)	5 (3)	5 (3)	1 (3)	1 (1)	4 (2)	2 (3)
USA	3 (3)	1 (1)	2 (1)	8 (9)	18 (9)	4 (4)	2 (3)	6 (11)	3 (2)
Japan	4 (2)	5 (3)	3 (3)	7 (1)	11 (4)	2 (2)	10 (2)	2 (1)	4 (1)
Korea	5 (6)	9 (8)	19 (22)	31 (14)	4 (1)	11 (24)	14 (8)	3 (3)	8 (4)
UK	6 (4)	3 (2)	47 (2)	3 (2)	16 (6)	8 (5)	4 (4)	38 (14)	16 (6)
Singapore	7 (14)	17 (15)	9 (16)	48 (47)	35 (23)	14 (9)	7 (25)	20 (9)	10 (8)
Germany	8 (5)	4 (5)	24 (9)	4 (4)	20 (17)	3 (1)	18 (5)	35 (18)	11 (18)
Malaysia	9 (9)	14 (24)	5 (6)	19 (27)	32 (27)	12 (17)	12 (20)	13 (10)	25 (12)
Indonesia	10 (18)	19 (35)	6 (17)	29 (38)	12 (226)	20 (18)	8 (6)	7 (5)	40 (28)
Taiwan	11 (11)	7 (9)	15 (12)	16 (25)	14 (15)	7 (10)	9 (9)	8 (4)	28 (14)
Hong Kong	12 (13)	13 (13)	21 (29)	13 (16)	3 (14)	13 (7)	5 (14)	39 (15)	5 (5)
Philippines	13 (22)	24 (71)	4 (8)	49 (34)	26 (224)	33 (25)	17 (31)	11 (8)	15 (37)
India	14 (25)	108 (78)	69 (92)	6 (7)	8 (12)	17 (28)	42 (62)	5 (13)	71 (227)
Thailand	15 (23)	32 (43)	14 (11)	15 (23)	10 (28)	10 (27)	16 (28)	10 (7)	9 (9)
UAE	16 (41)	25 (27)	7 (24)	34 (45)	28 (228)	15 (36)	28 (38)	18 (51)	18 (228)
Netherlands	17 (21)	6 (20)	36 (23)	27 (11)	41 (10)	5 (14)	13 (11)	14 (16)	29 (10)
Saudi Arabia	18 (17)	11 (14)	10 (15)	228 (48)	228 (223)	46 (22)	19 (44)	15 (55)	45 (26)
Canada	19 (8)	8 (4)	39 (30)	20 (26)	27 (13)	21 (15)	6 (10)	34 (39)	17 (16)
Vietnam	20 (121)	58 (226)	16 (75)	36 (227)	9 (221)	22 (227)	15 (96)	9 (227)	19 (224)

KEY TABLES AND FORECASTS

FX RATES	ACTUAL			FORECAST (END MONTH)						
	Dec-13	Jan-14	5-Feb	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
NZD/USD	0.822	0.809	0.823	0.83	0.82	0.80	0.78	0.78	0.77	0.76
NZD/AUD	0.921	0.923	0.923	0.97	0.98	0.95	0.93	0.93	0.92	0.90
NZD/EUR	0.597	0.600	0.609	0.61	0.59	0.57	0.55	0.55	0.54	0.52
NZD/JPY	86.31	82.51	83.59	87.2	87.7	88.0	85.8	85.8	84.7	83.6
NZD/GBP	0.498	0.492	0.504	0.50	0.49	0.48	0.46	0.46	0.46	0.44
NZ TWI	77.3	76.5	77.7	78.8	78.1	76.3	74.0	74.0	73.1	71.6

INTEREST RATES	ACTUAL			FORECAST (END MONTH)						
	Dec-13	Jan-14	5-Feb	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15
NZ OCR	2.50	2.50	2.50	2.75	3.25	3.25	3.50	3.75	3.75	4.00
NZ 90 day bill	2.84	2.90	2.89	3.20	3.50	3.50	3.90	4.00	4.00	4.40
NZ 10-yr bond	4.72	4.55	4.51	4.90	5.00	5.20	5.20	5.20	5.30	5.50
US Fed Funds	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.50	0.75
US 3-mth	0.25	0.24	0.24	0.40	0.40	0.40	0.50	0.60	0.80	1.10
AU Cash Rate	2.50	2.50	2.50	2.50	2.50	2.50	2.50	2.75	3.00	3.25
AU 3-mth	2.64	2.63	2.61	2.70	2.70	2.70	2.70	2.90	3.20	3.40

ECONOMIC INDICATORS	Sep-13	Dec-13	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15
GDP (% q/q)	1.4	**0.9**	**0.7**	**0.8**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.5**
GDP (% y/y)	3.5	**3.1**	**3.4**	**3.9**	**3.2**	**3.0**	**2.8**	**2.5**	**2.3**	**2.2**
CPI (% q/q)	0.9	0.1	**0.6**	**0.5**	**0.7**	**0.2**	**0.7**	**0.7**	**0.8**	**0.3**
CPI (% y/y)	1.4	1.6	**1.8**	**2.0**	**1.9**	**2.0**	**2.1**	**2.3**	**2.4**	**2.4**
Employment (% q/q)	1.2	1.1	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Employment (% y/y)	2.4	3.0	**3.3**	**3.2**	**2.3**	**1.5**	**1.3**	**1.3**	**1.2**	**1.2**
Unemployment Rate (% sa)	6.2	6.0	**5.8**	**5.7**	**5.6**	**5.6**	**5.6**	**5.6**	**5.5**	**5.5**
Current Account (% GDP)	-4.1	**-3.9**	**-4.5**	**-4.7**	**-4.8**	**-4.8**	**-4.8**	**-4.9**	**-5.1**	**-5.3**
Terms of Trade (% q/q)	7.5	**1.3**	**0.4**	**-0.1**	**-0.3**	**-0.6**	**-0.7**	**-0.9**	**-1.0**	**-1.0**
Terms of Trade (% y/y)	15.9	**18.8**	**14.4**	**9.1**	**1.2**	**-0.7**	**-1.7**	**-2.4**	**-3.1**	**-3.5**

Figures in bold are forecasts. q/q: Quarter-on-Quarter, y/y: Year-on-Year

IMPORTANT INFORMATION

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