NEW ZEALAND ECONOMICS
ANZ ECONOMIC OUTLOOK

MARCH 2016

INSIDE

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SPLIT PERSONALITY

NEW ZEALAND ECONOMIC OUTLOOK

The economy has Jekyll and Hyde characteristics. Housing is booming, as are construction and tourism. Yet dairying is in the doldrums and will be for some time. The mix of growth (borrow and spend) is not sustainable and a lower OCR (courtesy of low inflation and global unease) will mean more housing largesse at a time households are already heavily leveraged. Amidst uncertainty, we are forecasting 2½-3% growth over the coming three years.

INTERNATIONAL OUTLOOK

Global growth is respectable but this masks tensions. Prospects are firm in the US, subdued in Europe, modest in Australia, and a lottery in China. Although markets have recovered from their tumultuous start to the year, this appears to be driven more by liquidity than fundamentals and we question its sustainability.

PRIMARY SECTOR OUTLOOK

Another negative cash-flow year beckons for dairy farmers and until global milk supplies ease, prices will struggle to recover. Prospects in other sectors range from steady to stellar. New Zealand's meat supply is expected to be back by near double digits, but this should help support prices. The main horticulture crops are on track to post impressive yields, and combined with solid prices, are likely to deliver very profitable returns. Forestry prices are being supported by domestic building activity, shipping rates at multi-decade lows, and a favourable NZD.

FINANCIAL MARKETS OUTLOOK

Short-end interest rates remain biased lower, with the RBNZ expected to cut the OCR twice more in 2016. With the US Federal Reserve on track to deliver two hikes this year, our forecasts have the yield curve steepening and NZ/US spreads narrowing as US yields move higher. We expect the NZD to weaken gradually as the RBNZ eases policy and the USD strengthens in response to Fed hikes. However, we see this weakness as more of an H2 2016 story.

Calendar Years	2013	2014	2015	2016(f)	2017(f)	2018(f)
New Zealand Economy						
Real GDP (annual average %)	2.4	3.7	2.5	2.8	2.5	2.6
Unemployment Rate (Dec quarter)	6.1	5.8	5.3	5.5	5.3	5.0
CPI Inflation (annual %)	1.6	0.8	0.1	1.0	1.9	1.9
Terms of Trade (OTI basis; annual %)	20.2	-5.0	-3.2	-7.8	7.2	1.0
Current Account Balance (% of GDP)	-3.1	-3.1	-3.0	-4.7	-4.6	-4.1
Government OBEGAL (% of GDP)	-2.0	-1.2	0.2	-0.2	0.0	0.2
Global Growth (annual average %)						
US	1.5	2.4	2.4	2.3	2.3	2.3
Australia	2.0	2.6	2.5	3.0	3.2	3.1
China	7.7	7.4	6.9	6.4	6.0	6.0
Trading Partners	3.0	3.6	3.5	3.5	3.5	3.5
NZ Financial Markets (end of Dec quarter)						
TWI	77.3	79.4	73.7	63.4	63.1	
NZD/USD	0.82	0.78	0.69	0.59	0.62	
NZD/AUD	0.92	0.96	0.94	0.88	0.89	
Official Cash Rate	2.50	3.50	2.50	1.75	1.75	2.50
10-year Bond Rate	4.7	3.7	3.6	2.9	3.5	3.6

* Forecasts and text finalised 31 March 2016

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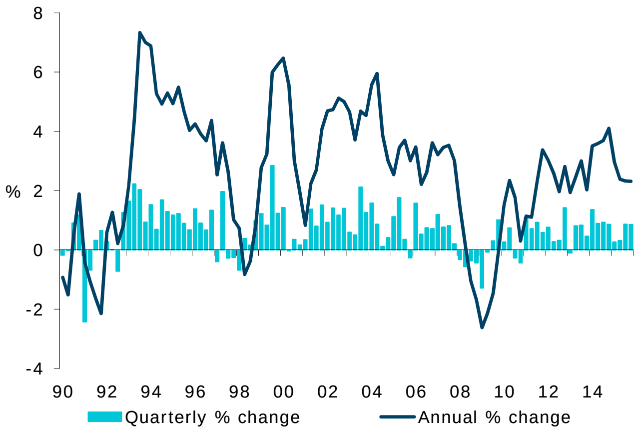
SUMMARY

The economy has Jekyll and Hyde characteristics. That's common over a business cycle; there are always winners and losers at any given time. However, divergences are now particularly stark. Housing is booming, as are construction and tourism. Yet dairying is in the doldrums and will be for some time. The mix of growth (borrow and spend) is not sustainable and a lower OCR (courtesy of low inflation and global unease) will mean more housing largesse at a time households are already heavily leveraged. A lower exchange rate would not go amiss but good growth means a stronger-than-desired currency. Amidst huge uncertainties, businesses are getting on with it, and we're backing more of the same amongst global palpitations. We are forecasting 2½-3% growth over the coming three years.

DR JEKYLL

The economy looks to be in reasonable shape. The economy ended 2015 showing strong momentum, with annualised growth of close to 3½% over the final six months (belying annual growth at just 2.3%). The labour market has recovered after a mid-year hiatus (although admittedly a 5.3% unemployment rate perhaps overstates strength) and consumer and business sentiment have held at decent levels despite dairy and global concerns. While there are the usual vagaries and volatility of the data to deal with, the general message is that the economy has carried this momentum into 2016 and is expanding solidly.

FIGURE 1. NEW ZEALAND ECONOMIC GROWTH



Source: ANZ, Statistics NZ

Importantly, this positive momentum story is not a one or two trick pony. There are a number of factors contributing (with many now quite familiar):

- **Tourism is strong.** While total visitor spending did dip a touch in Q4, it remains near record levels. Arrivals are growing at a 9% y/y pace and average spend per visitor has surged. China is a big part of the story, although it is much broader than that.
- **The construction pipeline is large.** The drag from a peak in the Christchurch rebuild is no myth. Yet work elsewhere is offsetting it. Dwelling consent issuance continues to trend higher and it is not just about Auckland. Large infrastructure projects not only add to the positivity but are spurring increased commercial activity too.
- **Record net immigration.** Net inflows are annualising at over 70k; that's a gain of 1½% of the population. While that is dampening per capita GDP growth in the interim, it still supports overall demand. And the associated lift in labour supply is helping to keep widespread capacity issues at bay. We expect net immigration to ease over the forecast period, but to hold at elevated levels. New Zealand's growth profile still looks better than many others and as long as this is maintained, migration trends will be favourable.
- **Regional housing markets are surging.** Housing market strength is no longer about Auckland alone. At a time when the Auckland market has cooled for a variety of reasons, regional markets (with the exception of Christchurch) are booming, buoyed by low interest rates, cash chasing investment outside of Auckland on a valuation and yield basis, and loan-to-value ratio tweaks that favour the regions over Auckland. This strength shouldn't be surprising. The Auckland – non-Auckland rubber band became taut and history shows numerous instances where Auckland strength eventually spills over and regions close the valuation gap. Regional lifts in house prices have further to run.
- **Financial conditions (a key lead indicator) are still supportive**, despite the restraining influence of the elevated NZD and lower dairy prices. Commercial property prices are up, as are equities. Interest rates are low, and the economy's credit wheels are still turning.
- **There is more cash in households' pockets.** Petrol prices have fallen, real wages are rising modestly (2.0% in the past year), food price inflation is low and the effective mortgage rate continues to ease. Combining these factors with the strongest gross labour earnings growth since 1994, we estimate that household discretionary cash flow (what is left over after paying the big bills) has lifted by close to 30% in the past 12 months, after falling 15% over the prior year. More money in the pocket equals more spending.

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- **Borrow-and-spend type behaviour has returned, providing a near-term boost.** Growth in credit is outstripping growth in incomes. While this leveraging behaviour has concerning aspects, it is also a sign of confidence in prospects. Household savings are being run down. That's borrowing growth from the future, which can only be temporary, but we'll take it for now. Encouragingly, borrow-and-spend behaviour has not been matched by a meaningful deterioration in the current account, as yet. However, this is expected to some degree over the forecast period.
- **Firms remain in a fairly buoyant mood.** People are spending. Employment intentions are robust, and there are signs of capacity pressures (skill shortages) emerging. That's a sign of an economy where success can breed more success. Such positive momentum can be hard to derail.
- **The economy has a lot of "small" things going for it.** The big picture macro stuff only takes an economy so far. Any economy is a collection of small performing parts. Examples of "small" things across the economy include an increase in the number of airlines flying into New Zealand (more tourists), projected rises in kiwifruit production, growth in boutique sectors such as Manuka honey, a burgeoning IT sector and slowly increasing depth across the stock market. Moreover, the Government is being smarter with its balance sheet – both in a social and economic investment sense. Such dynamics "round out" the macro story.

These positive forces are expected to persist over the next year or so, and for some, throughout the entire projection period.

MR HYDE

Good economic momentum is masking mixed performance both across sectors and within them as firms deal with both structural shifts and cyclical business cycle challenges. Both are typical at any one time, but it's atypical to see the degree of structural shift that's occurring at present overlaid on normal business cycle trends. Examples of the former include trade patterns (more Asia focused), attitudes to saving (KiwiSaver is now engrained in the national psyche), diluted wage bargaining power amidst the fourth industrial revolution, and demographics. However, there are also more direct challenges.

- **Success is no longer about managing macro shifts; disruptive technology and innovation mean ongoing change at a non-linear rate for all and sundry.** This has put pressure on firms to be even more flexible and adaptable than normal. Some can make that transition and others cannot. Performance within sectors is diverging as firms either deal with change or fail to do so.
- **The global scene is wobbly** (see a broader discussion on page 7). It's the biggest downside risk facing the economy and uncertainty and challenges are multi-faceted. Much of our focus is on China, which faces a real test rebalancing its economy, deleveraging, and balancing a social objective (more people in jobs) with an economic one (rebalancing the economy, which means near-term job displacement). Elsewhere, there is an unhealthy dependence on liquidity and policy support, an unbalanced global economy (too much saving by some and too little by others), excess leverage to still be worked through, overvalued asset prices, a lack of microeconomic reform, and increasing political fracturing making microeconomic reform and sound policy even more difficult to achieve. Our base case is that the global economy will experience modest growth overall, with risks remaining contained. However, we expect volatility to be high and with the policy support coffers looking reasonably bare, we need to be on the lookout for negative shocks.
- **Dairy: there is no way to sugar-coat the challenges.** The sector is in the midst of its second low-payout year and a third (the 2016/17 season) beckons. Price action is poor (refer page 8). Pressures have only really just started, and we don't see positive cash-flow into the sector being restored until 2018. Sector-wide borrowing is close to $40 billion (17% of GDP). That's non-trivial. Land prices are under pressure and costs are facing intense scrutiny. For a sector that directly contributes 5% to GDP and at least 10% indirectly, addressing its specific challenges will result in wider economic consequences.
- **Broader export prices are also under pressure.** While dairy prices may be stabilising at low levels, other export prices, particularly red meat, have recently faced some pressure. Together with a modest lift in oil prices off lows, we see the terms of trade falling by circa 10% over 2016. This comes on the heels of a 3% fall in 2015. Collectively we forecast a peak-to-trough fall in the terms of trade of 17%. That's a major drop in purchasing power and a collective hit to real GDP growth of around 2.5%pts between 2015 and 2017.
- **Financial conditions have tightened.** Financial conditions are supportive overall, but have tightened materially of late. Export price falls,

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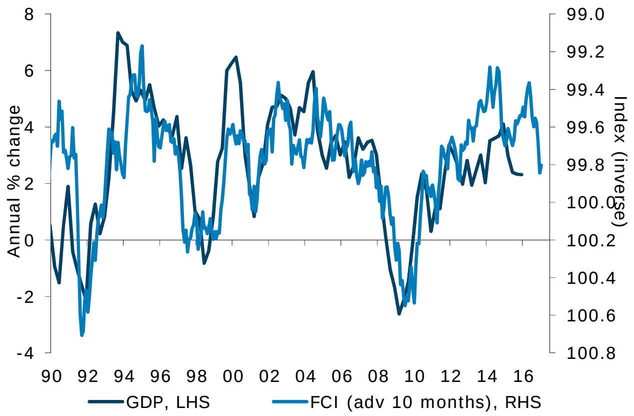
weaker credit markets, a stubbornly elevated NZD, and moderation in some asset prices such as farm values are a nasty mix. The tightening so far is enough to potentially knock 1%pt off real GDP growth over the next 12 months, all else equal.

FIGURE 2. GDP VERSUS FINANCIAL CONDITIONS



Source: ANZ, Statistics NZ

- **Asset valuation largesse together with deterioration in some structural indicators is an 'amber alert' combination.** The excesses associated with New Zealand house prices are well documented. A shortage of housing is only partly to blame. Globalisation, the chase for yield, connectivity with China, urbanisation, New Zealand's economic success, surging migration, cheap credit, high construction costs, lack of land availability, a lack of intensification and ambitious expectations about peoples' first home (since when is four bedrooms and two bathrooms normal?) are also influential. What concerns us is the combination of largesse with re-leveraging behaviour. The household debt to income ratio peaked at 159% prior to the GFC; it is now 162%, an all-time high, and rising. While low interest rates means serviceability is manageable at present, the debt still needs to be repaid and that is an impediment to future growth. Another year or two of strong credit growth and surging house price gains (particularly if Auckland fires up again) would turn us very bearish towards prospects for 2018.

THE TREND IS YOUR FRIEND

The economy has enough momentum and support to achieve modest growth over the coming years. Positives still dominate the scorecard. However, dairy sector weakness, global headwinds and tighter financial conditions should see growth moderate over the course of 2016. We are not talking about a full-blown slowdown, but moderation. Part of this is the natural braking effect from fewer available resources such as labour (despite booming net immigration). Whereas annualised GDP growth of over 3% is being recorded at present, rates of growth closer to 2½% are forecast over the years ahead. In other words, we see a growth backdrop that, while not remarkable, is certainly still solid – although quarterly volatility is likely to be high.

New Zealand has a number of key dynamics that will be influential over the coming years as challenges are navigated.

- **Policy firepower.** The OCR, while on the way down, still has a long way to go to get to levels comparable to offshore.
- **The fiscal position is strong,** with relatively low levels of net public debt (26% of GDP). There's scope for an expansionary fiscal stance. The 2017 Budget will likely deliver that via tax cuts; it's an election year after all. There is scope to boost infrastructure spending further if economic momentum wanes, though the construction industry is facing capacity bottlenecks so this lever could be challenging to pull effectively.
- **A free-floating currency.** It will adjust lower just as it did in mid-2015 if the growth picture warrants it. A strong economy equals a strong currency and the reverse applies too.
- **Better microeconomic foundations, building macroeconomic resilience.** We have some concerns over leverage ratios, but there is no doubting the economy is better placed all round than in the not-too-distant past. The financial system is well capitalised and profitable. More term funding is in place (a protective device against credit market palpitations). The synergy benefits of previous micro tweaks (the tax system, more roading investment, improving education and beneficiary outcomes, to name but a few) are only now coming together. The post-GFC era (2009 to 2011) has hardened the business sector. New Zealand is now like Australia (in prior years, not today!), which was buffeted by the likes of the Asian Crisis and dot-com bubble, but navigated them better than most.
- **Low levels of corporate debt.** Household and agriculture debt levels are high but corporate debt is low.

PLENTY OF CHALLENGES TO GET INFLATION UP

Despite respectable growth and falling unemployment, inflation has remained low. Headline inflation has been outside of the RBNZ's target band for 18 months, reflecting a combination of

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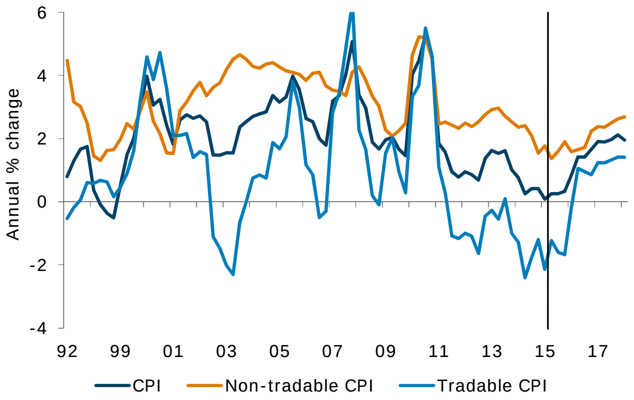
transitory (NZD and oil prices) and more enduring factors. Even core inflation measures are well below the middle of the 1-3% policy band.

FIGURE 3. NEW ZEALAND CPI INFLATION



Source: ANZ, Statistics NZ

As the temporary factors wane (oil prices need only stabilise, for instance), **our projections naturally show inflation rising.** Annual headline inflation is forecast to firm towards 1% by the end of the year, largely on the back of a lift in tradables inflation. Non-tradable inflation, after also being weighed down in part by temporary factors (ACC levy reductions), is expected to increase above 2% from the second half of next year. Pressure from demand-style factors (i.e. capacity constraints) are expected to exert a slight upwards influence on non-tradable inflation.

But this conceals considerable tensions. Capacity pressures are already evident locally, yet a number of factors are conspiring to dampen the traditional Phillips Curve relationship between capacity and inflation. Disruptive technologies are not only affecting firms' margins but also workers' job security, and hence wage-bargaining power. Legacy issues such as excess leverage post the GFC remain (deleveraging is deflationary), as does global overcapacity in some industries. Commodities have been swinging around for both cyclical and structural reasons. Inflation expectations have fallen and risk becoming embedded. We assume that cyclical forces will eventually win out and headline inflation settles around the 2% midpoint as the margin squeeze hits its limits. That's implicitly a vote of confidence in the monetary policy framework.

THE OCR IS GOING LOWER, BUT WE ARE A LITTLE UNEASY ABOUT IT

A backdrop of barely trend growth with low inflation and global challenges means further OCR cuts are more likely than not. We see the OCR being cut twice more this year to 1.75% (most likely in June and November), and holding there for an extended period. While we are backing a respectable growth picture, it needs more stoking to get inflation embers glowing brighter amidst an array of deflationary global forces. The unemployment rate still sits above our estimate of the NAIRU (non-accelerating inflationary rate of unemployment). Wage inflation is low and inflation expectations are below the inflation mid-point, for short-term measures anyway. China and global risks abound. Credit market price action is poor. We've already seen one cut in the OCR not fully passed into retail borrowing rates. The longer credit markets remain in a sombre mood –and we are picking that will remain the case for a while – the more pressure will come on banks' average cost of funds, and borrowing rates. So the OCR partly needs to drop just to keep retail rates unchanged, let alone drag them materially lower still.

But a lower OCR is not a view that sits overly comfortably with us. The pitfalls of deflation – central bank's current bug-bear – are clear; people will not spend if they expect prices to fall! You end up with an economy in a rut. So the RBNZ is focused on lifting inflation and expectation measures towards a more acceptable level (2% as mandated). Inflation is certainly low, but deflation is not around the corner. Witness rising construction costs, rents and accommodation charges, to name but a few (no coincidence that these are in the parts of the economy running hottest). We are not headed for a deflationary rut. Yet, a lower OCR penalises savers (the post-financial crisis era doesn't look pretty for retirement nest-eggs in a low interest rate world) and encourages leveraging behaviour at a time debt is already high and asset values (house prices) are booming. The trade-offs for additional monetary policy stimulus need to be weighed carefully. Some sit under the realm of financial stability but there is overlap with monetary policy. To be fair, the trade-offs leave us scratching our heads over the end-game.

OTHER FEATURES OF OUR FORECASTS INCLUDE:

- **Household consumption; buoyant:** Strong population growth, an improving labour market, petrol price and mortgage rate falls and a rundown in saving rates has boosted real spending growth. Annual growth looks set to peak close to 4%. However, deteriorating debt metrics and a moderation in net migration gains will eventually cap growth – we see real spending growth slowing towards 2½%. In short, we don't see recent borrow-and-spend style growth being sustained. Renewed vigour in spending and housing enthusiasm is temporary. It's a key judgement that ensures the current account and balance sheet metrics don't completely blow out.

- **Investment; an outperformer:** Modest residential investment growth of circa 5% is expected over the next year, masking divergence between Canterbury and the rest of the country. Other fixed asset investment is forecast to achieve decent growth rates (3-5%), as a low cost of capital and emerging capacity constraints drive firms' investment plans.
- **Labour market; jobs aplenty:** While the unemployment rate should rebound in Q1 from its sharp fall in Q4 2015, we see it moderating towards 5% over the next few years, with employment growth strong enough to absorb a slowing rate of new entrants into the labour force.
- **Current account; modest deterioration:** A record services balance surplus provides an offset, but the current account deficit is forecast to widen towards 5% of GDP by early 2017, largely on a further widening in the goods deficit (on assumed terms of trade falls). We're not picking it widening beyond that, based largely on our belief that current boosts to spending will prove temporary.
- **Fiscal; pristine numbers compared to fiscally profligate peers.** Our economic projections are broadly similar to those contained in the Half-Year Update, although a slightly softer nominal GDP profile corresponds with a more gradual pace of fiscal improvement, and an OBEGAL surplus of around 1% of GDP in 2018/19.

INTERNATIONAL OUTLOOK

SUMMARY

Global growth is respectable but this masks tensions. Prospects are firm for the US, subdued in Europe, modest in Australia, and a lottery in China. Although financial markets have recovered from their tumultuous start to the year, this appears to be driven more by liquidity than fundamentals and we question its sustainability. The world is awash with imbalances and leverage, policy firepower is facing diminishing returns, and appetites for sustained microeconomic reform are absent with political fracturing now apparent amid signs of voter backlash. That's a worrying combination.

STOP START

Financial markets have stabilised after their tumultuous start to the year. 'Down the elevator' has been replaced by 'up the stairs' for equities, commodities and emerging markets. More policy support (ECB, BoJ, PBoC) and a winding back of expected rate hikes by the US Federal Reserve have once again worked their magic.

We question the sustainability of the rebound.

- **Asset valuations need to transition away from liquidity-driven support to reflecting economic fundamentals (i.e. growth).** That's a tough transition to make if a) central banks keep offering more low-interest-rate stimulus in response to every market wobble, and b) fundamentals such as growth don't stack up.
- **The global economy is still lopsided;** too much saving by some (China, Japan, Germany), and not enough by others (the US).
- **The world's actions are dominated by self-interest and not group interest.** We need the reverse, but game theory tells us we won't get it.
- **Debt levels are still high around the globe.** The average level of government gross debt across the OCED is in excess of 85% of GDP.
- **China is an economic enigma.** Corporate debt is high, the return on equity for many industries is receding, non-performing loans are rising and with that follows questions towards the banking system, and the economy needs to transition from investment to consumption-centric growth. However, policymaker firepower is huge. Watch for the RMB to be a mechanism that exports "problems" as officials try to navigate the impossible trinity (a trilemma that states that it is impossible to have a fixed currency, free capital movement and independent monetary policy). Depreciation risks destabilising the Asian region.
- **The side effects of additional stimulus (i.e. negative interest rates) are becoming more and more apparent and openly debated.** We've seen credit spreads widen to partially compensate for negative rates. It's a farce to see negative rates and a world where creditors pay to lend and debtors are paid to borrow.
- **Microeconomic and structural reforms have been missing in action.** There has been too much central bank heavy lifting and insufficient government action.
- **Politics has moved more towards the "extremes".** Social unease, mistrust in the establishment and a failure to address growing inequality is seeing rising popularity of fringe politicians and parties in key jurisdictions. Witness the UK, Brexit debate and the US presidential campaigns. That portends poorer microeconomics, not stronger.

That said, there are bright spots. The world's largest economy – the US – is on a firm footing, although this is creating tensions over what the Fed ought to be doing locally (lift rates), versus globally (proceed cautiously). Europe is back recording anaemic but at least positive growth. China is seeing strong growth in service sector activity. The clamp-down on corruption – while painful for short-term growth – is a huge plug for the medium-term picture. Australia is navigating its shift from mining to non-mining led growth in a reasonably orderly fashion.

Our forecasts for the global economy depict a moderate growth backdrop overall. But this seemingly benign expectation belies the risks.

Calendar Years (annual average % change)	2012	2013	2014	2015	2016(f)	2017(f)	2018(f)
United States	2.2	1.5	2.4	2.4	2.3	2.3	2.3
Australia	3.5	2.0	2.6	2.5	3.0	3.2	3.1
Japan	1.7	1.4	-0.1	0.5	0.7	0.7	0.8
Euro Zone	-0.8	-0.2	0.9	1.6	1.5	1.6	1.6
China	7.8	7.7	7.4	6.9	6.4	6.0	6.0
Trading Partner Growth	**3.3**	**3.0**	**3.6**	**3.5**	**3.5**	**3.5**	**3.5**

PRIMARY SECTOR OUTLOOK

SUMMARY

The dairy and sheepmeat sectors are under pressure, significantly so in the case of dairying. Another negative cash-flow year beckons for dairy farmers and until global milk supplies ease, prices will struggle to recover. A sustained recovery in prices, buoying the payout, looks a 2017/18 season story. Prospects in other sectors range from steady to stellar. New Zealand's meat supply is expected to be back by near double digits, but this should help support prices. The main horticulture crops are on track to post impressive yields, and combined with solid prices, are likely to deliver very profitable returns. Forestry prices are being supported by domestic building activity, shipping rates at multi-decade lows, and a favourable NZD.

China's economic fortunes and supply dynamics remain front and centre for commodities. While the likes of milk powder and sheepmeat have continued to see negative pricing pressure out of China recently, this hasn't been universal. Log and wool exports, some of New Zealand's most highly exposed sectors to China (accounting for over half of total exports in each case), have seen stable to better in-market pricing in recent times. Within dairy, there is export growth outside of milk powders, for the likes of whey, lactose, butter and cheese. Other sectors such as beef, kiwifruit, pipfruit, and venison, which are less exposed, are continuing to see strong sales growth in China too. So it's far from one-way traffic.

On the supply side most sectors have had a better than anticipated growing season. National milk supply is likely to be back only 2-3% in 2015/16. This is impressive given the slow start to the season, a near 4% decline in the number of cows in-milk this season, and challenging financial conditions.

Plentiful global dairy supply is pressuring prices again. Europe remains the main area of competition. Supply has been higher than anticipated as efficient producing countries gun for market share and good weather conditions and low feed prices support milk yields. A product mix of SMP/milkfat continues to soak up excess milk, and is being exported to key New Zealand markets in Asia, Middle East and Africa. Import demand has been fairly steady outside the likes of Nigeria, Russia and Venezuela, which are all suffering economic/political challenges. China's milk powder demand picked up for the free-trade window at the end of 2015 too, suggesting inventory levels have normalised.

Prices are expected to "bounce along the bottom" until global milk supply growth reduces. History shows correcting supply-demand imbalances takes time. Producers invariably try to dig in and ride things out. There is pressure on governments for assistance. With this in mind, our milk price forecast is $3.95/kg MS for 2015/16 and $5.00 for 2016/17. The lower NZD helps the upcoming season but we are not expecting prices to lift in a sustained fashion for a while. A better payout helps in 2016/17 but we are still set for pressure on dairy cash-flow until 2018.

Supply is anticipated to be back in 2015/16 across other livestock sectors. Lamb supply is expected to be down 8%, beef -10% and venison -6%. High early-season sheepmeat production in anticipation of El Nino conditions and the smaller 2015 lamb crop is expected to see a tightening in supply for 2016. This will reduce the overhang of frozen inventory, supporting winter and new season pricing.

The beef market remains buoyant and supply focused too. Both Australian (-16%) and New Zealand (-10%) supply is anticipated to tighten. This is set to go head-to-head with improved market access for South American beef, some increase in US supply (2-4%) and fierce competition from competing meat proteins. Another high dairy cow cull is anticipated to moderate prices in the short term, but the spring and early summer period looks promising again.

The 2016 grape vintage is on track to bounce back above 400,000 tonnes (last year's vintage was 312,000 tonnes). Quality strategic decisions regarding management of heavy crop loads and disease pressures/risks will be required. While export market demand, fruit prices and the general outlook remain positive, appetite for a 2016 national harvest materially above average levels appears limited amongst wine businesses.

Good in-market prospects, especially in Asia, are expected to see a 5% increase in pipfruit exports despite a slightly smaller crop (less fruit diverted to processing). Nelson lost a significant amount of fruit (1.3 million TCEs, or 22% of the potential crop) in December to a hail storm. However, a heavier crop to start with and an expected 9% increase in the Hawke's Bay crop provide an offset.

The 2016 kiwifruit crop is expected to post a new record. Some crop management is anticipated to avoid oversupplying the market and increase the average size to provide market differentiation. Gold volumes are expected to double and the current hanging Green crop is nearly 89 million trays (up from 81 million trays in 2015). Pricing looks similar for Green around $5/tray and Gold continues to perform above expectations at around $8/tray.

Forestry prices have rebounded since late last year. Shipping rates at multi-decade lows and a more favourable NZD have been the main drivers. End Chinese demand remains uncertain, but inventory levels are not overly burdensome at present. Domestic timber demand remains solid driven by strong domestic housing activity.

FINANCIAL MARKETS OUTLOOK

SUMMARY

Short-end interest rates remain biased lower, with the RBNZ expected to cut the OCR twice more in 2016. The interest rate convergence theme remains in play, having been further underscored by easy global monetary policy settings and NZD divergence from fundamentals. With the US Federal Reserve on track to deliver two hikes this year, our forecasts have the yield curve steepening and NZ/US spreads narrowing as US yields move higher. We expect the NZD to weaken gradually as the RBNZ eases policy and the USD strengthens in response to Fed hikes. However, there is a limit to how soon or how quickly the NZD can weaken, given the ongoing strength of domestic economic data and the Fed's renewed dovish stance. We see NZD weakness as more of an H2 2016 story.

OCR LOWER, NZD BIASED LOWER TOO

We expect the RBNZ to cut the OCR twice more to a historic low of 1.75%. The combination of global uncertainty, China wobbles, low inflation (and inflation expectations), commodity (dairy) challenges, a high NZD on a TWI basis, and an unemployment rate above the NAIRU means even lower rates are on offer. It's not clear-cut – we have some clear concerns over what a lower OCR will mean for housing largesse and continued leverage build-up, and we still see the economy performing well overall – but rate cuts are simply more likely than not.

With market expectations for OCR cuts still shy of what we expect, front-end yields remain biased lower. At the time of writing, the market was pricing between one and two cuts by the end of the year, and for the first cut to occur by August. By contrast, we expect cuts in June and November. Moreover, with the OCR forecast to remain on hold through all of 2016 and 2017, and the first hike not expected until mid-2018, rates in the belly of the curve look set to remain low.

Assuming that the yield differential is also narrowed from the US side via two Fed hikes this year, that implies that the NZD will also go a lot lower, all else equal. This is particularly the case given the tendency for markets to respond more to the direction of policy moves than to interest rate differentials *per se*. Interest rate differentials have always been important for currencies, but correlation analysis shows that since 2012, the NZD has been more responsive to *six month changes* in the OCR than it has been to short-end interest rate differentials.[1]

This should not be particularly surprising given the mass of ultra-low (or negative) policy rates. Countries that have tended to pursue non-conventional or novel policy approaches have often seen their currencies face severe downward pressure. By contrast, those currencies with more normal policy settings have tended to be overvalued, making them vulnerable to a correction back towards fair value as policy rates converge.

While we have pencilled in a reasonably large fall in the NZD/USD (to 0.59) over the rest of calendar 2016, it needs to be put in perspective.

- While it is around 12% below the average level of the NZD/USD over 2016 to date, it is a much more modest reduction than was seen over the year to August 2015, for example, when it experienced a peak-to-trough fall of 30%.
- We reside in a world where currency volatility is high; 2 cent intra-day moves are now common-place, and the last two months has seen a 10% range – a low of 0.6348 on January 20th to a high over 0.6900 at the time of writing.
- It's a modest currency cycle on the downside. Typically, currencies overshoot and undershoot for material periods. The last two currency cycles have seen the NZD/USD hit 0.3915 and 0.4927 at the low point. This dynamic is somewhat tempered this time around, given:
  - We still expect NZD to remain attractive despite OCR reductions. Even if the OCR gets to 1.75%, it will still be 0.75%pt above where we expect the Fed Funds rate to be – and well above yields on offer across most of the OECD. In fact, yields are negative across a fair share of countries.
  - The NZD/USD is already around 22% off its 2014 peak of 0.88, and will have declined by 34% if it reaches our forecast level.
  - Of the seven total 25bp cuts we envisage at the completion of the RBNZ's easing cycle, five have already been delivered. The easing cycle is nearing maturity.
  - Growth in New Zealand is set to slow, but from a gallop to a canter. Financial conditions are flagging a growth slowdown, not a hard landing. It's the hard landings that have been associated with material undershoots in the NZD.
  - Outright New Zealand longer-term yields remain attractive on the global stage. Ten year yields are running at 3% compared with 1.8%

[1] Since 2011, the simple correlation between the NZD and 2 year swap rate differentials was 36%. By contrast, the NZD's correlation with the 6 month change in the OCR was 72%.

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in the US, and close to zero in Japan and Germany.

– Global policy settings are also getting easier – it is not just the RBNZ that is easing.

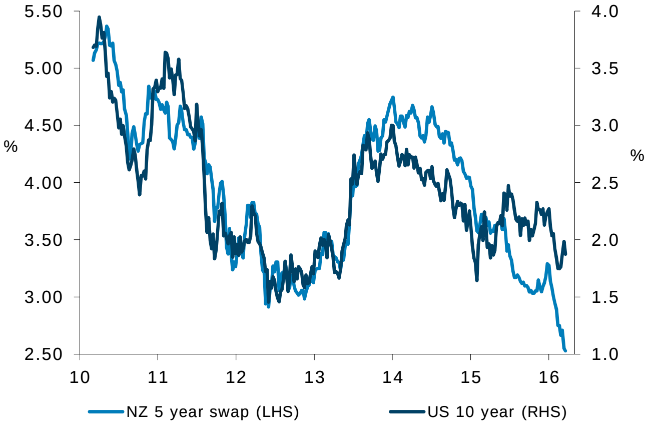
These considerations point to a mildly lower NZD, rather than a dramatic fall. They also point to a more demure trough in the currency cycle compared to previous cycles.

If there is a risk to the forecast it is that the NZD remains more elevated than projected. Put simply, New Zealand's economic credentials could continue to look decidedly stellar across global peers, particularly with the economy showing less hi-beta characteristics to the global economic cycle.

US LONG-TERM BOND YIELDS HIGHER, NZ YIELDS STABLE AS SPREADS NARROW

Our forecasts have US 10-year Treasury bond yields moving gradually higher over the course of 2016 and 2017 (to 2.2% and 2.8% respectively, from a current level of around 1.9%). Given the close correlation between US and New Zealand bond yields, (figure 1) we also expect local interest rates to rise over the next two years, with the bulk of the rise occurring over 2017. Over 2016, we expect New Zealand 10-year bond yields to hold broadly stable, with the rise in US yields absorbed via a narrowing in the NZ/US spread.

FIGURE 1: NEW ZEALAND AND US INTEREST RATES

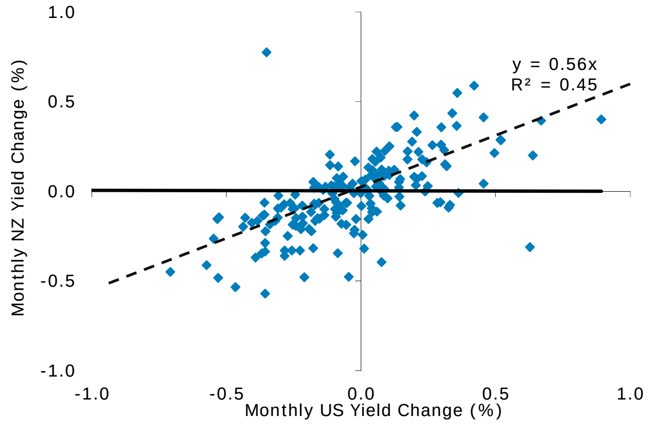


Source: ANZ, Bloomberg

This forecast is built on our expectation that the New Zealand market continues to trade as a "low beta" market with respect to the US (figure 2). Furthermore, we assume that upcoming RBNZ OCR cuts (pencilled in for June and November) come at approximately the same time as Fed hikes (which we have pencilled in for June and December).

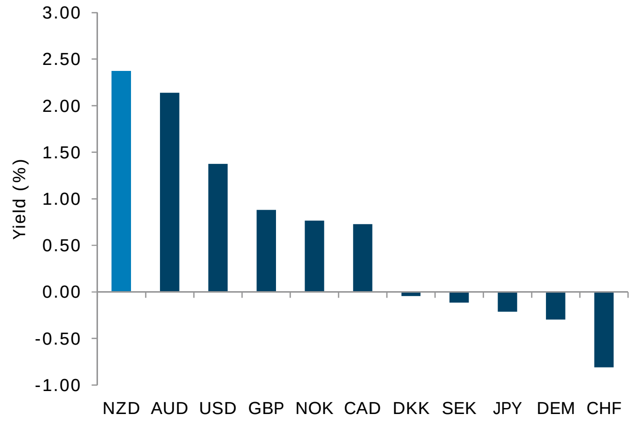
This forecast is also consistent with the "interest rate convergence" theme, which remains in play. With currencies now implicit vehicles for expressing monetary policy loosening and tightening, currency divergence from economic fundamentals necessitates interest rate convergence to realign the former. Countries where both rates and currencies diverge see an aggressive tightening in financial conditions that eventually rolls the economy. Witness the nations that tried lifting rates after the GFC; hikes rapidly became cuts. If anything, it is now even more relevant than it has been in years gone by, with the emergence of negative bond yields shining a light on New Zealand's (and Australia's) much higher yields (figure 3).

FIGURE 2: NEW ZEALAND AND US 10-YEAR BOND YIELD CHANGES SINCE 2000



Source: ANZ, Bloomberg

FIGURE 3: G10 SOVEREIGN 5-YEAR BOND YIELDS



Source: ANZ, Bloomberg

CREDIT SPREADS: MIND THE GAP

Credit spreads remain elevated, and while they have closed a tad in recent weeks, they are generally wider than they were in Q4 last year. Going forward, **the risk is they widen further.** What particularly concerns us is the harm being done to credit markets in countries with negative interest rates. As interest rates go lower, end investors in those markets are

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becoming increasingly disillusioned, which in turn leads to a reduction in issuance and liquidity. Price-makers respond to this by lifting bid/offer spreads, which leads to a downward spiral in market confidence as even less liquidity leads to even wider spreads, and so on.

FIGURE 4. ITRAXX AUSTRALIA INDEX OF 5-YEAR INVESTMENT GRADE CREDIT SPREADS

Source: ANZ, Itraxx, Bloomberg

Eventually the market reaches a point where the spread required to attract investors is uneconomic to issuers, and the market dries up. This has happened in some market segments in Europe. But because the issuers still need to fund, they look elsewhere, to markets where yields are still relatively normal, like New Zealand. As those issuers (who are typically global issuers) tap investors in the local market, that puts more supply into the market, which in turn leads local investors to become more price sensitive, with the end result being wider spreads here too.

This "downward spiral" is exacerbated by the deeper inversion of basis swap spreads that has occurred in Europe (which is itself a by-product of excess savings). As basis swap spreads in those markets move further into negative territory, it tends to lift credit spreads here, as it makes it even cheaper for European issuers to fund in New Zealand dollars, further crowding out domestic issuers.

All else equal, if sustained, wider credit spreads will have an adverse impact on financial conditions, which in turn poses downside risks to the OCR.

INDIVIDUAL CURRENCY PAIR FORECASTS:

NZD/USD: Downside risks, but timing critical. Domestic data remains relatively sound, despite having clear downside risks, with dairying at the epicentre. The NZD is currently showing resilience to economic downside risks, the RBNZ rate cut (the NZD is higher than when the RBNZ cut in March) and the subsequent re-pricing in the short end of the rates curve. Markets will probably have to wait for domestic data to actually soften before further domestic risks are priced into the NZD. Conversely, US data, while continuing to provide a rationale for USD optimism, is being ignored as markets remain wary of a US Federal Reserve that is reluctant to continue with the normalisation process. We would expect markets to lead and strengthen USD before the Fed comes to the party – with our current view being that that is likely in June. We continue to look for a final leg lower for NZD/USD in H2 2016 before turning more neutral on prospects in 2017.

NZD/AUD: Supported, but testing. We expect NZD/AUD will remain range-bound above historical averages, but the risks of a test lower are growing. Long term we are more comfortable selling this cross in the 90s than buying it at current levels. This is because we continue to see minimal prospects for parity on this cross, but do eventually see a return to longer-run averages. While we still see the New Zealand economy tracking better than Australia, our interest rate forecasts have the NZ OCR ending 2016 lower than the Australian cash rate. This suggests that while exporter hedging at 2½ year lows is prudent, risks are for a move lower. Options are favoured.

NZD/CNY: Freeing up. The pace of free-market reform is expected to accelerate in China in 2016. Continued steps toward liberalising its capital account are likely to keep China as a source of global economic downside risk. However, the de-emphasising of the USD/CNY peg allows USD/CNY to appreciate over the balance of the year, tempering the impacts of any NZD/USD weakness, and seeing this cross break away from NZD/USD. We recommend an increased focus on this cross as it trades increasingly on its own fundamentals.

NZD/GBP: Brexit – a defining question. Brexit is the defining question for NZD/GBP and indeed the GBP more generally. On June 23 the British public will vote yes or no to staying in the EU, with the result binding. A no vote would result in a two-year exit period for the UK, during which time uncertainty would be high and the UK economy and thus GBP would likely suffer. Polls are close, leaving direction in the hands of the British public. Given we believe the vote will be to stay in the EU, we believe exporters will see better levels in H2 2016. But it's risky to be unhedged for such a pivotal event.

NZD/EUR: Lower, but many unknowns. Our forecasts have EUR strengthening in H2 2016, sending NZD/EUR lower as Europe's slow recovery

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continues. But the volatility around this forecast is expected to be unusually high and risks are that this cross remains elevated. The ECB is expected to remain prepared for still further policy support and there is the question of the impact on EUR of a UK vote to leave the EU. This will likely keep this cross elevated in Q2 2016. Any NZD/EUR rallies should provide opportunities for importers, while exporters can wait until better opportunities present themselves.

NZD/JPY: Downside risks, based on efficacy of policy. We believe there are downside risks to NZD/JPY. This cross is perhaps the most interesting at the moment, as it is likely to provide insights as to whether monetary policy easing has limits. The JPY has risen 18% since the advent of "Abenomics" and associated BoJ monetary policy measures. Markets are questioning if the BoJ can do anything further to weaken the JPY.

Forecasts (end of quarter)								
FX Rates	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**
NZD/USD	0.69	0.65	0.63	0.59	0.58	0.58	0.60	0.62
NZD/AUD	0.90	0.88	0.88	0.88	0.88	0.88	0.88	0.89
NZD/EUR	0.61	0.59	0.59	0.55	0.52	0.50	0.50	0.51
NZD/JPY	77.8	68.3	66.2	62.0	58.0	58.0	60.0	62.0
NZD/GBP	0.48	0.48	0.43	0.39	0.37	0.37	0.38	0.38
NZD/CNY	4.44	4.26	4.16	3.92	3.87	3.89	4.03	4.19
NZ$ TWI	73.1	68.6	67.1	63.4	61.4	60.9	61.8	63.1
Interest Rates	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**
NZ OCR	2.25	2.00	2.00	1.75	1.75	1.75	1.75	1.75
NZ 90 day bill	2.34	2.13	2.05	1.88	1.88	1.88	1.88	1.88
NZ 2-yr swap	2.21	2.28	2.33	2.31	2.41	2.49	2.57	2.63
NZ 10-yr bond	2.98	2.98	2.92	2.90	3.05	3.20	3.35	3.50

KEY ECONOMIC FORECASTS

Calendar Years	2012	2013	2014	2015	2016(f)	2017(f)	2018(f)
NZ Economy (annual average % change)							
Real GDP (production)	2.6	2.4	3.7	2.5	2.8	2.5	2.6
Private Consumption	2.8	3.0	2.7	2.5	3.6	2.7	2.6
Public Consumption	-0.4	1.6	2.7	2.2	1.3	1.1	0.8
Residential investment	13.3	12.9	14.6	5.0	5.3	-3.6	-1.2
Other investment	5.2	2.9	9.7	2.5	3.7	4.5	4.2
Stockbuilding[1]	0.1	0.1	0.0	-0.3	0.2	0.1	0.1
Gross National Expenditure	3.1	3.2	4.4	2.3	3.5	2.4	2.4
Total Exports	1.9	0.8	3.0	6.7	2.0	3.3	3.3
Total Imports	2.8	6.2	7.9	3.7	2.4	3.6	3.7
Employment (annual %)	0.1	2.9	3.5	1.4	2.0	1.7	1.4
Unemployment Rate (sa; Dec qtr)	6.8	6.1	5.8	5.3	5.5	5.3	5.0
Labour Cost Index (annual %)	1.8	1.6	1.7	1.5	1.8	2.1	2.1
Terms of trade (OTI basis; annual %)	-8.9	20.2	-5.0	-3.2	-7.8	7.2	1.0
Prices (annual % change)							
CPI Inflation	0.9	1.6	0.8	0.1	1.0	1.9	1.9
Non-tradable Inflation	2.5	2.9	2.4	1.8	1.7	2.4	2.7
Tradable Inflation	-1.0	-0.3	-1.3	-2.1	0.0	1.2	1.4
Fiscal and External Balance							
Current Account Balance ($bn)	-8.5	-7.0	-7.4	-7.5	-11.7	-11.9	-11.2
as % of GDP	-3.9	-3.1	-3.1	-3.0	-4.7	-4.6	-4.1
Government OBEGAL ($bn)*	-9.2	-4.4	-2.8	0.4	-0.4	0.1	0.7
as % of GDP	-4.3	-2.0	-1.2	0.2	-0.2	0.0	0.2
NZ Financial Markets (end of December quarter)							
TWI	73.8	77.3	79.4	73.7	63.4	63.1	
NZD/USD	0.82	0.82	0.78	0.69	0.59	0.62	
NZD/AUD	0.79	0.92	0.96	0.94	0.88	0.89	
NZD/CNY	5.12	4.98	4.86	4.45	3.92	4.19	
NZD/EUR	0.62	0.60	0.64	0.63	0.55	0.51	
NZD/JPY	70.8	86.3	93.6	82.5	62.0	62.0	
NZD/GBP	0.51	0.50	0.50	0.46	0.39	0.38	
Official Cash Rate	2.50	2.50	3.50	2.50	1.75	1.75	2.50
90-day bank bill rate	2.69	2.84	3.68	2.75	1.88	1.88	2.72
2-year swap rate	2.67	3.85	3.80	2.85	2.31	2.63	2.99
10-year government bond rate	3.52	4.72	3.67	3.57	2.90	3.50	3.55

[1] Percentage point contribution to growth

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