NEW ZEALAND ECONOMICS
ANZ ECONOMIC OUTLOOK

SEPTEMBER 2015

INSIDE

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STEPPING UP TO THE CHALLENGE

NEW ZEALAND ECONOMIC OUTLOOK

The economy is soft but far from capitulating. Challenges exist, but key positives remain and our projections are of the "soft-landing" variety, with easier financial conditions and a still-decent economic backbone expected to see growth accelerate later next year. That said, the risk profile is still downwardly skewed. And while the key risks (China and now the weather) are not generally of the home-grown variety, a few more domestic vulnerabilities are creeping in too.

INTERNATIONAL OUTLOOK

Global economic risks are elevated. While the outlook for developed economies is for steady to slightly improving growth, the outlook for emerging market economies has weakened as the Chinese economy slows and transitions its growth model. We have pencilled in modest growth, but with a downwardly sloped risk profile. Volatility is set to remain high.

PRIMARY SECTOR OUTLOOK

Dairy prices have bounced aggressively, improving the outlook for incomes in 2015/16. Lower local supply is a key main driver, which isn't ideal for farm profitability. For red meat farmers, the income outlook depends on the farm type and income split between different enterprises. Horticulture is expected to see some of the best sector returns, led by kiwifruit and pip-fruit.

FINANCIAL MARKETS OUTLOOK

We expect more RBNZ easing, albeit at a slower, data-dependent pace from here. But the real issue for markets is where the risk profile resides. Like the RBNZ, we believe the risks are skewed lower, and all else equal, that implies lower short-term interest rates and a softer NZD over time. However, those are 2016 stories. We expect the NZD and NZ interest rate markets to wash around over the coming months given signs of stabilisation in the data flow.

Calendar Years	2013	2014	2015(f)	2016(f)	2017(f)	2018(f)
New Zealand Economy						
Real GDP (annual average %)	2.3	3.3	2.1	2.2	2.7	2.5
Unemployment Rate (Dec quarter)	6.1	5.7	6.2	6.1	5.5	5.4
CPI Inflation (annual %)	1.6	0.8	0.7	2.0	2.1	1.9
Terms of Trade (SNA basis; annual %)	16.9	-4.2	-6.5	2.8	0.4	0.2
Current Account Balance (% of GDP)	-3.2	-3.1	-4.4	-6.0	-5.5	-5.1
Government OBEGAL (% of GDP)	-2.0	-1.3	0.1	0.1	0.2	0.5
Global Growth (annual average %)						
US	1.5	2.4	2.4	2.3	2.3	2.2
Australia	2.1	2.7	2.2	2.4	2.9	2.5
China	7.7	7.4	6.8	6.3	6.0	6.0
Trading Partners	3.0	3.6	3.4	3.5	3.5	3.4
NZ Financial Markets (end of Dec quarter)						
TWI	77.3	79.2	67.7	64.1	63.7	
NZD/USD	0.82	0.78	0.61	0.59	0.59	
NZD/AUD	0.92	0.95	0.91	0.92	0.92	
Official Cash Rate	2.5	3.5	2.8	2.5	3.5	
10-year Bond Rate	4.7	3.7	3.2	3.0	3.2	

* Forecasts and text finalised 28 September 2015

NEW ZEALAND ECONOMIC OUTLOOK

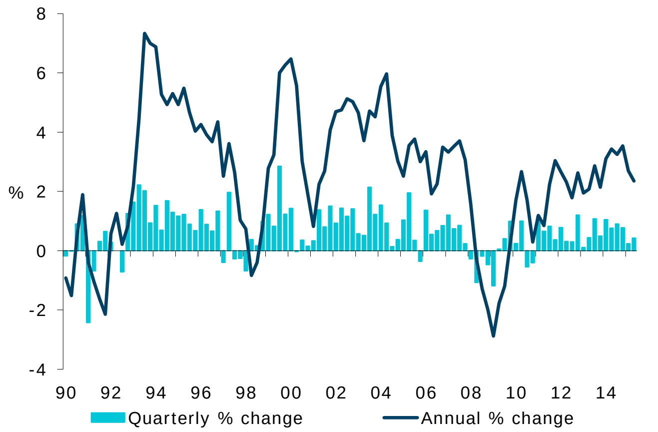
SUMMARY

The economy is soft but far from capitulating. Challenges exist, but key positives remain and our projections are of the "soft-landing" variety, with easier financial conditions and a still-decent economic backbone expected to see growth accelerate later next year. That said, the risk profile is still downwardly skewed. And while the key risks (China and now the weather) are not generally of the home-grown variety, a few more domestic vulnerabilities are creeping in too.

STEPPING UP TO THE CHALLENGE

The New Zealand economy has clearly entered a more challenging period. Growth averaged just a 0.3% quarterly pace over the first six months of the year vis-à-vis a 0.9% quarterly pace over the second half of 2014. Annual growth slowed to 2.4% in Q2 (the slowest since December 2013) and timelier indicators suggest a pace tracking perhaps a tad below 2% at present; not dire – nor a downturn – but certainly sluggish and consistent with deceleration. In per-capita terms, activity is treading water and slowing labour demand (but still-strong labour supply growth) has seen the unemployment rate tick up to close to 6%. Consumer and business confidence have fallen, and where the expansion was previously relatively broad-based, a more divergent regional performance is now evident.

FIGURE 1. NEW ZEALAND ECONOMIC GROWTH



Source: ANZ, Statistics NZ

While some of the blame can be placed on the dry weather earlier this year and volatility in agricultural production, part of this deceleration – at least its initial stages – is natural. Economies record strong growth when rebounding off lows (there is plenty of "room to grow"). They then transition into a period of moderate growth but off a higher base as speed limit constraints kick in. In themselves, therefore, decelerations should not be seen as alarming.

However, there are clearly other forces that are contributing to this weaker picture. Domestically at least, these forces are now reasonably well known and centre on three main elements:

1. **The terms of trade (dairy price) hit.** The recent recovery in dairy prices has been remarkable (over a 40% rise in the past three auctions) and removes some of the extreme downside risk that was previously evident. However, price gains have come on the back of expectations of lower volumes. Cash flow is still extremely tight and will remain so for some time. Farmer spending is constrained and downstream industries and rural regions are now feeling the pinch. While the terms of trade outlook is not looking as grim as it did a few months ago, we are still assuming a circa 15% peak-to-trough fall to the middle of next year, which represents the largest fall over a two-year period since the mid-1970s. Beyond the purchasing power hit, the weaker terms of trade brings with it associated pressures on national incomes, fiscal revenues, household spending and confidence.
2. **A peak in the earthquake rebuild.** The pipeline of work is still large. But the impetus to growth from rebuild activity is now negligible (i.e. the level of work is plateauing). Considering that over 2012, 2013 and 2014, the rebuild directly contributed around 0.7, 0.6 and 0.3 percentage points to GDP growth respectively, this plateauing in activity is a meaningful source of growth the economy can no longer rely on. While we are not overly concerned from a nationwide perspective (spare construction resources will eventually relocate to other pressure points), clearly it brings with it regional challenges. Canterbury house prices and rents have fallen and confidence has reacted accordingly.
3. **Structural metrics have deteriorated at a time when asset prices** (read Auckland house prices) **are extended.** Credit growth is tracking above nominal GDP, the household savings rate is deteriorating, the current account is widening and household debt-to income is elevated – and rising again. For now, these developments are a fillip to growth, filling the likes of the terms of trade void. But it's a temporary one. Borrow-and-spend type growth cannot extend. It's a combination that doesn't necessarily foretell a correction, but it certainly flags an additional layer of vulnerability.

Other factors can of course also be thrown into the mix. After phenomenal strength, Auckland house prices now appear to be plateauing (although other regions are not), household income growth is slowing, and firms are being more cautious with their investment decisions. While some forward-looking

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indicators have, encouragingly, stabilised, they are more consistent with the economy holding its own and not taking another leg lower, rather than suggesting an acceleration just yet. We have pencilled in a 0.5% quarterly pace of GDP growth to finish off the year, and while there are both upside and downside risks to that (there always are, given the fickle nature of New Zealand's GDP figures), annual growth is forecast to end the year at just 1.7% y/y – the lowest since 2011.

That's sub-par, but far from recessionary. The economy would normally expect to track around 0.7% per quarter on average, so the economic engine is stuck in 3rd gear at present as challenges are worked through. The current rate of growth is insufficient to soak up new entrants into the labour market (particularly with migration booming). That means the unemployment rate is forecast to tick higher, peaking at 6.3% early next year, keeping wage growth contained.

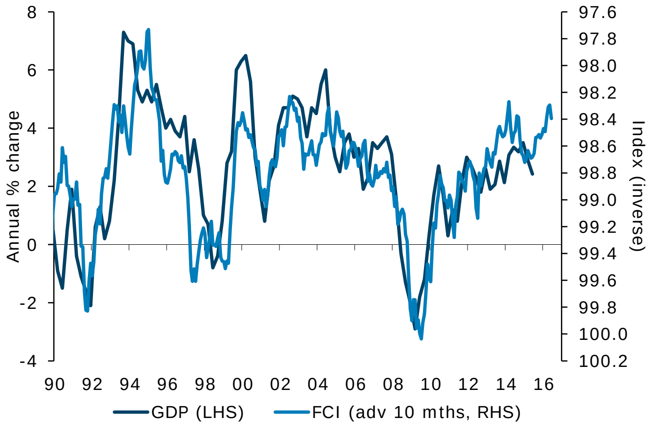
Domestic inflation pressures should remain sedate as a result. Non-tradable inflation is forecast to trough at just 1.4% y/y early next year, which would be the lowest since 1999. The lower NZD will help generate a modest lift in tradable inflation (although we are assuming only a modest pass-through given the sluggish demand backdrop) and this will see headline inflation back within the target band early next year. But it is still a backdrop that warrants additional easing in monetary conditions. We expect this easing to come through a combination of both a lower OCR (to 2.5%, although not necessarily in October) and the NZD (to 0.59 at the end of Q1 2016).

BUT HOLD ON, IT IS CERTAINLY NOT ALL BAD

Activity is sluggish at present, but the economic picture is far from one of capitulation. There are challenges and pressures in some pockets. But an undue focus on the negatives means one risks missing some key positives that are still present.

- **NZD weakness has made a number of export industries far more competitive.** Tourism is booming and should shortly take the title from dairy as the country's top export earner. International connectivity is rising; just look at the airports, which are attracting more airlines and routes. The lower NZD is adding cyclical support to what has already been a positive structural story. And importantly, the sectoral multipliers from the tourism sector are likely to be larger than in dairy. The manufacturing sector appears to be absorbing dairy headwinds, with the PMI lifting recently and averaging 53.7 year-to-date. Positive anecdotes are abundant from some of other export sectors (pip-fruit, kiwifruit, wine, beef etc).
- **The construction sector pipeline remains significant.** Demographic housing needs and infrastructure requirements in many regions – but particularly in Auckland – mean that the construction sector more broadly will still contribute positively to growth for a time yet, even with plateauing Canterbury rebuild activity. There are a number of major projects that are yet to get underway and recent dwelling consent data has been encouraging. Residential investment is forecast to grow 6% over 2016.
- **An array of economic indicators are still healthy.** Migration is strong, and with New Zealand expected to more than hold its own against Australia in the growth stakes, the net numbers should remain high. Headline confidence is weak, but what firms expect for their own business is still reasonably positive, and this matters more. The housing market is responding to lower interest rates and some regions are now playing catch-up to Auckland, given how stretched the rubber band had become. New Zealand equities are holding in better than global peers amidst uncertainty; that's a healthy sign.
- **Financial conditions have loosened – a lot.** Taken at face value, our Financial Conditions Index is pointing to a meaningful acceleration in growth prospects next year. For sectors outside of dairy, the lower NZD is massively beneficial. Mortgage rates have fallen and even recent equity price declines haven't dented overall conditions much.

FIGURE 2. FINANCIAL CONDITIONS



Source: ANZ, Statistics NZ, Bloomberg

- **The small things still matter too.** We have long been proponents of New Zealand's strong microeconomic story and still think this theme is underappreciated. It is the hard yards grafted over recent years and the "just get on with it" attitude that we sense is still a big part of the New Zealand business psyche. There is a self-belief that is

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keeping the business wheels turning and this gives the economy more resilience and "back-bone".

Our projections are of the "soft-landing" variety. We do not buy into speculation of a pending recession. In fact, we see risks of such a scenario as being quite low at present. And even so, there is more room for the NZD, OCR and fiscal policy to step up to the plate to provide additional support if domestic growth prospects fail to stabilise. After levelling out later this year, we forecast annual growth to gradually accelerate over 2016, reaching 2¾% early in 2017. This should be enough to eventually help to stabilise labour market conditions and see the unemployment rate begin to head back towards 5½%.

BUT RISKS ARE ELEVATED

Our base case for the economy is relatively sanguine. But the risk profile is still down (as are risks for the OCR and NZD). First and foremost, when an economy slows to its current 1-2% pace, that leaves it far more vulnerable to any negative shocks, particularly when structural metrics are starting to deteriorate as noted above.

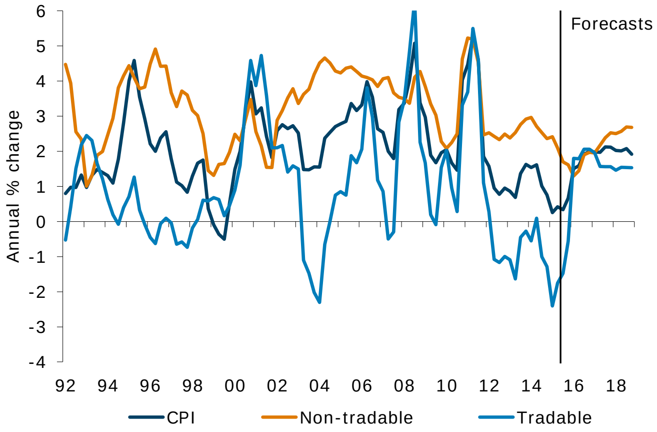
The majority of the risks, however, reside offshore, with our eyes especially drawn to China. Chinese growth has slowed, with little sign yet that the economy is responding meaningfully to policy support. And together with the attempts by policymakers to wean the economy off a credit binge, open it up to more market forces, and maintain social cohesion, there is certainly plenty of scope for wobbles. China is the biggest source of upside potential for New Zealand, but it is also the biggest source of downside risk in the near-term. Not only this, but we are still waiting for clarity on how financial markets will fare on the back of Fed tightening (a marginal tweak in the cost of capital but still a key one). Recent equity market volatility shows that growth concerns are now dominating the allure of cheap credit. And then there is the weather – in particular the possibility of a severe El Nino event that could potential throw the economy a curve-ball (see page 6). It has historically often been a global event rather than a domestic one that has driven the New Zealand economy into significantly weaker outcomes.

While global risks are elevated, they are partly mitigated by the potential for the OCR and NZD to move lower still if necessary, and for fiscal policy to step up to the plate too.

IN SHORT: OTHER FEATURES OF OUR FORECASTS

- **Domestic demand:** Slowing household consumption but reasonable (but not spectacular) investment growth will see Gross National Expenditure grow in a 2 to 2½% range over the next few years.
- **Net exports:** After dragging on growth to the tune of 0.3%pts per quarter on average since 2012, net exports contribute positively to growth (0.1%pt per quarter on average over the forecast period), led by services exports.
- **Current account:** Courtesy of a wider goods deficit, the current account deficit is forecast to widen towards 6% of GDP by the middle of 2016, but then improve modestly.
- **Inflation:** Headline inflation is forecast to average 0.4% and 1.7% over 2015 and 2016 respectively, with tradable inflation (NZD) largely behind the lift.
- **Fiscal:** Underlying fiscal surpluses return in FY15 and remain over the projection period, but only modestly (around 0.1% to 0.5% of GDP) – smaller than Treasury projections. Net debt remains below 27% of GDP.

FIGURE 3. NEW ZEALAND CPI INFLATION



Source: ANZ, Statistics NZ

INTERNATIONAL OUTLOOK

SUMMARY

Global economic risks are elevated. While the outlook for developed economies is for steady to slightly improving growth, the outlook for emerging market economies has weakened as the Chinese economy slows and transitions its growth model. We have pencilled in modest growth, but with a downwardly sloped risk profile. Asset prices are transitioning away from cheap money as the main driver and towards sustainable growth. Volatility is set to remain high.

GENTLY DOES IT

We expect global growth of 3.5% over the next couple of years. That's respectable on the face of it but it masks some key tensions. **Emerging market (EM) economies are moderating from high rates of growth** and financial risks are rising in some countries after a period of rapid leverage. A trade recession is apparent across parts of Asia.

China is a focal point – it is expected to slow to 6% growth over the next two years. A shift to lower growth is inevitable for both China and the world economy as the Chinese growth model transitions. However, key questions surrounding the extent of the slowdown are unanswered, including: how leverage is unwound; the mispricing of risk; the extent of low-quality investment; vulnerability to a stronger USD; and how an even slight tweak higher in US interest rates will impact, given debt levels. Weakness in global commodity prices is partly related to China demand, and volatility across Asian equities is unsettling.

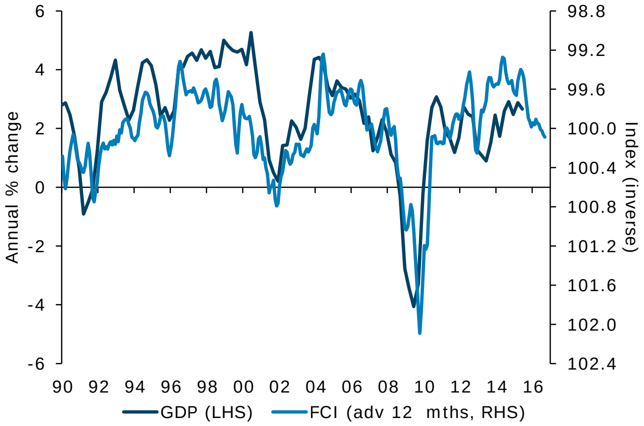
A key focal point in the coming months will be tension between cheap money (low interest rates) and growth. The former has dominated asset price valuations post the GFC. With a hike in the Fed Funds rate around the corner, attention is turning more towards growth. Equity market and commodity volatility is on the rise as a consequence. The ECB and BoJ are still running abundant QE programmes. However, the US Federal Reserve is the key bellwether for the global cost of capital and strength across the domestic economy flags rates moving up, though not in an aggressive manner.

Markets are becoming more attuned to the consequences; hence the shift in emphasis towards growth as opposed to liquidity and cheap money. The cost of capital is not set to move up aggressively; it can't – and won't need to, given subdued inflation. However, small tweaks will still pack some punch due to high leverage, particularly in the EM world.

The outlook for developed economies is for steady to slightly improving growth. The US economy is likely to be the standout, but even the world's largest economy is not immune from weakness elsewhere given that we reside in a coupled, as opposed to a decoupled, world. Nor is Europe immune, where a subdued outlook is forcing policymakers to keep the policy floodgates open. The high USD and lower equity values have tightened US financial conditions (see chart) and given limits on available capacity it is difficult to envisage a scenario where US growth can exceed its potential rate of around 2% over the medium term. Meanwhile, Japan and Europe are expected to grow between 1 to 2% in the coming years. **We expect modest growth in Australia.**

From a longer-term perspective, structural drivers point to lower potential growth in both advanced and emerging economies. Ageing populations are encouraging saving rather than spending, while productivity growth has slowed. Global inflation is expected to remain low owing to commodity price weakness and excess manufacturing capacity. Both short and long-term interest rates are set to stay low amid soft inflation and nominal GDP.

FIGURE 1. US GDP AND FINANCIAL CONDITIONS



Source: ANZ, Bloomberg

Calendar Years (annual average % change)	2012	2013	2014	2015(f)	2016(f)	2017(f)	2018(f)
United States	2.2	1.5	2.4	2.4	2.3	2.3	2.2
Australia	3.6	2.1	2.7	2.2	2.4	2.9	2.5
Japan	1.7	1.6	-0.1	1.1	1.0	1.0	1.0
Euro Zone	-0.8	-0.2	0.9	1.5	1.5	1.6	1.5
China	7.8	7.7	7.4	6.8	6.3	6.0	6.0
Trading Partner Growth	**3.3**	**3.0**	**3.6**	**3.4**	**3.5**	**3.5**	**3.4**

PRIMARY SECTOR OUTLOOK

SUMMARY

Dairy prices have bounced aggressively, improving the outlook for incomes in 2015/16. Lower local supply is a key driver, which isn't ideal for farm profitability. For red meat farmers, the income outlook depends on the farm type and income split between different enterprises. Horticulture is expected to see some of the best sector returns, led by kiwifruit and pip-fruit.

In the livestock sectors, the NZD and domestic supply outlooks dominate the direction for farm-gate prices at present. Dairy prices have bounced aggressively, but from extremely low levels. Buyer impetus has increased post the capitulation seen in prices during July/early August. The main catalysts have been: 1) anticipated lower New Zealand supply due to a reduction in cow numbers and the recalibration taking place in farm management practices to cope with tight cash-flow; 2) Fonterra substantially reducing the seasonal supply of powder to be auctioned via GDT; and 3) an increase in China's seasonal import requirements, as well as bargain hunting by others. **The market continues to think buyer impetus will return and will front-run lower New Zealand production, pushing prices back over US$3,000/t in short order. Such an outcome could deliver a milk price in the lower $5/kg MS range**, given the magnitude and speed of the turnaround.

However, we are a little more cautious from here. New Zealand product is now more fairly priced relative to key competitors such as the US and Europe, many buyers have loaded up on cheap product in recent times, and the global demand backdrop is still fragile. **Hence we have a milk price forecast of $4.25-$4.50/kg MS at present.** From a farm profitability view it must be remembered that lower output is not the ideal catalyst for a price turnaround as it still impacts on the revenue-line. Cash flow is still tight too and will remain so for some time even with the recent forecast upgrade for 2015/16. This means farmers won't be out spending on anything non-essential in a hurry. Given the changeable nature of the marketplace, caution should be applied to any forward-looking views on what may, or may not, be delivered into bank balances over the coming 12+ months.

In the red meat sectors, lower output across the board is expected. This is largely due to lower sheep, deer and beef cattle breeding stock numbers from a mixture of lower stocking rates from previous dry periods (particularly 2013) and continued land use change in recent years to dairying, or dairy support. **The focal point for lower supply is sheep meat.** Breeding ewe numbers have dropped by a further 0.90 million head (-4.5%) this year. Combined with tough tupping conditions, this has set up expectations of a substantially smaller 2015 lamb crop (-7.2% y/y). The partial offset to this appears to be good lamb survival rates so far this spring. All up, when combined with a lower NZD, this is expected to be supportive for farm-gate prices, especially on the shoulders of the season. This is despite softer in-market conditions in the two main markets of the UK and China.

Therefore, farm incomes will depend on the farm type and income split between different enterprises. Beef, venison and wool are expected to see solid-to-good returns; sheep meat will be okay; and dairy support/cash cropping will be tougher.

Horticulture is expected to see some of the best sector returns. The kiwifruit sector will have its best year since Psa was discovered and pip-fruit sales across both Europe and Asia have been solid. In viticulture, while there was a materially lower 2015 vintage, a lift in bulk wine and grape prices softens the blow. The overall impact is variable depending on the specific attributes of an individual wine company.

There has been a lot of talk about potentially the fourth-strongest El Nino conditions on record and its possible impact on the 2015/16 season. Typically during an El Nino event the country tends to experience stronger and/or more frequent winds from the west and south-west, leading to less precipitation in the far north and east of the country, but more in the west.

Recent El Nino episodes have not led to the "typical" conditions that accompany such an event, making it difficult to draw firm conclusions. But even **a "typical" El Nino would lead to quite different outcomes for farmers depending on location, but also farm type.** In the dairy sector it would lead to a tougher time for production and feed costs outside the West Coast of both islands (nearly 40% of total supply). The offset would likely be better international prices, depending on the magnitude and extent of the drop in total local production. For red meat farmers on the East Coast, which captures roughly 50% of beef cattle, 60% of deer and 60% of the sheep flock, it would lead to the earlier turn-off in finishing stock and possible further reduction in capital stock numbers, depending on severity. This would likely weigh on prime and store prices. For finishing farmers on the West Coast of the North Island and Southland it would likely create better store stock buying options. In the horticulture sectors it would depend crucially on the timing of certain conditions during the different growing seasons. It could perhaps weigh on the quality of the 2016 kiwifruit crop if there was too much rain and wind in the Bay of Plenty region. Pip-fruit and grape crop quality would probably be better, as long as there was no water stress along the way.

FINANCIAL MARKETS OUTLOOK

SUMMARY

We expect more RBNZ easing, albeit at a slower, data-dependent pace from here. With near-term market expectations reasonably closely aligned with the RBNZ's projections and our forecasts, the real issue for markets is where the risk profile resides. Like the RBNZ, we believe the risks are skewed lower, and all else equal, that implies lower short-term interest rates and a softer New Zealand dollar over time. However, those are 2016 stories. We expect the NZD and NZ interest rate markets to wash around over the coming months given signs of stabilisation or improvement in key economic indicators such as dairy prices.

EASING MONETARY CONDITIONS

Currency and interest rate markets remain highly attuned to central bank policies, particularly with the Fed signalling that it expects to raise rates soon, the RBA expected to deliver a further 50bps of cuts next year and the RBNZ signalling that it expects to cut again.

For currency markets, **such an outlook would ordinarily be suggestive of NZD/USD weakness.** We tend to concur, noting only that: 1) the NZD has already depreciated by around 25 cents from its peak; and 2) the Fed's decision not to hike in September is likely to see the USD's advance take a breather. Nonetheless, this is more about timing than direction. The recent lift in dairy prices off lows also portends a period of NZD consolidation before the downtrend resumes, ultimately taking NZD/USD into the 0.50's; our forecast is 0.59 by the end of Q1 2016.

Our assumptions for individual currency pairs are as follows:

NZD/USD: Consolidating – with downside risks. The risk profile for the NZD/USD is still skewed toward further depreciation. This profile is driven by the China/EM slowdown, and the USD 'normalisation' bull trend. Domestic risks have stabilised and we see domestic and RBNZ pressure on the NZD as having moderated.

NZD/AUD: Above long-run averages. Our expectations of 50bps of RBA cuts from next year as opposed to a solitary RBNZ rate cut (also next year) should support NZD/AUD above historic levels. We now forecast NZD/AUD to end 2016 above 0.90. In the short term, we expect external factors to be influential for both AUD and NZD, which will see NZD/AUD volatility persist.

NZD/GBP: Still normalising. The UK economy continues to improve and we agree with the widely held belief that the UK economy will be strong enough for the BoE to begin raising interest rates shortly. This will ensure the trend for this cross is lower.

NZD/EUR: Large tail risks. Our central scenario is that the EUR will gradually strengthen, but the tail risks on this cross are large. The ECB has committed to another 12 months of QE, which should limit EUR strength, and the potential for even more ECB policy stimulus presents upside risks to this cross.

NZD/JPY: Consolidation phase. We believe that JPY devaluation driven by QQE is largely complete, and the JPY should find demand near current levels. This leaves this cross driven by NZD factors, which also argue for a period of consolidation.

NZD/CNY: Unpegged. China recently announced a move toward a free-floating CNY. While this process is expected to be slow, we see prospects of the CNY depreciating over the coming years. Thus the unpegging of the CNY removes some of the downside risk for this cross, and should provide some insulation to China-induced NZD shocks.

As the NZD consolidates near term, the New Zealand interest rate market also faces something of a timing dilemma. But with approximately 32bps of OCR cuts now priced into the short end, and the risk profile skewed lower, it is difficult to argue strongly against the overall state of market pricing.

We expect the OCR to go lower, and while our forecasts have the OCR bottoming out at 2.5%, there is a non-trivial chance it will go below that. Until the case for deeper OCR cuts goes away, we expect there to be sustained downward pressure on the short end of the yield curve, particularly given the more benign global monetary policy environment.

For now, though, we are not calling the OCR immediately lower. Key reasons include:

- The recent recovery in dairy prices, which mitigates the terms of trade hit the RBNZ was assuming.
- Expected stabilisation in the tenor of dataflow.
- Record net immigration and supportive anecdotes for tourism, signalling pockets of strength exist.
- Acknowledgement that financial and monetary conditions have eased a lot and policy works with a lag; it's time for a cup of tea.

Looking into 2016, it is the combination of low inflation, continued sub-trend growth and

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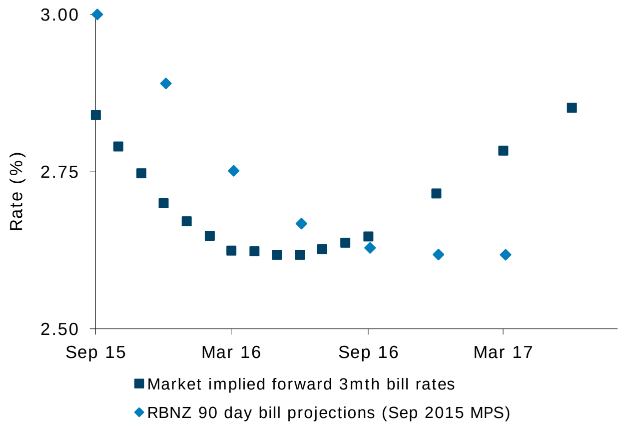
global unease that we suspect will have the RBNZ moving again.

FIGURE 1. MARKET IMPLIED FORWARD & RBNZ 90-DAY BILL PROJECTIONS



Source: ANZ, Bloomberg

Although the question of when the OCR will go lower matters, that's not as important as *whether* it actually goes lower, and what the terminal rate is. The case for an October cut is not strong at the moment, but a cut will be more likely if global fragilities emerge and local Q3 CPI data is soft. What really matters, however, is how confident markets are that the RBNZ's easing cycle is not yet over. We are confident that at least one more OCR cut is coming. Our GDP forecasts have growth slipping to 1.7% this year, driven by a close to 15% peak to trough decline in New Zealand's terms of trade, the topping out in the Canterbury rebuild and less rampant house price growth in Auckland. Inflation remains well below the 2% mid-point of the RBNZ's inflation target range, and while the lower NZD will drive tradable inflation higher temporarily, low domestically generated inflation ultimately points to more easing, especially if the Fed and other central banks become more cautious (as this will make it harder for the NZD to weaken). This outlook and the downward risk profile should keep downward pressure on short-end interest rates.

As the easing cycle continues, we also expect the market to form a clearer view of the long-term profile for the OCR. At the moment, markets are picking the OCR to bottom out over Q3 next year, after which it is assumed to rise. In contrast, the RBNZ and our forecasts have the OCR on hold for longer. We expect markets to eventually gravitate to the "lower for longer" mantra, and as the assumed low point in the OCR cycle is pushed out, we expect two to three year interest rates to fall further. The tick-shaped curve will also eventually disappear once the RBNZ has finished easing – by then the OCR will become the low point on the yield curve.

Although the US Federal Reserve left policy on hold at its September meeting, citing low inflation and financial market volatility, it has said that it intends hiking in 2015. US inflation is projected to gradually rise as the effects of falling oil prices fade, and our forecasts assume that the Fed will lift the fed funds rate by 25bps in December, and hike a further 75bps over the course of 2015. The gradual lift in inflation and normalisation in Fed policy is expected to drive US 10-year bond yields gradually higher, reaching 2.5% by the end of this year and 2.8% by the end of 2016.

With New Zealand short-end interest rates going lower and global long-end rates going higher, our forecasts assume the yield curve will steepen, albeit to a lesser degree than one might initially assume, with some of the rise in global long term bond yields absorbed locally via spread compression. At the moment, the NZ/US 10 year bond spread is around 1.1%, and our forecasts have the spread narrowing to 0.4% by the end of 2016.

Forecasts (end of quarter)										
FX Rates	**Sep-15**	**Dec-15**	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**
NZD/USD	0.63	0.61	0.59	0.59	0.59	0.59	0.59	0.59	0.59	0.59
NZD/AUD	0.93	0.91	0.91	0.92	0.92	0.92	0.92	0.92	0.92	0.92
NZD/EUR	0.57	0.58	0.56	0.55	0.53	0.51	0.51	0.51	0.51	0.51
NZD/JPY	78.8	76.3	73.8	73.8	73.8	73.8	70.8	70.8	70.8	70.8
NZD/GBP	0.40	0.39	0.37	0.37	0.37	0.36	0.36	0.36	0.36	0.36
NZD/CNY	4.06	4.00	3.89	3.92	3.95	3.98	3.99	4.01	4.02	4.04
NZ$ TWI	68.6	67.7	65.6	65.6	64.8	64.1	63.7	63.7	63.7	63.7
Interest Rates	**Sep-15**	**Dec-15**	**Mar-16**	**Jun-16**	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**
NZ OCR	2.75	2.75	2.50	2.50	2.50	2.50	2.75	3.25	3.25	3.50
NZ 90 day bill	2.88	2.88	2.63	2.64	2.67	2.67	3.09	3.42	3.42	3.84
NZ 2-yr swap	2.75	2.68	2.53	2.81	2.89	2.93	3.12	3.25	3.26	3.33
NZ 10-yr bond	3.30	3.15	3.00	3.00	2.98	3.00	3.05	3.10	3.15	3.20

KEY ECONOMIC FORECASTS

Calendar Years	2012	2013	2014	2015(f)	2016(f)	2017(f)	2018(f)
NZ Economy (annual average % change)							
Real GDP (production)	2.3	2.3	3.3	2.1	2.2	2.7	2.5
Private Consumption	2.9	3.0	3.2	2.4	2.0	2.1	2.2
Public Consumption	-0.9	2.0	3.0	2.7	0.7	1.0	0.8
Residential investment	14.1	16.6	16.2	6.4	6.0	-2.5	0.8
Other investment	6.3	6.2	6.5	0.5	3.4	3.7	3.8
Stockbuilding[1]	0.1	0.1	0.1	-0.2	0.0	0.1	0.1
Gross National Expenditure	3.1	4.0	4.4	2.2	2.3	2.0	2.2
Total Exports	1.9	0.8	3.0	5.3	1.2	3.4	3.3
Total Imports	2.8	6.2	7.9	4.9	1.4	2.1	2.2
Employment (annual %)	0.1	2.9	3.5	1.3	1.1	1.5	1.2
Unemployment Rate (sa; Dec qtr)	6.8	6.1	5.7	6.2	6.1	5.5	5.4
Labour Cost Index (annual %)	1.8	1.6	1.7	1.6	1.8	2.0	2.1
Terms of trade (SNA basis; annual %)	-8.9	16.9	-4.2	-6.5	2.8	0.4	0.2
Prices (annual % change)							
CPI Inflation	0.9	1.6	0.8	0.7	2.0	2.1	1.9
Non-tradable Inflation	2.5	2.9	2.4	1.6	2.0	2.5	2.7
Tradable Inflation	-1.0	-0.3	-1.3	-0.6	2.1	1.6	1.5
Fiscal and External Balance							
Current Account Balance ($bn)	-8.5	-7.2	-7.4	-10.6	-14.9	-14.1	-13.8
as % of GDP	-4.0	-3.2	-3.1	-4.4	-6.0	-5.5	-5.1
Government OBEGAL ($bn)*	-9.2	-4.4	-2.9	0.3	0.1	0.4	1.2
as % of GDP	-4.4	-2.0	-1.3	0.1	0.1	0.2	0.5
NZ Financial Markets (end of December quarter)							
TWI	74.4	77.3	79.2	67.7	64.1	63.7	
NZD/USD	0.83	0.82	0.78	0.61	0.59	0.59	
NZD/AUD	0.80	0.92	0.95	0.91	0.92	0.92	
NZD/CNY	5.16	4.98	4.84	4.00	3.98	4.04	
NZD/EUR	0.63	0.60	0.64	0.58	0.51	0.51	
NZD/JPY	71.9	86.5	93.4	76.3	73.8	70.8	
NZD/GBP	0.51	0.50	0.50	0.39	0.36	0.36	
Official Cash Rate	2.50	2.50	3.50	2.75	2.50	3.50	
90-day bank bill rate	2.69	2.84	3.68	2.88	2.67	3.84	
2-year swap rate	2.67	3.85	3.80	2.68	2.93	3.33	
10-year government bond rate	3.52	4.72	3.67	3.15	3.00	3.20	

[1] Percentage point contribution to growth

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