ANZ RESEARCH

NEW ZEALAND ECONOMICS
ANZ ECONOMIC OUTLOOK

July 2016

INSIDE

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ROLLING WITH THE PUNCHES

NEW ZEALAND ECONOMIC OUTLOOK

The economy continues to perform well and we expect more of the same over the years ahead. Challenges in dairying and a high NZD are being outweighed by other sectors. Solid demand will see capacity constraints intensify and domestic inflation pressures gradually lift off lows. Key risks are that a) too much domestic-centric growth, a housing market boom and the associated debt build-up will require a purging process; and b) global wobbles turn into outright weakness.

INTERNATIONAL OUTLOOK

While our global growth forecasts depict a reasonable outlook, this masks considerable tension and risks. High leverage, investment misallocation and a populist-driven backlash against globalisation are a potent mix. Prospects for Europe and Japan are sombre. Emerging market economies, including China, face transitional challenges. The exception is the US, which is battling on nicely.

PRIMARY SECTOR OUTLOOK

The dichotomy across key primary sectors is expected to continue in 2016/17. Dairy farmers are facing their third low payout year and second year of cash losses. Cuts in discretionary spend will continue. In the red meat and fibre sector there are knock-on impacts from dairying on arable and support prices. In contrast, the main horticultural crops are on track to post near-record export volumes, with solid prices lifting revenues and bottom-line returns.

FINANCIAL MARKETS OUTLOOK

We are lukewarm over prospects for the OCR moving lower in the short-term (we expect the RBNZ to hold fire in August). Short-end interest rates are still biased lower, with an elevated TWI and global risks bringing the RBNZ back to the easing table down the track. The Brexit vote has created significant uncertainty, increased the likelihood of further easing in Europe, the UK and Japan, and side-lined the Fed. Against that, we expect the NZD and local interest rate markets to be well supported, in the absence of a meltdown across emerging markets.

Calendar Years	2013	2014	2015	2016(f)	2017(f)	2018(f)
New Zealand Economy						
Real GDP (annual average %)	2.4	3.7	2.5	3.2	3.3	2.3
Unemployment Rate (Dec quarter)	5.7	5.5	5.0	4.8	4.6	4.2
CPI Inflation (annual %)	1.6	0.8	0.1	1.1	1.7	2.1
Terms of Trade (OTI basis; annual %)	20.2	-5.0	-3.2	-4.9	7.4	1.1
Current Account Balance (% of GDP)	-3.1	-3.1	-3.1	-3.7	-4.0	-3.5
Government OBEGAL (% of GDP)	-2.0	-1.2	0.2	0.3	0.2	0.8
Global Growth (annual average %)						
US	1.5	2.4	2.4	2.0	2.3	2.0
Australia	2.0	2.7	2.5	3.1	3.2	3.3
China	7.7	7.4	6.9	6.4	6.2	6.1
Trading Partners	3.0	3.6	3.5	3.5	3.4	3.5
NZ Financial Markets (end of Dec quarter)						
TWI	77.3	79.2	73.6	71.9	66.8	69.8
NZD/USD	0.82	0.78	0.68	0.65	0.63	0.67
NZD/AUD	0.92	0.95	0.94	0.97	0.90	0.88
Official Cash Rate	2.50	3.50	2.50	2.25	1.75	2.00
10-year Bond Rate	4.7	3.7	3.6	2.0	2.5	2.6

* Forecasts and text finalised 8 July 2016

NEW ZEALAND ECONOMIC OUTLOOK

SUMMARY

The New Zealand economy continues to perform well and we expect more of the same over the years ahead, with growth averaging close 3% per year over the next three years. Challenges in dairying and a high NZD are being outweighed by non-dairy exports, construction, migration, housing, services and tourism. Solid demand will see capacity constraints come more to the fore. The unemployment rate should continue to fall and domestic inflation pressures gradually lift off lows. Key risks are that a) too much domestic-centric growth, a housing market boom and the associated debt build-up will require a purging process (a hangover in 2018 or 2019); and b) global wobbles turn into outright weakness.

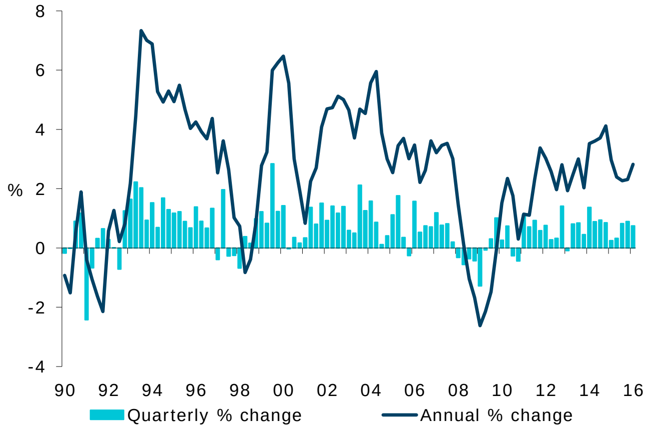
ROLLING WITH THE PUNCHES

The New Zealand economy continues to perform well. Annual GDP growth has accelerated to 2.8% y/y, and forward-looking indicators and financial conditions suggest growth will lift above 3% over the next quarter or two. That is close to, if not a touch above, trend. Business and consumer confidence sit at decent levels, and firms are continuing to signal a desire to go out and hire and invest. The unemployment rate is trending lower once again and real household income growth is running at an above-average pace.

This reasonable performance comes despite a number of challenges. The earthquake rebuild has passed its peak, the dairy sector continues to deal with poor returns and the threat of ongoing low prices, the NZD is far higher than desirable, and the global economy continues to wobble. Yes, domestic growth has slowed from the 4%-odd pace seen over 2014. But 3% growth certainly shouldn't be scoffed at considering the above headwinds. In many ways, the New Zealand economy is like a boxer, bobbing and weaving and avoiding that knockout shot. And even when a punch lands (dairy strains), the economy has proven that is has a strong enough jaw to withstand it. In fact, the dairy sector is attempting to do something of a rope-a-dope given the cost recalibration that is now underway.

Admittedly, growth is far less positive in per capita terms. Annual per capita GDP growth is just 0.7% at present. That's poor on the face of it, and conversations are required in terms of the mix of migrants being attracted (though a host are simply uncontrollable flows: returning New Zealanders and Australians being a key one). However, part of the reason for low per capita growth is simply timing. A booming population courtesy of migration does not immediately add to a country's value added; it takes time to integrate people, just as it takes time to integrate new employees into a business. And going forward, the economy is going to need a core nucleus of immigrants given a) emerging capacity constraints across the labour market; and b) population ageing. Such factors need key consideration given the sensitivity obviously being directed (or should we say targeted) at migrants.

FIGURE 1. NEW ZEALAND ECONOMIC GROWTH



Source: ANZ, Statistics NZ

While this strong population growth has played a key role, we still don't believe New Zealand's economic resilience gets the recognition it should. If you'd asked a number of economists or commentators a few years back how the economy would be faring following three consecutive seasons of poor dairy returns at the same time as the boost from the earthquake rebuild was waning and the global economy continued to lurch from problem to problem, most would have told you that the domestic economy would be down for the count. But the fact it has remained on its feet (and is still throwing punches) is testament to a newfound resilience.

This resilience reflects a number of forces:

- **The economy is far more than just a large dairy farm.** Dairying is just under 5% of GDP directly and 10% in total, so it does matter. However, non-dairy agriculture (particularly wine, pipfruit and kiwifruit) are performing well. The tourism sector continues to boom and is now larger than the dairy sector. Despite annual dairy export revenues falling around $4.2bn over the past 18 months, total export earnings are still up $1.6bn over the same period, despite the strong NZD. The construction pipeline is massive, and Auckland house price love is now being shared around many other parts of the country, further supporting construction and confidence. Households are showing confidence to go out and borrow. The broadness of the economic story has given the economy more steel.

NEW ZEALAND ECONOMIC OUTLOOK

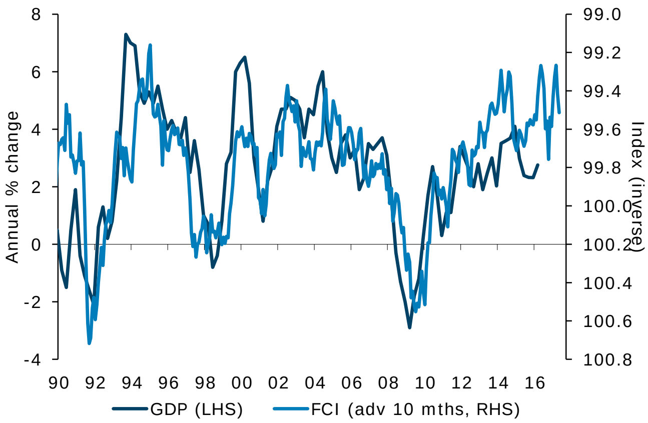
- **The terms of trade are down *only* 6% from their highs.** This is despite global dairy prices falling close to 60%. While non-dairy export prices have fallen too (to a far lesser degree), lower import prices (largely oil) have provided a clear offset. This has seen the terms of trade remain at historically high levels and has allowed domestic purchasing power and national income growth to remain far stronger than would have been the case otherwise. Put simply, New Zealand exports food and imports technology / manufacturing. The outlook for prices 10 years out is more positive for the former.
- **The economy has put in the hard yards and is in a better position structurally than in the not-too-distant past.** The fiscal position is in surplus and the current account deficit is smaller than average. External debt as a share of GDP (56%) is well below its peak (84%) and the maturity profile of our international liabilities has lengthened. There are admittedly some red flags emerging (discussed below), but the starting point is one of an economy less vulnerable to negative shocks than it has been in the past.
- **Decent microeconomic foundations.** The GFC was a huge wake-up call across New Zealand, and businesses have been prudent. A booming tourism industry has not just happened because of China; there are more strings to the industry's bow. The same applies to the success across pipfruit, kiwifruit and other sectors. Firms continue to show a "just get on with it attitude", and, as with the better structural metrics discussed above, this gives the economy more steel.
- **A stable political backdrop.** The New Zealand political scene is boring, and that's a good thing! Centrist policies, reasonable growth and political stability give economic stakeholders more confidence to go out and plan for the future. Putting cash to work by expanding capacity or spending on innovation is a far less risky proposition when you know you are less likely to be blindsided by a shift in policy. It's a model where success breeds more confidence and success. It stands in stark contrast to the populist shift sweeping the globe.
- **Where the economy does need to adjust and respond, it is doing so.** The dairy sector is undertaking significant cost recalibration and management changes. We don't think whole milk powder prices are going to average US$3,500 a tonne in the future so forget about a payout averaging $6.50/kg MS. Something closer to $6/kg MS is more likely, and costs need to respond accordingly. The average dairy farm break-even looks set to drop below $5/kg MS from roughly $5.25 now and $5.50 over a year ago. This will make the sector leaner and meaner and put it in a good position to take advantage when global prices eventually recover, which they will, albeit too late for some.
- **The policy framework works.** It's far from perfect. The RBNZ has had some hits and misses, but by-and-large is in the right ball-park. When policy needed to move it has done so. The NZD does respond when the growth picture sours. New Zealand is building a fiscal war-chest now that surpluses are being recorded.

STILL PLENTY LEFT IN THE TANK

We forecast GDP growth to accelerate modestly in the near term, continuing at an above-trend pace. We forecast full-year growth of 3.2% over 2016 and 3.3% over 2017. Population growth courtesy of net migration should remain strong for some time yet, largely because we believe New Zealand will remain an attractive destination for migrants in a world of "Brexits" and lacklustre economic performance elsewhere. We see annual per capita growth lifting back towards 1½% over the next 12 months or so.

Financial conditions are still supportive despite the high NZD. Interest rates are low, asset prices are strong and commodity prices have started to recover. That's delivering a broad-based level of financial conditions that is conducive to solid growth.

FIGURE 2. NEW ZEALAND GDP VS FINANCIAL CONDITIONS



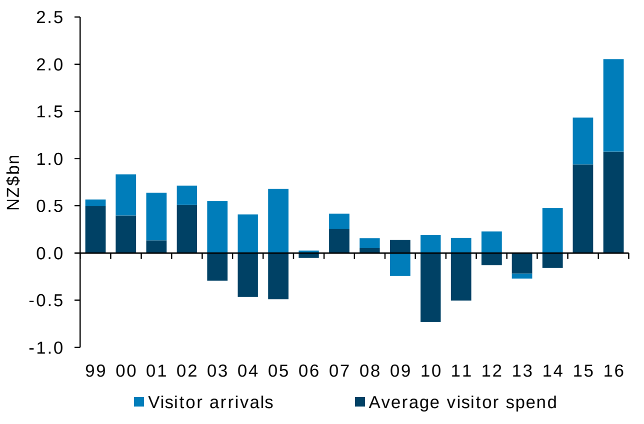
Source: ANZ, Statistics NZ

The tourism and construction sectors have more upside. Both sectors are dealing with capacity issues, which will naturally slow their overall growth contributions. But the tailwinds that have brought them to this point are still blowing strongly:

NEW ZEALAND ECONOMIC OUTLOOK

- **The construction sector pipeline is still massive.** Ongoing falls in borrowing rates, near-record net migration gains, strong existing house price growth and a strong political desire for ongoing housing supply growth are all strong stimulatory forces. Large infrastructure projects are also spurring spill-overs into increased commercial activity. As the Christchurch earthquake rebuild continues to mature and moderate, we expect these resources to gradually shift to other pressure points, enabling the growth to continue. That may not be a smooth process, but the trend in activity is expected to be upwards. We forecast total construction activity volumes to rise 5.0% and 3.8% in 2016 and 2017 respectively. Considering the high base construction is growing off, those sorts of figures are not to be scoffed at.
- **The positive tourism sector story is a structural one as well as cyclical.** New airlines, greater airline capacity, more competition, and new route development into New Zealand are ongoing themes. Historically, these factors have been dominant drivers of visitor arrivals growth (which is already running at circa 10% y/y), in a "build it and they will come" type story. The NZD has an important influence on the average spend per visitor, so its recent strength is something to be mindful of, but the composition of arrivals matters too. What is important is that where much of the new airline capacity has been added (China and the US), these visitors spend over 40% more per person on average than the average. Total visitor spend rose 25% in the year to March. Growth of that magnitude again over the next 12 months is a stretch, but we do expect growth to be positive.

FIGURE 3. CONTRIBUTION TO TOTAL VISITOR SPENDING GROWTH (MARCH YEARS)



Source: ANZ, Statistics NZ

There are positive tailwinds for household consumption. Employment is growing and real household income growth is estimated to be running at an annual pace of 4.0%. Courtesy of house price growth, net wealth gains are broadening, and the impact of previous monetary policy easing is also still flowing through, given a still-falling effective mortgage rate. We expect wages to accelerate as a) unemployment falls; and b) headline inflation lifts (an important input into wage bargaining). To be fair, households are (so far) showing more restraint than in previous episodes of strong house price growth, perhaps reflecting higher levels of debt, but strong population growth is also a key factor supporting decent overall spending levels. Real household consumption is forecast to grow over 3% per year over the next two years.

Capacity constraints are becoming more evident, and we expect this to be a continuing theme. At just over 5%, the unemployment rate is approaching its natural rate. Capacity utilisation is high. Firms are reporting more difficulty finding skilled labour, especially in the construction sector where the shortage is becoming acute. Such constraints will exert somewhat of a natural braking influence on the economy over the coming years and highlight the importance of continued tweaks in the policy arena to lift the economy's supply-side capacity.

This is a backdrop where domestic inflation pressures should continue to lift off lows. While structural influences have severely tested historical relationships (and look set to continue doing so given the impact of the likes of technology, ongoing overcapacity in global manufacturing, excessive debt levels etc), we are still believers in the traditional "Phillips curve" drivers of domestic inflation. We are already seeing that where the most capacity pressure is evident (construction), costs and prices are rising accordingly. If it weren't for some upcoming ACC levy changes, annual non-tradable inflation would have already troughed, which ties in with the growth story eating into capacity. Non-tradable inflation is forecast to lift to 2.7% by the end of 2017. That's the component of inflation the RBNZ can more directly control.

The strong NZD and low inflation expectations present key risks on the other side. Annual tradable inflation is naturally forecast to lift as the impact of previous oil price declines drops out, but recent NZD strength will further delay a return to positive territory until 2017. Our forecasts have annual headline inflation rising to 1.1% by the end of 2016, and back to the target mid-point by mid-2018.

NEW ZEALAND ECONOMIC OUTLOOK

BUT SOMETIMES IT'S JUST NOT A FAIR FIGHT

The global economy remains the most significant risk to the outlook. A broader discussion of the global scene is on page 7, but it's fair to say we remain very watchful (read cautious) in a number of areas.

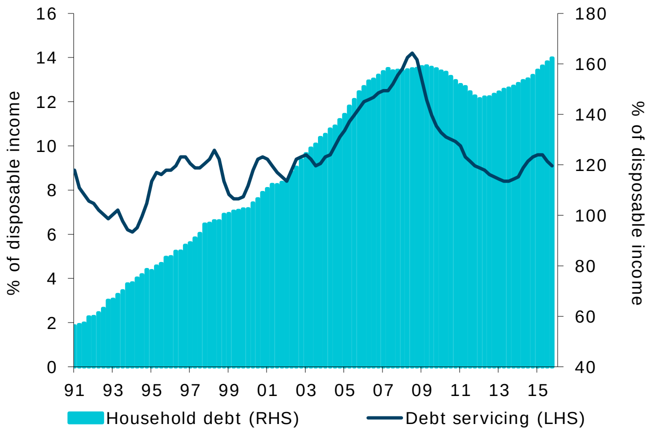
Political developments are the latest element to what remains a vulnerable global picture, with increasing populism set to make it even more difficult to drive sensible policy outcomes at a time when economies are crying out for just that. Stronger microeconomics and structural reform have been the missing ingredients for better growth outcomes post GFC, and that doesn't look set to change any time soon. Growth will naturally be hampered as a result, and with that asset values will need to adjust. Put simply, there has been too much reliance on central banks and not enough emphasis on policy reform. Populism makes the latter a forlorn hope. People are angry for a range of reasons and politicians are increasingly focusing on the short term as a result.

Markets continue to have an unhealthy obsession with central bank liquidity, which has driven valuations far from economic fundamentals. Leverage has increased (particularly across emerging markets), risk is being miscalculated as low (negative) interest rates force investors up the credit curve, and asset valuations are being dictated by liquidity as opposed to fundamentals. Ultra-low borrowing rates have allowed global overcapacity issues to persist and are encouraging investment misallocation. China (and emerging markets more generally) continue to face a real test of economic rebalancing, deleveraging and maintaining social cohesion simultaneously. Given excessive leverage, the Asian region is more vulnerable to shocks emanating elsewhere and that would have clear consequences for New Zealand.

Domestically, housing and credit largesse are creating clear vulnerabilities. House prices are lifting strongly across the country. On a 3-month average basis compared with a year ago, prices are up 11% in Auckland, 20% in the Waikato/Bay of Plenty, 11% in Wellington and 30% in Central Otago. That's dwarfing income growth. Any "model" where house price growth is exceeding income growth by a factor of two or three times is on borrowed time. Credit growth is rising rapidly too so it's a "leverage" driven game. Some of this reflects vibrancy across the economy more generally, and housing shortages are at play in some regions. However, Auckland house prices are trading at a multiple of over nine times income and have risen 36% in two years (90% since 2011) and rents are not keeping pace with house prices, so it clearly has bubble-like attributes.

Structural metrics are deteriorating. Household debt-to-income is already at an all-time high (163%) and the current pace of debt growth will see it rise further. This is not a problem when interest rates are at record lows, but that will not always be the case. There was a scenario in the June *Monetary Policy Statement* where house price exuberance flows into consumption and inflation, and forces the RBNZ to hike rates. Credit growth is outpacing deposit growth, which means more offshore borrowing. New Zealand has lessened its reliance on foreign funding post the GFC and increasing it now would only add to the economy's vulnerability to twists and turns in global markets. Household savings are falling as exuberance broadens. Another two years of excesses like the past 12 months would up the ante greatly on a market correction in 2018/19.

FIGURE 4. HOUSEHOLD DEBT AND SERVICING



Source: ANZ, Statistics NZ

Right here and now, the strong NZD is a vote of confidence in NZ.Inc, but it's denting the economy's future earning capability. The economy is borrowing and spending its way to growth. We've been here before and it didn't end well. Non-tradable GDP is massively outstripping tradable sector GDP. However, restoring it to more competitive levels is easier said than done when other central banks are playing hari-kari economics by taking interest rates to ever more negative levels. Ultimately, the NZD will correct, but the timing looks a way off.

THE REFEREE IS GOING TO NEED MORE HELP

The RBNZ is grappling with some considerable tensions at present. There are a number of challenging and opposing forces: an overvalued NZD versus housing strength; monetary policy versus financial stability considerations; historically low interest rates locally but even lower ones globally; booming asset prices versus weak consumer prices; solid domestic growth versus a still-fragile global scene. The list goes on. **But all this means that the outlook for the OCR is delicately placed. We are**

certainly lukewarm over prospects of the OCR moving lower in the short-term.

While the timing is uncertain (arguably even more so than normal), we still believe further OCR cuts are more likely than not. One of our overarching themes is that in a world of currency divergence from fundamentals, interest rates ultimately need to converge. Put simply, other central banks keeping rates low (and taking them lower) heightens the attractiveness of New Zealand yields, which means a higher NZD in the absence of rates falling. It's looking increasingly like the NZD is experiencing a portfolio shock. And the only way to address that is to take rates lower over time. A high currency eventually batters you into submission. We've got enough confidence in the domestic picture to believe a strong NZD will not roll the economy. But we also need to realistic about where the OCR will need to be given global pressures. We have pencilled in a further 50bps of OCR cuts, but not until early 2017.

The end-game for containing housing exuberance and currency strength is a wedge between borrowing rates and wholesale ones. This means additional macro-prudential measures to counter housing strength are inevitable.

INTERNATIONAL OUTLOOK

SUMMARY

While our global growth forecasts depict a reasonable outlook, this masks considerable tension and risks. High leverage, investment misallocation and a populist-driven backlash against globalisation are a potent mix. Prospects for Europe and Japan are sombre. Emerging market economies, including China, face transitional challenges. The exception is the US, which is battling on nicely.

PUSH BACK

On the face of it our forecasts depict a reasonable global growth picture. After 3.2% growth in 2016 (similar to 2015), global growth is forecast to accelerate to 3.7% by 2017. The US economy's prospects remain firm. Capacity constraints are emerging in the labour market and inflation should rise, spurring the FOMC into resuming rate hikes (albeit gradually). While China's growth is moderating, it is expected to hold above 6%. Asia ex-Japan, more generally, is forecast to see growth accelerate modestly after a soft 2016 as some earlier headwinds wane. Australian growth should accelerate as the non-mining economy continues to emerge from the doldrums.

However, our steady-as-she-goes central expectation masks tension and risks.

- **Populism looks set to trump leadership.** Society is kicking back. Income equality is front and centre, with asset price inflation rampant and wage inflation anaemic. Brexit, the Scottish referendum, the divisive US presidential campaign, increased popularity of Euro-sceptic parties, a hamstrung Australian election outcome… the list goes on. Anti-globalisation and economic dis-integration rhetoric is on the rise. For 30-plus years, globalisation and economic integration have been at the forefront of economic thinking and asset valuations. Emerging markets (EM) and China have soared on the back of this. Asset valuations now need to reflect more barriers, not less.
- **A rise in populism amidst a) high debt** (particularly across the EM world); **b) investment misallocation; and c) high asset valuations, is potentially a potent mix.** The world is crying out for better micro-economic policy outcomes, not worse. We'll see lower growth on average across the cycle if populist policies come to the fore.
- **Central banks will continue to shoulder the burden, but more liquidity is about all they have on offer.** The BoE looks set to cut again and the ECB and BoJ on track to deliver more stimulus too. The Fed is dragging its heels hiking rates, despite an economy warranting it. We're already seeing the side-effects of ever more negative interest rates. Wider credit spreads, misaligned currencies (and policymakers such as the BoJ losing control), capital misallocated, and debt levels rising off already high levels. Financial stability risks appear to be rising.

Looking around the globe:

- **Prospects for Europe and Japan look sombre.** Structural reform is missing.
- **The US looks reasonably solid.** The Fed should be hiking rates off emergency settings, but the global scene means it can't.
- **Australia is entering a phase of grumpy growth** but will still be better than most. However, policy paralysis beckons, given the election outcome.
- **China remains the dark horse.** We're expecting the fabled soft landing, but the odds of a hard landing are non-trivial.

Global risks are to the downside. Critical to watch over the coming months, particularly from an Australasian perspective, will be the flow-on from developments in the UK and Europe (weak growth) into emerging markets. Our eyes are on EM credit spreads and currencies.

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	2.0	2.3	2.0
Australia	3.5	2.0	2.7	2.5	3.1	3.2	3.3
Japan	1.7	1.4	-0.1	0.6	0.6	0.5	0.8
Euro Zone	-0.8	-0.3	0.9	1.6	1.6	1.7	1.6
China	7.8	7.7	7.4	6.9	6.4	6.2	6.1
Trading Partner Growth	**3.3**	**3.0**	**3.6**	**3.5**	**3.5**	**3.4**	**3.5**

PRIMARY SECTOR OUTLOOK

SUMMARY

The dichotomy across key primary sectors is expected to continue in 2016/17. The operating environment looks challenging for key livestock sectors. Dairy farmers are facing their third low payout year and second year of cash losses. Cuts in discretionary spend will continue. In the red meat and fibre sector there are knock-on impacts from dairying on arable and support prices. The reason for sheepmeat and venison price increases is lower New Zealand supply. In contrast, the main horticultural crops are on track to post near-record export volumes with solid prices lifting revenues and bottom-line returns.

Supply dynamics and how key economies navigate increased political uncertainty will drive the pricing environment.

New Zealand livestock and milk supply is expected to be under more pressure over the coming year, but the main horticulture exports are expected to hit new records. The likely price outcomes will be different for each sector though. Where New Zealand is the main global supplier and there is limited competitive pressure there should be gains from tighter supply. For others where there is more competition, abundant stocks and greater exposure to those countries experiencing political uncertainty, it will be a more challenging environment.

The other indirect supply catalyst for New Zealand's commodity basket could be a lift in the cost of production for direct competitors and substitute products. Recently a larger weather risk premium entered grain markets for a short period of time due to supply challenges in Brazil and Argentina, as well as the US entering its key growing period for corn. This will need to continue to be watched until the Northern Hemisphere harvest. The other area of cost increase has been a move higher in shipping costs and oil/energy prices.

Supply dynamics aside, the other area of challenge is low global growth amidst heightened uncertainty. There continues to be a lot of focus on China, but Europe is likely to take centre stage following the political uncertainty created by Brexit. Two near-term impacts are a lower currency (higher NZD) and more subdued end demand from a hit to consumer confidence/spending. The long-term implications will affect market access and the scope of farm support programmes – both very political topics.

Sectors with high direct earnings exposure (over 30%) to Europe are pipfruit, sheep meat, venison, wool, hides/skins, kiwifruit and wine. With Asia also going through a period of lower growth, it will be more difficult for these export sectors to divert extra product elsewhere if the European market becomes more challenging.

The beacon of light has, and continues to be, the US. Where there are already good business relationships, favourable market access and less local competition (i.e. red meat and wine), there has been a notable lift in exports in recent times.

In terms of sector specifics:

We expect the revenue and cash flow environment for dairying to remain challenging. We expect a high $4/kg MS milk price for the 2016/17 season, but are cautious this looks optimistic at present. Farmers are focused on extracting any further cost or productivity efficiencies they can. Many are having a surprising degree of success. This lowers the break-even point, but has wider spill-over impacts to support businesses and their incomes. Lower prices are expected to see supply removed and the global market move more into balance. So prospects for 2017/18 look better but we are not expecting sustained $6 plus payouts going forward. Supply and cost dynamics have changed. Pressure on dairy land values will remain.

Sheepmeat prices are likely to be stronger despite the economic challenges in China and Europe. This is due to expectations it will be the smallest lamb crop ever in 2016 due to a further fall in breeding ewe numbers and lower lambing percentages. **Venison production has dropped** significantly too, with some herd rebuilding occurring after 13 years of decline. This is **supporting prices** at five-year highs. Elsewhere, **beef and wool prices look fairly solid** due to lower Australasian supply and steady demand in the US. The major area of challenge is arable crop prices and other support activity for dairying, which won't improve until the milk price does.

The main horticulture crops are on track to post near-record export volumes. Many smaller crops continue to grow strongly too. For wine the 2016 vintage was 436,000 tonnes, which is only slightly below the all-time record from 2014. This is not expected to see a substantial decline in bulk wine pricing given lower supply in 2015. Pipfruit exports are on track to lift 5%. The first half of the season has seen NZD prices lift 15% y/y, with very strong demand from Asia. The 2016 kiwifruit crop will also hit new highs. The Gold crop is expected to be around 45 million trays and Green between 88 to 91 million trays. Some crop management of poorer-tasting green fruit has been undertaken to maintain Zespri's brand and reputation for high-quality. Gold pricing is expected to be similar to last year, but Green slightly lower due to increased European supply.

Forestry returns are solid. Wharf-gate returns for export logs are well above the 5-year average. Domestic market pricing remains positive, driven by housing and construction activity.

FINANCIAL MARKETS OUTLOOK

SUMMARY

We are lukewarm over prospects for the OCR moving lower in the short-term; amidst housing largesse the economy simply doesn't need more easing right now. We expect the RBNZ to hold fire in August. Short-end interest rates are still biased lower over time, with more OCR cuts likely down the track. We see an elevated TWI and global risks ultimately bringing the RBNZ back to the easing table. The Brexit vote has created significant uncertainty, increased the likelihood of further easing in Europe, the UK and Japan, and side-lined the Fed. Against that backdrop, we expect the NZD and local interest rate markets to be well supported, in the absence of a meltdown across emerging markets (which, to be fair, is a key risk). Last quarter we were of the view that Fed tightening and RBNZ easing would see the curve steepen, but Brexit has turned that on its head; and we now expect global yield curves to flatten as markets adjust to a prolonged period of uncertainty and easy policy.

MORE EASING COMING – EVENTUALLY, YIELDS CONVERGING

It is not clear the RBNZ should follow through on its easing bias in the short-term and we expect them to hold fire in August. On the face of it, the high NZD and low headline inflation almost demand a cut. However, it is far from conclusive that OCR cuts will lower the NZD amidst even lower rates elsewhere. And on domestic considerations, the economy certainly does not need more pump-priming.

Among other things, this is what we know now:

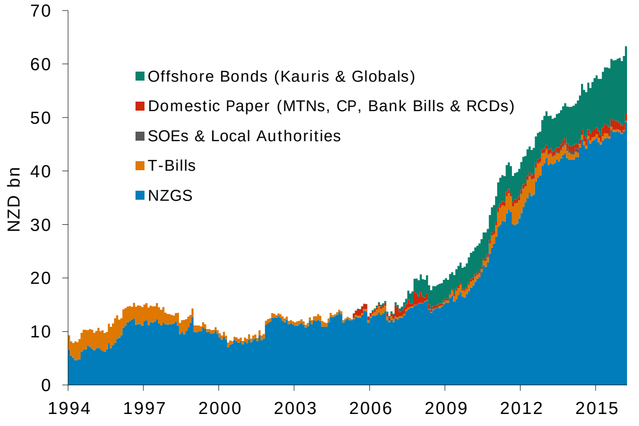
1) The domestic economy is accelerating;
2) The housing market is gaining momentum;
3) Household credit growth is picking up;
4) Inflation has stabilised, but at low levels;
5) Indicators for non-tradable inflation (which is what the RBNZ really influences) are pointing up;
6) Political uncertainty (Brexit) has cast a long shadow over the UK and Europe (and to an extent, Australia);
7) A lower OCR may not drive the NZD lower; it hasn't in the past year, with other central banks outdoing the RBNZ in a race to the bottom (and deeper into negative territory for some);
8) Currency tensions are building in China and Japan;
9) Global bond yields have sunk to record lows across all major markets;
10) Global credit spreads are widening again;
11) Central bank policy will be easier over the next year than was envisaged a month ago.

So it is not clear that the RBNZ should be in any hurry to ease, particularly given the first three considerations. Housing largesse (rather than currency strength) looks to be the bigger economic challenge in the near-term. If the latter was a real problem, the economy would be rolling, or on the cusp of rolling. It's not.

However, New Zealand is not immune from global forces and there are many at play.

While it would be nice to think that the RBNZ could keep interest rates high in a bid to slow demand and credit growth, the reality is that New Zealand's interest rates are simply too high, and will continue to attract capital flows until they converge on global interest rates. The more the NZD diverges from fundamentals, the more interest rates need to converge over time. Foreigners continue to buy record amounts of New Zealand dollar securities (Figure 1), driving yields down and flattening the curve. We expect this to continue, compressing interest rate spreads to the US and Australia.

FIGURE 1: NZD DEBT SECURITIES HELD OFFSHORE



Source: ANZ, G10 central banks, Bloomberg

Prior to the Brexit vote, we had been of the view that global yield curves (which are extraordinarily flat) would steepen as Fed normalisation progressed, and as the impact of earlier easing in Europe and Japan took hold. That all changed following the Brexit vote – with markets now expecting the Fed to remain on hold through till late 2018, and the Bank of England and ECB all eyeing further stimulus. All of this suggests global yield curves will continue to flatten.

FINANCIAL MARKETS OUTLOOK

Adding together the high NZD, global fragility and funding cost pressures that we expect to emerge, and you get a cocktail that eventually sees the OCR go lower. But this is over time, as opposed to immediately. And more than likely after the RBNZ delivers a macro-prudential response towards housing, which looks to be coming, just not until later in the year.

NZD INTEREST RATE SUPPORT

The search for yield remains a key driver of currency markets. Although New Zealand bond yields are at historic lows, they remain high compared to global peers (Figure 2). Until this premium is "arbitraged" away, with domestic growth holding up and global uncertainty on the rise, or unless the term structure of global interest rates undergoes a rapid normalisation (which seems unlikely), interest rate markets will provide the NZD with a leg of support.

FIGURE 2: G10 SOVEREIGN BOND YIELD "HEAT MAP"

Country	2-3 Year	5 Year	10 Year	Average
Switzerland	-1.17	-1.05	-0.65	-0.96
Germany	-0.68	-0.61	-0.18	-0.49
Japan	-0.34	-0.36	-0.27	-0.32
Denmark	-0.61	-0.38	0.03	-0.32
Sweden	-0.67	-0.36	0.09	-0.31
Norway	0.41	0.52	0.87	0.60
UK	0.13	0.34	0.76	0.41
Canada	0.48	0.53	0.97	0.66
USA	0.58	0.94	1.37	0.96
Australia	1.55	1.58	1.86	1.66
New Zealand	1.95	1.95	2.24	2.05

Source: ANZ, G10 central banks, Bloomberg

Some weakening of the NZD is expected, but we doubt it will be a lower OCR that does it. There is scant evidence that lower rates have had any meaningful impact this cycle, and we suspect the OCR would need to be much lower (i.e. 100-150bps lower) before the interest rate impact is "neutralised". **Rather, we expect the NZD to roll over as growth slows, and as global market conditions stabilise and the USD firms**. In our last edition we mentioned that well-performing countries do not tend to have weak currencies, and that is being played out in New Zealand now.

GLOBAL VERSUS LOCAL

Localised support factors are pushing strongly against global centric factors and we'd be remiss not to acknowledge international factors at play.

- The NZD is overvalued on PPP and equilibrium exchange rate models. It has been for some time. The rubber band is getting taut.
- Risk appetites are flaky; the current bout of Brexit related unease needs to be respected. New Zealand is not immune. A key risk going forward is to what degree Brexit and growing moves towards populism impact on global growth, particularly in the emerging market world, which is export-centric and has built up considerable debt. Recent weakness in the RMB is a worrying sign.
- The NZD tends to undershoot just as it overshoots. Downside movements can be sharp.
- Dairy prices are still hugely relevant.
- The more global forces push the NZD against fair value, the more the RBNZ will need to lower the OCR.

We expect tensions to continue but global forces ultimately to reassert and hold the greater sway over time. **This means a slight downwards bias for the NZD within the forecasts but high levels maintained overall. The cycle we envisage is mild by historical experience, but this critically assumes the fallout from Brexit does not manifest materially in emerging market currencies and general commodity prices.**

INDIVIDUAL CURRENCY PAIRS

NZD/USD: Steady for now, then lower. New Zealand's high interest rates and above trend growth prospects point to the NZD remaining elevated. US markets have all but dismissed the prospect of Fed policy normalisation, undermining USD strength. But the USD looks oversold at present and set for a come-back.

NZD/AUD: Parity? This cross has broken higher in the wake of the Brexit vote, Australian elections, and the downgrade to Australia's credit rating outlook (from stable to negative). While we expect the NZD to remain supported by its far higher yields and better growth pulse, the bulk of this is now priced in. While a move to parity can't be ruled out given recent volatility and momentum, our forecasts have the cross peaking at around 0.97 at the end of 2016.

NZD/GBP: Sea change. This cross has moved sharply higher post Brexit. We expect GBP/USD to weaken further over coming quarters, reaching 1.20 by year-end as the BoE eases policy and embarks on further liquidity provision. RBNZ easing will cap the NZD/GBP cross in the mid 50's, but if NZD strength is sustained, the risk is we see a break higher.

NZD/EUR: Slippery slope. We also expect further EUR weakness in coming quarters, and for EUR/USD to reach a low of 1.03 by year-end. As with NZD/GBP, the potential for NZD/EUR strength to be limited depends on whether NZD/USD can be tamed.

FINANCIAL MARKETS OUTLOOK

NZD/JPY: On borrowed time. Safe haven buying since the Brexit vote has taken USD/JPY to levels that are likely to be intolerable for the Bank of Japan (having ended 2015 at 120.20, USD/JPY ended June at 103.19). Further BoJ action and ongoing strength in the NZD should put a floor under this cross in the low 70s.

Forecasts (end of quarter)								
FX Rates	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**
NZD/USD	0.69	0.65	0.64	0.64	0.63	0.63	0.64	0.65
NZD/AUD	0.96	0.97	0.97	0.97	0.93	0.90	0.89	0.88
NZD/EUR	0.66	0.63	0.62	0.61	0.57	0.57	0.57	0.58
NZD/JPY	72.5	68.3	64.0	64.0	63.0	63.0	67.2	71.5
NZD/GBP	0.55	0.54	0.52	0.51	0.48	0.47	0.46	0.46
NZD/CNY	4.62	4.39	4.33	4.35	4.30	4.32	4.39	4.47
NZ$ TWI	74.5	71.9	70.4	69.9	67.3	66.8	67.5	68.5
Interest Rates	**Sep-16**	**Dec-16**	**Mar-17**	**Jun-17**	**Sep-17**	**Dec-17**	**Mar-18**	**Jun-18**
NZ OCR	2.25	2.25	2.00	1.75	1.75	1.75	1.75	1.75
NZ 90 day bill	2.50	2.41	2.16	1.99	1.99	1.99	2.00	2.00
NZ 2-yr swap	2.12	2.14	2.17	2.16	2.19	2.22	2.42	2.42
NZ 10-yr bond	2.08	2.03	2.20	2.20	2.45	2.45	2.50	2.50

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	3.2	3.3	2.3
Private Consumption	2.8	3.0	2.7	2.4	3.1	3.2	2.9
Public Consumption	-0.4	1.6	2.7	1.9	1.3	2.2	2.1
Residential investment	13.3	12.9	14.6	5.0	6.4	2.6	-4.3
Other investment	5.2	2.9	9.7	2.0	3.2	5.5	3.0
Stockbuilding[1]	0.1	0.1	0.0	-0.3	0.4	0.0	0.0
Gross National Expenditure	3.1	3.1	4.4	2.1	3.7	3.4	2.3
Total Exports	1.9	0.8	3.0	6.6	1.8	2.6	2.7
Total Imports	2.8	6.2	7.9	3.6	2.1	2.9	2.7
Employment (annual %)	0.1	2.9	3.5	1.4	2.9	1.6	1.5
Unemployment Rate (sa; Dec qtr)	6.3	5.7	5.5	5.0	4.8	4.6	4.2
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	-4.9	7.4	1.1
Prices (annual % change)							
CPI Inflation	0.9	1.6	0.8	0.1	1.1	1.7	2.1
Non-tradable Inflation	2.5	2.9	2.4	1.8	2.3	2.7	2.9
Tradable Inflation	-1.0	-0.3	-1.3	-2.1	-0.6	0.5	1.1
Fiscal and External Balance							
Current Account Balance ($bn)	-8.4	-7.0	-7.4	-7.7	-9.9	-11.8	-10.8
as % of GDP	-3.9	-3.1	-3.1	-3.1	-3.9	-4.5	-3.9
Government OBEGAL ($bn)*	-9.2	-4.4	-2.8	0.4	0.7	0.5	2.3
as % of GDP	-4.3	-2.0	-1.2	0.2	0.3	0.2	0.8
NZ Financial Markets (end of December quarter)							
TWI	74.4	77.3	79.2	73.6	71.9	66.8	69.8
NZD/USD	0.83	0.82	0.78	0.68	0.65	0.63	0.67
NZD/AUD	0.80	0.92	0.95	0.94	0.97	0.90	0.88
NZD/CNY	5.16	4.98	4.84	4.43	4.39	4.32	4.62
NZD/EUR	0.63	0.60	0.64	0.63	0.63	0.57	0.59
NZD/JPY	71.9	86.5	93.4	82.1	68.3	63.0	73.7
NZD/GBP	0.51	0.50	0.50	0.46	0.54	0.47	0.47
Official Cash Rate	2.50	2.50	3.50	2.50	2.25	1.75	2.00
90-day bank bill rate	2.69	2.84	3.68	2.75	2.41	1.99	2.25
2-year swap rate	2.67	3.85	3.80	2.85	2.14	2.22	2.54
10-year government bond rate	3.52	4.72	3.67	3.57	2.03	2.45	2.60

[1] Percentage point contribution to growth

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