NEW ZEALAND ECONOMICS
ANZ ECONOMIC OUTLOOK

JULY 2015

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MANAGING SOME UNRULY CHILDREN

NEW ZEALAND ECONOMIC OUTLOOK

The economy is facing challenges. We characterise the outlook as having some “unruly children” to manage as opposed to an economy heading off the rails. The economy is growing at a below trend pace. However, natural shock absorbers – a lower OCR and a weaker NZD – as well as some other positive forces are expected to keep the economy on an even keel, limiting the downside to the business cycle before uplift over 2016.

GLOBAL OUTLOOK

Our projections assume a moderate rate of global expansion overall. But the risk profile is heavily skewed to the downside, particularly surrounding the outlook in China.

EXPORT COMMODITY PRICES

Global commodity prices are under pressure. There is some commonality in the drivers, while others are industry specific. This means diverse outlooks for the different primary sectors in 2015/16. We have a milk price forecast of $4.50/kg MS for 2015/16.

LABOUR MARKET

The demand for labour is moderating from strong rates of growth. But in conjunction with still solid labour supply growth, the unemployment rate is expected to hover around current levels for the next 12 months or so, keeping wage inflation contained for the time being.

FISCAL POLICY

The fiscal accounts are effectively back in surplus and net debt is low. But given that the impact of a weaker nominal income growth outlook is yet to be fully felt, future surpluses will not be large. The microeconomic agenda remains an unheralded part of the broader economic story and there is room for the fiscal stance to turn expansionary if growth doesn’t recover in 2016.

INFLATION

Annual inflation is expected to remain below 1% over 2015, and remain below the midpoint of the RBNZ inflation target over the bulk of the projection period. Our forecasts assume the lower NZD will help push annual inflation closer to the inflation target midpoint, although a benign outlook for non-tradable and core inflation will keep overall inflation rates low.

EXCHANGE RATE

The NZD remains biased to the downside. However, in the absence of a market meltdown, the pace of declines should dramatically slow, although the volatility of the currency will remain high. Cross dynamics should come to the fore; we expect the NZD/EUR to move up then down, and the NZD/AUD to remain elevated.

INTEREST RATES

The OCR is on the move lower. We expect the RBNZ to completely unwind all four of last year’s rate hikes. A tick-shaped yield curve has emerged, and is here to stay, but the trough has scope to move lower as the RBNZ follows through with cuts. Our forecast assumes New Zealand long-term rates rise gradually in line with global rates, but to a lesser extent as geographic spreads narrow.

KEY ECONOMIC FORECASTS

Calendar Years	2012	2013	2014	2015(f)	2016(f)	2017(f)	2018(f)
NZ Economy (annual average % change)							
Real GDP	2.4	2.2	3.3	2.2	2.7	2.6	2.5
Employment	0.2	1.5	3.5	2.9	1.5	1.2	1.2
Unemployment Rate (Dec qtr)	6.8	6.1	5.8	5.8	5.6	5.4	5.2
Terms of trade (SNA basis)	-4.2	6.2	4.7	-0.3	-5.7	-0.7	-0.8
Global Growth (annual average % change)							
US	2.3	2.2	2.4	2.6	2.7	2.5	2.5
Eurozone	-0.8	-0.3	0.9	1.7	2.1	1.8	1.5
Australia	3.6	2.1	2.7	2.4	3.0	2.9	2.8
Japan	1.7	1.6	-0.1	1.1	1.5	1.2	1.2
China	7.8	7.7	7.4	6.8	6.7	6.6	6.5
Trading Partners	3.3	3.0	3.5	3.6	3.9	3.8	3.7
NZ Inflation (annual % change)							
CPI Inflation	0.9	1.6	0.8	0.7	1.8	2.0	2.1
Non-tradable Inflation	2.5	2.9	2.4	1.8	2.0	2.2	2.4
Tradable Inflation	-1.0	-0.3	-1.3	-0.9	1.6	1.8	1.7
NZ Financial Markets (end of December quarter)							
TWI	74.4	77.3	79.2	73.0	69.1	66.9	
NZD/USD	0.83	0.82	0.78	0.66	0.64	0.62	
NZD/AUD	0.80	0.92	0.95	0.90	0.91	0.89	
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	
10-year bond rate	3.52	4.72	3.67	3.75	3.90	4.00	
Fiscal and External Balance							
Current Account Balance ($bn)	-8.5	-7.2	-7.9	-10.9	-14.2	-14.2	-14.3
as % of GDP	-4.0	-3.2	-3.3	-4.6	-5.8	-5.6	-5.4
Government OBEGAL ($bn)*	-9.2	-4.4	-2.9	0.5	0.1	1.0	1.5
as % of GDP	-4.4	-2.0	-1.3	0.2	0.1	0.4	0.6

*Operating balance excluding gains and losses, June years. Forecasts and text finalised 10 July 2015.

KEY FORECAST ASSUMPTIONS:

- The NZD is assumed to end 2015 at 66 US cents and gradually ease to 62 US cents by late 2017.
- Net annual permanent and long-term (PLT) migration inflows are assumed to peak close to 60,000 persons over the next few months and taper off over the projection period, ending 2017 at around 30,000 persons.
- The value of earthquake reconstruction work is equivalent to $40bn in 2013 dollars. This will be spread across residential ($20bn), commercial and social assets ($15bn), and infrastructure ($5bn). More than half of this work is assumed to be completed by the end of 2017. The economic impact will be partly diluted by contractionary fiscal policy, equivalent to around 1½% of GDP over the projection period.
- Dubai oil prices are assumed to trade within a USD50 to USD80 per barrel range over the forecast period.
- Potential growth is expected to remain around 2¾-3% in the early part of the projections and around 2½-2¾% over the medium term.
- There is considerable uncertainty surrounding the level of the neutral OCR. In normal times, it arguably resides around 4½%. However, in the current environment of ultra-stimulatory global monetary policy settings it is perhaps in the low to mid-3s.

NEW ZEALAND ECONOMIC OUTLOOK

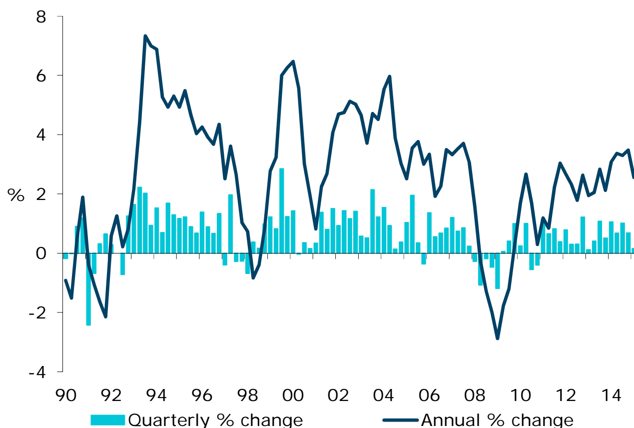
SUMMARY

The New Zealand economy is facing challenges. We characterise the outlook as having some "unruly children" to manage as opposed to the economy heading off the rails. Headwinds are mounting in the form of dairy stresses, fading incremental impetus from a city rebuild and global ructions. However, natural shock absorbers – a lower OCR and a weaker NZD – in association with solid migration, a still strong construction pipeline and better microeconomic foundations are expected to keep the economy on an even keel, limiting the downside to the business cycle before uplift over 2016.

LOSING MOMENTUM

The gloss is beginning to dull on New Zealand's growth backdrop. The economy grew just 0.2% q/q in the March quarter, which saw annual growth ease to 2.6% – the softest rate since late 2013. Admittedly, some of this weakness was due to temporary factors. Mother Nature was certainly not obliging at the start of the year, with drought conditions weighing on agriculture and primary food production. Additionally, sectors that have historically shown little correlation with the overall economic cycle (mining, government and utilities value added) were also coincidentally weak. But there were legitimate signs of softness – particularly weak business investment – which does not bode well for growth over the remainder of the year.

FIGURE 1. NEW ZEALAND ECONOMIC GROWTH



Source: ANZ, Statistics NZ

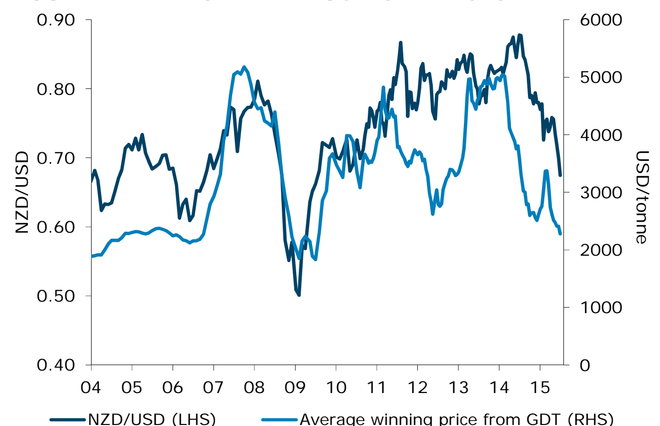
High-frequency macroeconomic indicators have also rolled over. Consumers remain reasonably upbeat, but business sentiment has retreated to its lowest levels since the February 2011 earthquake. Employment and investment intentions have also softened. While the agriculture sector is at the forefront of this weaker sentiment, optimism in the construction sector has also softened. In addition, the likes of our Truckometer, which has fallen in five of the past six months, points to the prospects of Q2 GDP growth being weak too, while job ads suggest the demand for labour is beginning to moderate. On their own, each of these indicators is a red flag, but together they send a clearer signal. This softer growth picture is also consistent with the more mixed tone of our internal anecdotes of late.

But it's far from doom and gloom. Mother Nature can throw the economy around and it certainly did over the first part of the year. There will be recoil. Some sectors such as tourism (a $24 billion industry) are doing well and house prices are still surging. In many ways, a more modest growth picture should not be overly surprising. An economy doesn't always move in a seamless fashion, rather it can move in fits and starts. And New Zealand's economic expansion is in a more mature phase where capacity (i.e. finding the right staff) becomes a bottleneck to growth.

Headwinds are mounting though. Some challenges are obvious, including restrictive fiscal policy and a NZD that has been persistently high relative to history and where commodity prices suggest it should be for some time. **But the economy is also facing new challenges.**

- **The terms of trade now looks set to experience a peak-to-trough fall of around 20%.** That's a massive fall in purchasing power. Even after this fall, they will still remain at a historically elevated level and we are mindful that the historical experience is that mean reversion tends to take hold. A 20% fall represents a likely hit to real activity growth of circa 3 percentage points over the next two years. Most of the adjustment obviously centres on the dairy sector, and there is little doubt that strains and cash flow pressures are intense. Farmers are cutting back, herds are being reduced, working capital requirements increased and this is all at a time when global prices are yet to stabilise. Pressures could last well into 2017.

FIGURE 2. NZD VS DAIRY AUCTION PRICES



Source: ANZ, GlobalDairyTrade, Bloomberg

NEW ZEALAND ECONOMIC OUTLOOK

- **The growth stimulus from the Christchurch earthquake is fading.** While the pipeline of work remains massive – very little commercial construction work has actually taken place to date – it is clear that the incremental contribution to growth from the rebuild is waning. Both Christchurch house prices and rents are now falling as a better balance has returned to the market.
- **Broader residential building activity – a pro-cyclical part of the economy – has started to tread water.** Capacity constraints are certainly part of the issue here – builders' capacity utilisation surged to close to record levels in Q2; there are just not enough builders available to meet demand in some parts, but easing confidence is at play too.
- **Policymakers are seriously attempting to slow Auckland house prices**. Tighter loan-to-value ratio lending restrictions are imminent for Auckland (on financial stability grounds). The central Government has also changed what was a soft intent-based capital gains tax regime for housing investors into a hard one (if you sell within two years you are subject to tax). It has also tightened up rules around offshore investment by requiring foreign investors to have a NZ bank account and tax number and share their offshore tax identification details. Auckland still has a shortage of housing (which leaves us constructive on the construction sector outlook overall) but speculative demand is in the crosshairs. It may tip the balance.
- **A lower NZD brings both winners and losers**. It's not enough to rescue dairy farmers this season but a lot of exporters are smiling. Conversely, importers and retailers are set to face margin pressure, caught between high input costs and a consumer who will be resistant to price increases.
- **The global scene is taking a turn for the worse.** That's not good for domestic confidence or commodity prices, and risks creating contagion. Greece is at the epicentre, and dominating headlines. But for us, the real issue is China (refer page 7).

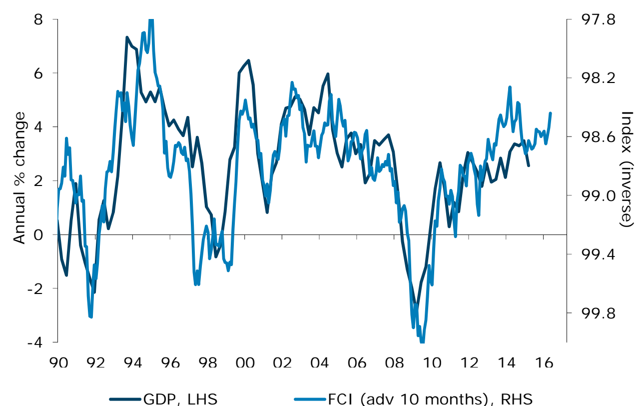
This combination sets the scene for sub-trend growth in the near-term. We expect that theme to continue over the remainder of the year. We forecast annual GDP growth to slow towards 2% y/y by the end of 2015, vis-à-vis trend growth that arguably still sits around 2¾% to 3%.

ACCENTUATE THE POSITIVE

Despite challenges and risks, we're remaining constructive towards the economic outlook more broadly.

- **Interest rates and the NZD have fallen and we're expecting more of the same on both fronts.** Both are natural shock absorbers that will support growth in 2016. We expect the RBNZ to fully reverse all of last year's 100bps of hikes, taking the OCR back to 2.5%. That's helped loosen financial conditions, which track GDP well.

FIGURE 3. GDP VS FINANCIAL CONDITIONS



Source: ANZ, Bloomberg, Statistics NZ

- **Fiscal policy can step up to the plate** and turn expansionary as the government uses its large balance sheet to lean against the cycle. Tax cuts are provisionally pencilled in for the 2017 Budget, but they could be fast-tracked to 2016 if growth prospects dim further.
- **The economy still has numerous supports.** Net migration continues to hit new record highs and is showing little signs of turning. Credit growth is picking up even outside of the increased working capital requirements in the agricultural space. The tourism sector is on a roll and operators who have been doing well despite NZD headwinds must surely be rubbing their hands together now considering recent NZD weakness. Airline capacity and new route developments are structural changes that should not be downplayed. And the services sector is also still bubbling away.
- **New Zealand is competitive and cost-focused.** Unlike Australia, New Zealand did not see reduced competitiveness and a massive run-up in costs during the terms of trade boom. That behaviour helps to soften the terms of trade hit. Costs did not surge recently when the dairy payout was high, and farmers are rapidly trying to reset cost baselines now.

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- **Sub-trend growth will free-up resources**. This is particularly relevant for the likes of construction, which faces immense capacity bottlenecks. With rebuild work close to peaking, even a gradual waning is a negative for the Canterbury region itself. However, as rebuild stimulus passes its peak this will make it easier for the construction sector to find staff, and there is no shortage of work nationally.
- **The economy enters the current period of uncertainty in a healthier fashion structurally.** Historically, it has been a combination of internal excesses and global events that have tripped the economy up. While the global backdrop remains fickle (there are the obvious candidates for negative shocks) and there remains largesse in the likes of the overvalued Auckland housing market, we are not detecting the same degree of domestic imbalance that has often plagued the New Zealand economy in the past. Net external debt has fallen, households are saving and showing relative spending restraint, household deposit growth has been outstripping credit growth for the better part of seven years, banks have more term funding in place, inflation is low, potential growth higher, and the fiscal position is robust.
- **The economy has better microeconomic foundations (or to put it more aptly, it has a lot of smaller things going for it). Individually, these may not make a significant difference, but collectively they do.** The free-trade-agreement agenda is ongoing. Foreign capital is easily being attracted to New Zealand assets. The Government sector is being more dynamic with its investment approach to spending. Labour force participation is high, in part due to welfare-related reform. Domestic banks are better placed to withstand offshore credit market seize-up risks. The RBNZ and Government attacks on the Auckland property market are aimed at mitigating associated vulnerabilities.

The above list is non-exhaustive and doesn't negate business cycle dynamics coming into play. The economy is far from bullet-proof – the current account deficit is on a widening trajectory highlighting that vulnerabilities do still exist. **However, these forces do strengthen the economy's ability to navigate through the cycle with less volatility.**

When growth is decelerating it is easy to become overly bearish and extrapolate this trend. However, we have also not lost sight of what we feel remains a strong medium-term picture. We don't deny the economy has some near-term challenges to navigate. But rather than growth performance over a 12 month period, what matters more for business performance and households' living standards more generally is the trend over a number of years. And on this front we are still relatively upbeat. Underpinning this positive medium-term story is a positive supply-side outlook reflecting improved productivity performance, rising capital intensity and high labour utilisation. New Zealand is connecting more and more into the fast growing Asian region. The complacency virus has been kept at bay and there remains considerable scope to unlock growth from areas of advantage, especially our considerable natural resources endowment. There is scope for further opportunities across the tradable sector to be realised and there are growing signs of a more tech-savvy economy emerging. A well-functioning political system is ensuring that leadership is dominating populism, and a sound microeconomic reform agenda is in place.

KEY FEATURES OF OUR GDP FORECASTS INCLUDE

- **After a below trend 2015, growth is forecast to return to close to trend over 2016.** Annual growth is expected to accelerate modestly over 2016, after softness in the back half of 2015. Our full-year forecast for 2016 of 2.7% is broadly close to trend. It should be enough to see the likes of the unemployment rate gradually drift lower again after an expectation of it holding around current levels (5.8%) over 2015. The uplift in growth critically assumes however that the terms of trade stabilise and the dairy payout rebounds in the 2016/17 season (though we expect the cash-flow impact to take longer to flow through).
- **Consumption growth is forecast to be modest.** There are both structural and cyclical reasons for this. Households are more savings-conscious today than pre-2008; witness the 2.5 million who have signed up to KiwiSaver. Household income growth is set to slow, largely due to weaker rural incomes but also due to a moderating labour market performance. The boost from lower petrol prices is also now behind us. We also suspect house price growth (largely in Auckland) will moderate as affordability constraints and policymaker action bites.
- **An increasing contribution to growth from net exports.** Over the past five years, net exports have dragged on growth to the tune of an average of 1.1ppts per year. While a modest negative contribution to growth is still forecast over 2015, we see net exports contributing positively to growth by around 0.3ppts per year over the

NEW ZEALAND ECONOMIC OUTLOOK

subsequent three years, in large part due to NZD weakness. While biological constraints in the primary sector limit the elasticity of New Zealand's exports to the NZD, services exports is one area where we see a solid growth performance eventuating.

- **Investment should continue to rise as a share of GDP.** Residential investment growth has moderated from the double-digit rates seen between 2012 and 2014. And while the impact of the earthquake rebuild is winding down, this should be offset by demand elsewhere, particularly in Auckland. Modest rates of growth are forecast over the next few years. Moreover, business investment is assumed to rebound from weakness seen earlier this year. Investment intentions have fallen, but they remain above historical averages in many cases. But more importantly, improved labour productivity and low unit labour costs should support overall profit margins (although not in all sectors admittedly) and investment growth overall. As a share of GDP, business investment is forecast to rise towards 14% of GDP, from 12½% currently.
- Despite an increasingly positive contribution from net exports, further weakness in the terms of trade will see the **annual current account deficit widen towards 6% of GDP by the end of 2016.** That said, it is expected to be capped around this level, given assumed ongoing restraint by households and the Crown, and a stabilisation in the goods terms of trade from mid-2016.

NEW ZEALAND NATIONAL ACCOUNTS FORECAST

Calendar years (average annual % change)	2012	2013	2014	2015(f)	2016(f)	2017(f)	2018(f)
Total Consumption	**1.9**	**2.7**	**3.3**	**2.6**	**1.8**	**2.1**	**2.3**
Private Consumption	2.9	2.9	3.2	3.0	2.2	2.5	2.8
Public Consumption	-0.9	2.0	3.4	1.5	0.6	0.8	0.6
Total Investment	**7.9**	**8.5**	**8.8**	**1.3**	**4.1**	**2.8**	**1.6**
Residential investment	14.1	16.6	16.2	1.4	3.2	0.7	-5.2
Other investment	6.3	6.2	6.5	1.3	4.4	3.5	3.8
Stockbuilding[1]	**0.1**	**0.1**	**0.2**	**0.0**	**0.1**	**0.1**	**0.1**
Gross National Expenditure	**3.1**	**3.9**	**4.6**	**2.2**	**2.4**	**2.3**	**2.2**
Total Exports	**1.9**	**0.9**	**3.3**	**6.3**	**3.4**	**3.8**	**3.9**
Goods	4.1	0.6	1.8	7.5	3.2	3.6	3.6
Services	-3.8	1.7	7.4	3.2	4.1	4.1	4.7
Total Imports	**2.8**	**6.1**	**7.9**	**5.2**	**2.6**	**2.6**	**2.7**
Goods	3.9	6.7	9.0	6.0	2.9	2.7	2.8
Services	-4.6	0.9	5.5	8.9	1.7	2.0	2.0
Expenditure on GDP	**2.9**	**2.5**	**3.3**	**2.3**	**2.5**	**2.7**	**2.5**
GDP (production based)	**2.4**	**2.2**	**3.3**	**2.2**	**2.7**	**2.6**	**2.5**

[1] Percentage point contribution to growth

GLOBAL OUTLOOK

SUMMARY

Our projections assume a moderate rate of global expansion overall, but the risk profile is heavily skewed to the downside. Our working assumption is that actions by European policymakers will be sufficient to contain the fallout from the latest Greek debt impasse. The US economy is looking reasonable. Conversely, China's economic engine is spluttering as it transitions its growth model, converts debt to equity and weans itself off infrastructure and manufacturing centric growth. Chinese equity bourses have started to correct but it is the movement in commodities (down) that is more telling.

DIVERGENCE

The international scene remains fractured. Stimulus from policymakers is immense and financial conditions incredibly supportive. Arguably they might be too supportive, as low interest rates and less price tension across credit markets and sovereign bonds distorts investment decisions and misallocates capital. Overall, we're seeing reasonable growth in some regions and challenges in others.

While market attention is fixated on Greece and the tug-of-war with creditors (one wants debt relief first and reform second, and the other party the reverse), in our view **China is the real story**.

On the face of it, China is still doing well. Official GDP is running at 7%. However, partial indicators don't support that. In addition, recent falls in equity values, hard and soft commodity markets and the AUD are an ominous mix.

The long-term story for China (and New Zealand) still looks good, but there are some harsh near-term realities. China is transitioning its growth model and weaning itself off infrastructure spending, debt needs to be converted to equity, corporate leverage is high, there has clearly been speculative behaviour in both housing and more recently equities, and there is a crackdown on corruption. As the Fed gets closer to raising interest rates, heavy borrowers during the era of low rates will come under the spotlight, and that's Asia. A host of these challenges are welcome dynamics, but they bring realities too as they portend of a transitioning economy. Seldom have such transitions been seamless. **So the risk profile for China is skewed to the downside**.

We've pencilled in moderate trading partner growth overall, but with clear divergences:

- **A solid US outlook. On the face of it the US economy looks in good shape.** Labour market conditions are improving, household spending has bounced back, manufacturing activity has stabilised and housing market developments remain positive. But it faces challenges. Key litmus tests are a) can the US remain decoupled from the rest of the globe; and b) how will the rest of the world respond to higher US interest rates with USD funding globally dominant? Those are tug-of-war questions and leave us expecting US growth to be only reasonable and lifts in interest rates from the Fed very gradual.
- **A sombre outlook for Europe.** The region simply does not have the flexibility within its economic framework (think labour market, tax system) to grow at a reasonable clip. We suspect the region is going to be running from firefight to firefight over the coming years, with the ECB the chief fireman.
- **Moderate growth in Australia.** A dramatic fall in the terms of trade is being partially offset by lower interest rates and AUD. But structural issues (low productivity growth and high cost structures) still need to be addressed. Until they are tackled, growth will be "stumbly and grumbly".
- **Slowing growth in China.** Sub-7% pa growth is forecast for China over the next few years. Our forecasts assume authorities successfully manage the earlier mentioned tensions – therefore somewhat holy grail in nature. The reality tells us otherwise, so there is considerable downwards skew. We do expect a substantial support package from the Chinese authorities over the coming months. It will help, but still leave questions unanswered.

GLOBAL ECONOMIC GROWTH FORECAST

Calendar years	2012	2013	2014	2015(f)	2016(f)	2017(f)	2018(f)
United States	2.3	2.2	2.4	2.6	2.7	2.5	2.5
Australia	3.6	2.1	2.7	2.4	3.0	2.9	2.8
Japan	1.7	1.6	-0.1	1.1	1.5	1.2	1.2
Eurozone	-0.8	-0.3	0.9	1.7	2.1	1.8	1.5
China	7.8	7.7	7.4	6.8	6.7	6.6	6.5
Trading Partner Growth	**3.3**	**3.0**	**3.5**	**3.6**	**3.9**	**3.8**	**3.7**

ANZ

EXPORT COMMODITY PRICES

SUMMARY

Global commodity prices are under pressure. There is some commonality in the drivers, while others are industry specific. This means diverse outlooks for the different primary sectors in 2015/16. For New Zealand, most attention centres on dairy. Current low prices are expected to eventually stimulate more demand and prompt lower supply as farmers respond. We have a milk price forecast of $4.50/kg MS for 2015/16; that will hurt cash flow for some time. Prospects for a rebound are far from certain given both demand (China, Russia and oil dependant countries) and supply (Europe) uncertainty.

PRESSURE COOKER

Commodity prices are under pressure globally. There is some commonality in the drivers, while other aspects are industry specific.

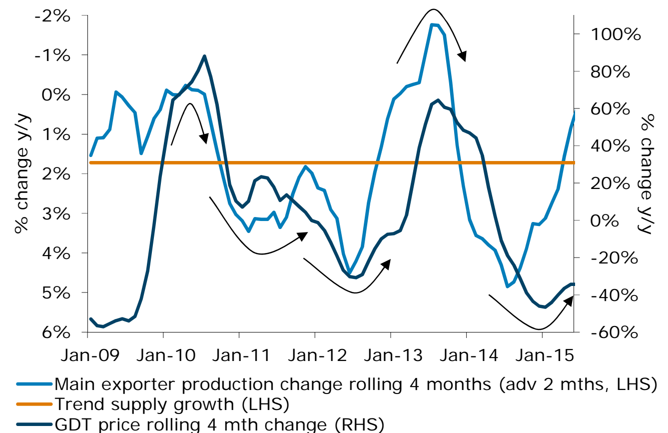
- Global demand remains fickle in many markets.
- Rising uncertainty over China. Greece doesn't help either, nor do other geopolitical ructions.
- Lower feed costs and reasonable Northern Hemisphere seasonal conditions boosting others' competitiveness.
- A swathe of industries saw an outsized response to higher prices and it's taking time for supply to respond to lower price signals. Examples are oil (think shale oil), iron ore and dairying.
- Farm support policy changes taking constraints off, but still providing certain backstops.
- Generally lower commodity prices for key inputs, such as oil and fertiliser, weighing on both the cost curve, general sentiment, and reducing the purchasing power for some key buyers.
- Large producers in some industry segments are trying to undermine high cost producers.
- Competitors opening up more market access into China and other emerging markets.
- Foreign exchange volatility altering competitiveness in soft commodity markets.

For New Zealand, most attention centres on dairying. GDT auction prices are down 60% from their peak and the next few months could see further downward pressure due to seasonally higher volumes from New Zealand and many buyers' requirements being covered.

But we expect price tension to develop over the second half of the season. Key reasons include:

- **Low farm-gate prices are expected to eventually lead to lower supply.** Our indicator shows this has already started to occur over the first half of 2015. This should help rebalance the market.
- **Lower wholesale prices are yet to be fully passed through to retail.** As this continues to occur, demand growth is expected to lift, especially from price sensitive markets.

FIGURE 1. MILK PRODUCTION GROWTH VS GDT PRICE CHANGES



Source: ANZ, Dairy Australia, DCANZ, CLAL, Datum, USDA

We have a milk price forecast of $4.50/kg MS for 2015/16. Current dairy prices are consistent with a payout below $4, so our anticipated lift over this season is a critical part of our $4.50 expectation. Two mid-$4/kg MS milk prices back-to-back will hurt cash flow for an extended period. At this stage we are more constructive on a rebound in the payout for 2016/17, but prospects are far from certain given both demand (China, Russia and oil dependant countries) and supply (Europe) uncertainty.

In terms of other commodities:

- **The trough appears to have been found for logs and sheepmeat, but a slow recovery can be expected.** Higher domestic sheepmeat supplies in the UK and China are expected to be offset by lower tradable supply from New Zealand and Australia. In-market log prices have stabilised, but competition from Russia remains.
- **Kiwifruit prices are expected to be lower** with a rebound in volumes impacting on the market mix and increasing marketing costs.
- **Beef prices are expected to remain strong for now**, driven by the continued outperformance of the US market and a slowdown in Australian supply.
- **Wool prices have proved resilient** largely due to reduced New Zealand supply.
- **The significantly smaller 2015 Sauvignon Blanc vintage** is expected to smooth supply between adjoining years reducing bulk wine volumes, which should support prices.

LABOUR MARKET OUTLOOK

SUMMARY

The demand for labour is moderating from strong rates of growth – a natural occurrence as the economic expansion matures. But in conjunction with still solid labour supply growth, the unemployment rate is expected to hover around current levels for the next 12 months or so, keeping wage inflation contained. It is not until labour supply growth also begins to ease (on an assumed moderation in the migration cycle), that a lower unemployment rate and modestly stronger wage growth emerges later in 2016.

SOLID BUT MATURING

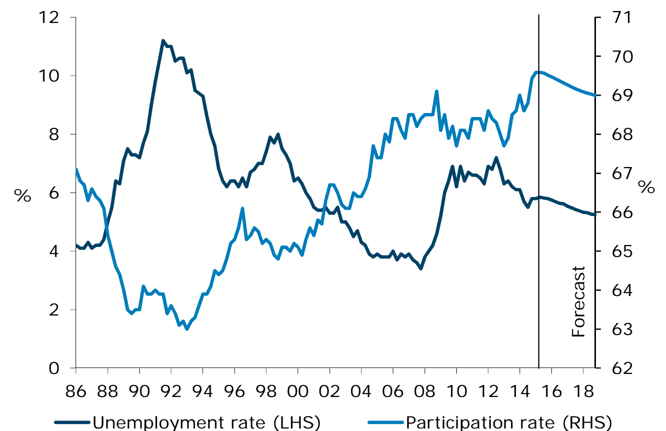
The demand for labour has been strong. Official HLFS employment has expanded for ten consecutive quarters – the longest string of gains since 1992-96. At 3.2% y/y, annual employment growth sits near a decade high. Importantly, over 80% of the 74K jobs created over the past year have been full-time positions and like the expansion itself, jobs growth has been reasonably broad-based (11 of 16 sectors are experiencing positive annual employment growth), although the construction sector has outperformed.

But the cycle is now maturing. Firms' hiring intentions have become less positive, and while some survey measures remain above historical averages, they point to a more moderate pace of employment growth over the next 12 months. Other indicators such as job advertising and our unemployment rate direction index are also consistent with this moderating theme.

Slowing labour demand shouldn't be alarming. It is a natural response to a maturing economic expansion and more modest activity growth generally. But it also reflects the impact of skill shortages in some sectors (i.e. construction). In fact, it is notable that construction sector hiring intentions have fallen to their lowest levels since mid-2012 despite what is still a solid pipeline of activity across the country. **Overall, we forecast employment growth to cool from over 3% to around 1½% by mid-2016.**

But the overall performance of the labour market will hinge heavily on supply-side developments. At 5.8%, the unemployment rate remains above most estimates of NAIRU as labour supply growth has kept pace with labour demand (even outpacing it more recently). Net migration gains have contributed to the strongest working age population growth in a decade and the labour force participation rate continues to post new all-time highs (69.6%). This labour market spare capacity, along with low inflation more generally (containing cost of living adjustments) and structural elements (such as increased global labour mobility) has ensured that wage inflation has remained relatively low for this stage in the cycle.

FIGURE 1. UNEMPLOYMENT AND PARTICIPATION RATE



Source: ANZ, Statistics NZ

We assume that these supply-side forces have a few more legs yet. While it is unlikely that we see the same magnitude of supply-side gains that were experienced over the past year (i.e. the participation rate is assumed to hold at current record levels and not rise further), ongoing net migration gains should still support decent working age population and labour supply growth more generally. At a time of moderating employment growth, this is expected to see the unemployment rate hold around current levels for the next 12 months. In fact, there is arguably some modest upside risk in the near-term. It is certainly not expected to be an environment conducive to stronger wage inflation, despite some sectoral evidence of skill shortages.

It is not until labour force growth slows that the unemployment rate is projected to begin falling again, and modestly stronger wage growth emerges. Admittedly, there remains considerable uncertainty over projections for labour supply. Critically, they hinge on an expectation that record net migration inflows begin to return to more historically average levels and demographic pressures begin to see the participation rate ease from record highs.

But under these assumptions, slowing labour force growth is expected to see the **unemployment rate gradually ease towards 5.2% by the end of the projection period.** Modest wage growth from later in 2016 is also expected to emerge.

FISCAL POLICY

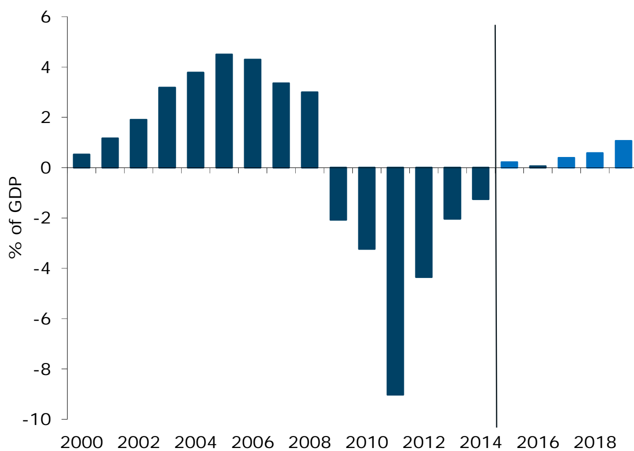
SUMMARY

The fiscal accounts are effectively back in surplus and net debt is low. But given that the impact of a weaker nominal income growth outlook is yet to be fully felt, future surpluses will not be large. The microeconomic agenda remains an unheralded part of the broader economic story; the Government's investment approach to spending is world class. There is room for the fiscal stance to turn expansionary if growth doesn't recover in 2016, in effect offering a plan "B". That requires thinking caps to be put on now.

BACK IN BLACK

Underlying fiscal surpluses have effectively been re-established. In the 11 months to May, an OBEGAL surplus of $1.2bn was achieved, which was close to $1bn better than Budget forecasts. Better tax revenue and lower expenditure are both contributing to this theme. We await for confirmation in the full-year numbers published in October, but clearly there is a decent chance that 2014/15 will be marked as the year that underlying surpluses were returned – for the first time since 2007/08.

FIGURE 1. UNDERLYING OPERATING BALANCE



Source: ANZ, NZ Treasury

Our base case is that this fiscal improvement continues. In terms of the numbers themselves, we see the OBEGAL rising towards 1% of GDP by 2019 (slightly less than Treasury projections). Core Crown expenditure is projected to continue to fall as a share of GDP (below 30%), and net debt is forecast to peak at a touch over 27% of GDP. New Zealand's fiscal accounts will remain in the top echelon globally. Typically that would see us raising the prospect of a credit upgrade, but there is enough in a deteriorating external position to keep rating agencies watchful.

Headwinds to improvement still exist. Slowing real economic activity growth, low inflation and falling terms of trade make for a challenging nominal GDP growth outlook. In fact, we forecast nominal GDP growth to average just 3% per year over the next five years vis-à-vis the Treasury's projection of over 4%, and this will in turn weigh on the Government's revenue generating capabilities.

But we'll also give a hat-tip to the Government's investment style approach to managing finances and the microeconomic agenda. This is helping cement a massive improvement in the fiscal accounts longer-term while the former is starting to manifest in some macroeconomic statistics. New Zealand has a labour force participation rate that is 5 percentage points above Australia's – thanks in a large part to welfare reform incentivising people into the labour market.

TIME TO LOOSEN THE PURSE STRINGS?

The fiscal stance is tight. Treasury's projections portray it as an economic headwind to the tune of 1½% of GDP over the coming four years. That approach is apt when the economy was tracking well and deficits were being run. It's not now.

The fiscal stance should be returned to a more neutral, if not expansionary stance. The Government has a large balance sheet that allows it to operate in a counter-cyclical fashion and support the economy; fiscal policy is equally as important a stabiliser as monetary policy is. Plan "A" for the Government looks to be an economy remaining strong and tax cuts held back until the 2017 Budget. However, we'd also have a plan "B" given economic risks. There is of course issues with timing (fiscal policy comes with longer lags) and throwing money at the economy willy-nilly is also not the answer. But if the economy does not improve as we expect, nor dairy prices recover, we would not rule out the likes of the tax cuts being brought forward to next year's Budget.

FISCAL FORECASTS

June years	2014	2015(f)	2016(f)	2017(f)	2018(f)	2019(f)
OBEGAL ($bn)	-2.9	0.5	0.1	1.0	1.5	2.9
– as % of GDP	-1.3	0.2	0.1	0.4	0.6	1.1
Operating Balance ($bn)	2.8	1.8	3.0	3.8	4.4	5.8
– as % of GDP	1.2	0.8	1.2	1.5	1.7	2.2
Net Core Crown Debt ($bn)	59.9	61.4	65.6	67.7	68.3	67.4
– as % of GDP	25.6	25.6	27.3	27.1	26.3	25.0
Core Crown residual cash ($bn)	-1.8	-0.6	-1.7	-0.8	-0.2	0.4
Bond Tender Programme ($bn)	7.7	8.0	8.0	7.5	7.5	7.5

ANZ

INFLATION

SUMMARY

Annual inflation is expected to remain below 1% over 2015, and remain below the midpoint of the RBNZ inflation target over the bulk of the projection period. Our forecasts assume the lower NZD will help push annual inflation closer to the inflation target midpoint, although a benign outlook for non-tradable and core inflation will keep overall inflation rates low. We are also increasingly of the view that fundamental changes impacting the inflation process will contribute to a prolonged undershoot of core inflation from the inflation target midpoint.

LOWER FOR LONGER

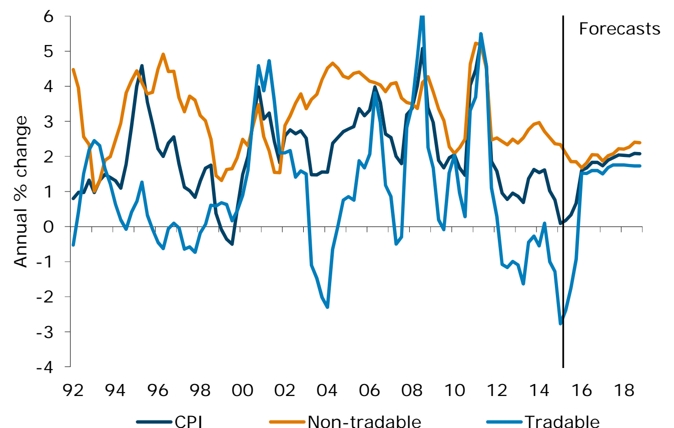
Annual inflation fell to a 15-year low at the start of the year, with the impact of the high NZD, the benign global inflation backdrop and lower commodity prices all impacting. But what is also evident is that despite the expansion being well advanced, measures of core inflation have been mild, surprising both the RBNZ and analyst community forecasts to the downside. More enduring influences have had an impact on containing domestic wage and price pressure, including migration and participation rate assisted increases in labour supply, enhanced productivity, the impact of new technology and the disinflationary impact of globalisation. Inflation expectations also remain historically low. There is a global element to what is going on, with low inflation not just a New Zealand specific phenomenon. While it is too soon to consign traditional approaches for forecasting inflation to the dustbin, recent experience encourages a serious rethink.

We expect annual CPI inflation to remain below 1% for all of 2015. A low inflation starting point, low global commodity prices and the last vestiges of NZD strength are expected to maintain downward pressure on tradable prices. While the impact of recent NZD weakness will be felt for some tradable prices, and higher retail petrol prices look set to make a 0.2-0.3ppt contribution to annual inflation over 2015, this will be partly offset be the impact of July ACC levy cuts, which are expected to shave 0.2ppts off annual inflation over the June 2016 year.

The impact of NZD weakness is expected to make itself more evident on the retail price front from early next year, which will be a factor pushing up annual CPI inflation. The NZD TWI is down more than 12% since April and has fallen by more than 20% against the USD over the past 12 months. We expect only a mild degree of pass-through into consumer prices as we doubt the retail environment will be sufficiently robust to enable retailers to pass on full cost increases to consumers, who will already be feeling the squeeze from a weaker household sector backdrop and the loss in purchasing power from the lower terms of trade.

Our assessment is that the economy will expand at a sub-trend rate over the early part of our projection period, which will limit pressures on domestically generated inflation. Pricing pressures will still be evident in some pockets (e.g. construction) but the judgement we have made is that they will not filter through into broader price increases. Administrative price changes will also affect the inflation profile, although the Government is yet to announce any further increases in tobacco excise beyond March 2016 (which have been making an approximate 0.2ppt contribution to annual CPI for the past five years). Our inflation projections do not assume any further excise tax hike, although that is clearly a risk.

FIGURE 1. CPI INFLATION



Source: ANZ, Statistics NZ

CPI FORECAST

Quarter	Qtr % chg	Ann % chg
Mar-15	-0.3	0.1
Jun-15 (f)	0.3	0.2
Sep-15 (f)	0.5	0.3
Dec-15 (f)	**0.2**	**0.7**
Mar-16 (f)	0.6	1.6
Jun-16 (f)	0.4	1.7
Sep-16 (f)	0.6	1.8
Dec-16 (f)	**0.2**	**1.8**
Mar-17 (f)	0.5	1.7
Jun-17 (f)	0.6	1.9
Sep-17 (f)	0.7	2.0
Dec-18 (f)	**0.2**	**2.0**
Mar-18 (f)	0.4	2.0
Jun-18 (f)	0.6	2.0
Sep-18 (f)	0.8	2.1
Dec-18 (f)	**0.2**	**2.1**

EXCHANGE RATE

SUMMARY

The NZD remains biased to the downside courtesy of lower interest rates, a widening current account deficit, weak commodity backdrop, global risks and firmer USD sentiment. However, in the absence of a market meltdown, the pace of declines should dramatically slow, although the volatility of the currency will remain high. Cross dynamics should come to the fore; we expect the NZD/EUR to move up then down, and the NZD/AUD to remain elevated.

A NECESSARY ADJUSTMENT…

The case for a lower NZD on a TWI basis looks clear.

- The RBNZ is at the beginning of an easing cycle. At this stage we expect it to take until March 2016 to reverse last year's OCR hikes, and markets have not yet fully priced this scenario. However, markets are eyeing contemporary examples in Sweden, Norway, Israel, and Australia where the cycle has been quicker and indeed extended. In those examples, currency declines have also extended.
- Commodity prices are weakening and uncertainty surrounds whether a much-awaited rebound in dairy prices will emerge anytime soon, or if the price decline will extend to other New Zealand export commodities. These declines are leading to an increased trade deficit, and the economy needs to see the natural offset of ongoing currency declines. We project a 20% peak-to-trough fall in the terms of trade, and the NZD has only fallen 12% from its peak on a TWI basis, therefore a lower TWI is likely.
- Thanks to the deteriorating trade dynamics, the current account is on a widening trajectory. A lower NZD is required to restore some "balance" across the economy.
- There are developing economic risks associated with New Zealand's largest and second largest trading partners; Australia and China.

…BUT AN ORDERLY ONE

While the case for a weaker NZD is clear, the magnitude of decline is not. Basic economics argues for a more substantial adjustment. The economy needs the NZD to act as a shock absorber for the widening trade deficit driven by the declining terms of trade. But stepping back, there are other equally important forces at play:

- New Zealand is still expected to outperform the majority of overseas counterparts in the growth stakes over coming years. This will ensure that New Zealand assets are attractive for offshore investors, especially at the new lower NZD valuation.
- New Zealand's yield differential will be narrower, but it will still be substantial even after upcoming OCR cuts. We are not forecasting the OCR to go below 2.5%, and it is increasingly apparent that prospects for global yield normalisation are dropping. The US is currently the most likely to close the gap to New Zealand, with the Fed set to begin the normalisation process this year. However, at the June FOMC meeting the Fed flattened its forward projections for the policy interest rate path and at this stage markets have the Fed Funds rate taking two years to return to just 1.5%.
- Thus, New Zealand assets still look cheap on a global stage and money is looking for a home. On the assumption that policymakers can contain volatility, money will return to being put to work.
- While the external accounts are weak, the fiscal accounts are strong; this negates credit rating risk. NZGS are still the only G10 AA rated asset yielding over 3%.

FOUR KEY INTERNATIONAL CURRENCY DYNAMICS INFLUENCE OUR CROSS VIEWS

While local characterisations are a key influence on the NZD TWI, movement in various crosses is heavily influenced by trends in currency majors. We note the following four expected themes:

1. **Firm USD sentiment to remain.** One of the central themes for currency markets over the last year has been a firmer USD. As growth continues to slowly rotate back from the east (as China slows) to the west (as the US normalises) we expect the firm USD trend to continue with a particular focus on gains against Asian and Asian-focused currencies like the NZD.
2. **It will be a game of two-halves for the EUR.** Europe isn't quite ready to return to sustained growth, as political issues and capital flight (driven by the early impact of QE) ensure that the EUR will remain under pressure over the rest of the year. However, we do expect the ECB QE program and incremental improvements in the political/fiscal situation to drive the EUR to make gains next year. The situation is clearer for GBP as **we expect GBP to follow the USD script with the UK economy improving**. The caveat to this is whether or not Europe finds a lasting solution for its current issues.

EXCHANGE RATE

3. **Stability for JPY.** The early impacts of Abenomics are over, and Japanese authorities have expressed a desire for yen stability. We concur with their desire, and the next stage in JPY direction will depend on whether Abenomics is successful in driving change in economic performance. If it does improve, this could result in a longer period of stability as JPY attracts investment.
4. **AUD suffers from both cyclical and structural challenges.** The cyclical challenges facing the AUD are obvious; commodity prices have tanked and the economy is struggling to reallocate resources away from mining into other areas of the economy. However, structural challenges are also relevant, namely a loss of competitiveness and the inability of political leadership to drive economic reform. Labour relations, the fiscal and regulatory environment, and political leadership are likely to remain key challenges for Australia, keeping NZD/AUD above long run averages.

MINOR RISKS OF A MACRO OVERSHOOT

Currencies have an inherent tendency to overshoot in either direction; witness the extremes in the NZD over the years. We acknowledge this dynamic, but are equally mindful that there are typically strong macro reasons driving such overshoots, especially when it is an overshoot to an under-valuation. We are also mindful that the NZD navigated the Asian crisis, dotcom bubble, September 2001 crash, and the GFC, only to recover to stronger valuations. Finally, we note that markets have been bearish NZD for some time, so are already short.

The obvious candidates for a material shakeout to the downside for the NZD are an unravelling of China's growth story – and associated flow-on to commodity prices – or a disorderly "Grexit". We can see semblances of market dynamics consistent with both scenarios right here and now (particularly in the commodity space), but not the array of consistent nuances to make it a core view.

NZD/USD: USD BULL TREND

We continue to view the NZD/USD as being on a declining trend, as we are still in the early stages of an RBNZ easing cycle. While the move observed is significant, we still expect the NZD/USD to drop further, although we caution that the domestic drivers for the currency are well understood and relatively fully priced. This will mean further weakness will be hard fought and the potential for bounces is significant. We still expect the USD to find support the further we move through the start of the interest rate normalisation process. The USD has the added benefit of being the ultimate safe-haven in a troubled world, and this would ensure NZD/USD declines on any 'catastrophic' global economic event.

NZD/AUD: CLOSE TO FAIR VALUE

The RBA and RBNZ are back on convergent policy paths and NZD/AUD has quickly reverted to levels more consistent with fair value. External factors discussed earlier in this document are likely to impact AUD and NZD relatively equally leaving just domestic factors to consider for this pair. We continue to see New Zealand in better economic shape than Australia and we believe this dynamic will keep NZD/AUD above longer run averages.

NZD/GBP: RETURNING TO FUNDAMENTALS

GBP strength agrees with our long-held view of this cross converging toward fundamental fair value in late 2016. The move has been driven by a number of factors but mostly expectations that the UK economy is on the path to normalisation. Given the rapidity of the recent move and the potential for global events to slow the potential pace of Bank of England policy normalisation – especially due to events in the UK's largest trade partner Europe – we remain cautious over the pace of further declines from current levels – there exists a strong chance of temporary reversals of recent GBP strength.

NZD/EUR: REMAINING ELEVATED

We expect EUR to remain under pressure, keeping NZD/EUR elevated, before eventually declining toward long-run averages. EUR has been remarkably stable – as the NZD plummeted – despite political problems in Europe. Given the hesitancy of economic activity in Europe and the ECB's commitment to continue QE measures until Q3 2016 – which will have the side impact of driving capital flight from Europe, we would expect EUR to weaken vs the NZD over the remainder of the year.

NZD/JPY: ASYMMETRIC RISKS

Given Japanese desire for JPY stability we see risks of NZD/JPY continuing lower, driven by NZD/USD direction. QQE no longer looks like the magic bullet it was when it drove the initial JPY devaluation. In fact, comments from BoJ Governor Kuroda seem to indicate that the official desire is for stability in the JPY on a REER basis. This is not to say that JPY will not weaken further over time, but it does suggest topside risks have been truncated and risks are lower driven by NZD/USD direction.

EXCHANGE RATE

EXCHANGE RATE FORECASTS (AVERAGE OF QUARTER)

Quarter	NZD/USD	NZD/AUD	NZD/JPY	NZD/GBP	NZD/EUR	NZ TWI
Mar-14	0.87	0.94	89.3	0.52	0.63	80.5
Jun-14	0.87	0.93	88.6	0.51	0.64	80.9
Sep-14	0.77	0.89	85.0	0.48	0.62	75.6
Dec-14	**0.78**	**0.96**	**93.6**	**0.50**	**0.64**	**79.4**
Mar-15	0.75	0.98	89.7	0.51	0.70	80.0
Jun-15	0.68	0.88	82.7	0.43	0.60	71.2
Sep-15(f)	0.68	0.92	82.3	0.45	0.65	73.6
Dec-15(f)	**0.66**	**0.90**	**80.5**	**0.44**	**0.67**	**73.0**
Mar-16(f)	0.65	0.90	80.0	0.43	0.64	71.6
Jun-16(f)	0.65	0.92	80.6	0.42	0.61	70.8
Sep-16(f)	0.64	0.91	80.0	0.41	0.57	69.1
Dec-16(f)	**0.64**	**0.91**	**80.0**	**0.41**	**0.57**	**69.1**
Mar-17(f)	0.63	0.90	78.8	0.41	0.56	68.0
Jun-17(f)	0.63	0.90	78.8	0.41	0.56	68.0
Sep-17(f)	0.62	0.89	77.5	0.40	0.55	66.9
Dec-17(f)	**0.62**	**0.89**	**77.5**	**0.40**	**0.55**	**66.9**

INTEREST RATES

SUMMARY

The OCR is on the move lower. We expect the RBNZ to completely unwind all four of last year's rate hikes, with a second cut later this month, a third cut in September and a fourth cut in March 2016. Market expectations for the OCR remain more timid than our forecasts, implying further downside risk for short-end interest rates. A tick-shaped yield curve has emerged, and is here to stay, but the trough has scope to move lower as the RBNZ follows through with cuts. Our forecast assumes New Zealand long-term rates rise gradually in line with global rates, but to a lesser extent as geographic spreads narrow.

WHAT GOES UP, COMES BACK DOWN

The OCR is set to drop further. The economy is growing at a sub-trend pace, inflation is below the target midpoint of 2% and has been for a while (and sub-trend growth will not drive it back to the midpoint), the RBNZ needs to get the NZD down and there are numerous risks on the horizon.

We expect the OCR to be cut to 2.5% by early 2016, reversing hikes undertaken in 2014. Sceptics will say hikes never should have taken place in 2014 anyway. While the RBNZ probably did push the OCR up too far, the harsh reality is that economic circumstances have simply changed. A 20% fall in the terms of trade and collapse in dairy prices was simply not envisaged.

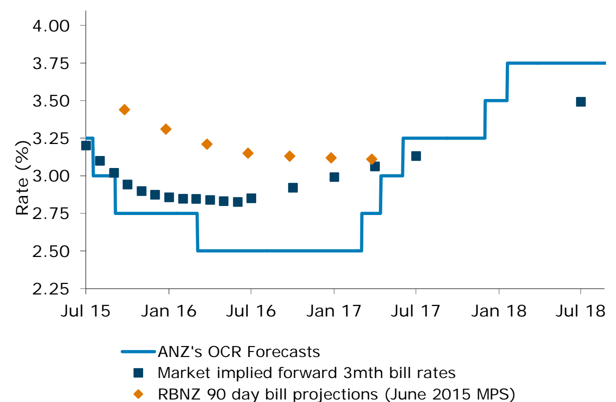
We can foresee scenarios where the OCR falls even further, but they are precisely that, scenarios and nothing more. The most obvious one is China-centric global ructions. A more extensive decline and failure of dairy prices to recover for the 2016/17 season is another. And while the RBNZ views the inflationary dragon as merely sleeping, the longer it does the greater the likelihood it has actually been slayed.

This combination not only has implications for policy in the near-term but it has us thinking about where the terminal or neutral OCR resides. Basic economics tells us it's around 4.5%, broadly where potential nominal growth is. But amid current global interest rate settings this looks incredulous. The RBNZ has embarked on a tightening cycle twice since the GFC, and rates have eventually moved back lower from 3.5% and 3% respectively. Neutral may now reside in the low 3's, until we see global monetary policy settings start to change, and that looks a long, long way off.

SHORT-END HAS MORE DOWNSIDE, TICK-SHAPED YIELD CURVE HERE TO STAY

Sentiment has turned quickly but markets have yet to fully embrace a full unwind of last year's OCR hikes, though are gradually doing so. We expect this process of incremental adjustment to continue over the course of Q3, with the odds of a rate cut at each meeting to grow as each meeting approaches. By July 7th, market expectations had all but priced in a cut on July 23rd as though it was a foregone conclusion. However the odds the market placed on a follow-cut in September sat at around 60/40 in favour, and the low point was assumed to be around 2.65% in March 2016 (Figure 1).

FIGURE 1: ANZ OCR FORECAST AGAINST MARKET IMPLIED FORWARD 3MTH BILL RATES AND RBNZ 90 DAY BILL PROJECTIONS



Source: ANZ, Bloomberg

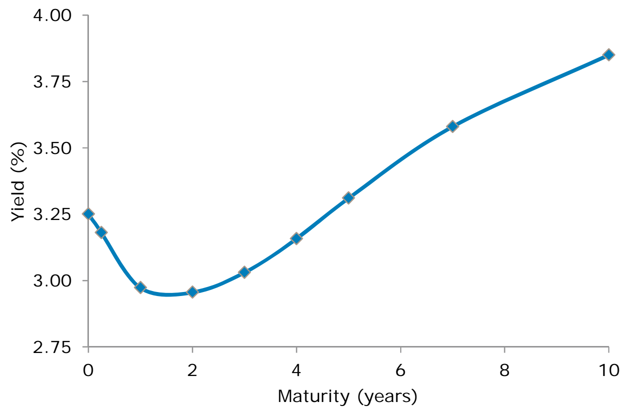
While market expectations differ from our forecast, other forecasters are still in the process of changing their views, and markets are coy not to place too much emphasis on a lower OCR given falls seen in the NZD. Welcome as the fall in the NZD has been, it remains in restrictive territory, and our fear is that the downtrend will not remain intact unless the RBNZ eases. To be sure, RBNZ policy is not aimed at the exchange rate, but the exchange rate is a key driver of inflation, and inflation has yet to emerge despite growth having peaked. The RBNZ has significant capacity to ease, and we expect it to use that capacity.

One peculiar aspect of the curve at the moment is that it is tick-shaped. While uncommon, tick shaped curves occur during periods of transition, like the market is going through right now. Unusual as it is, we expect the tick shape to endure until at least the beginning of next year, as it is the only logical shape for the curve to adopt and "join the dots" between an OCR that's headed

INTEREST RATES

lower, and long term interest rates that are gradually rising.

FIGURE 2: SWAP YIELD CURVE – 7 JULY 2015



Source: ANZ, Bloomberg

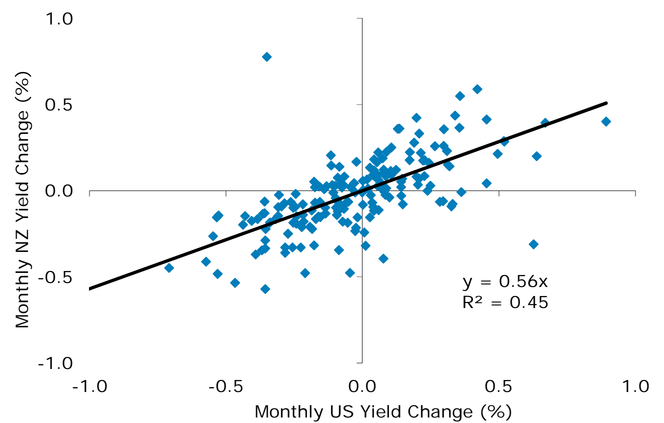
Given our expectation that markets slowly move to price in a complete unwind of last year's rate hikes, we expect the trough in the curve to gradually move lower, and advance forward slightly. At the moment, forward interest rate start to rise from mid-2016 onwards. While they do need to rise at some stage to reflect the reality that the OCR will eventually rise, and to link up with higher long term rates, as the rise in forward rates gets further delayed, we expect the bellwether 2 year swap rate to gradually inch towards (and possibly beyond) 2.75%.

LONG-END FOLLOWS OFFSHORE RATES HIGHER, ALBEIT TO A LESSER DEGREE

The outlook for long term interest rates has changed markedly since the beginning of the year, when the search for yield was in full swing. Those sentiments were driven primarily by the ECB's announcement that it would engage in €60bn of QE per month from March, joining the Bank of Japan, who started buying bonds as the Fed abandoned its QE programme. Although the ECB remains committed to QE and continues to acquire bonds, markets have become more cautious as European inflation has lifted off lows seen earlier in the year. The ECB has been at pains to point out that it is too soon to declare victory on disinflation, and ECB President Draghi has said he is committed to completing the planned QE programme in full (i.e. through till September 2016). At face value, this should give the bond bears some comfort, but as inflation has risen, so too has the prospect of a stepped-up QE programme. Greece may well have the last word, but for now, markets seem comfortable that the lows for global interest rates are in.

US bond markets have also become more cautious in the lead-up to "lift-off" – i.e. the start of the Fed policy normalisation process. As in Europe, events in Greece may derail the timetable, as might a deeper downturn in sentiment and equity prices in China, but at the moment our working assumption is that the Fed starts lifting rates in September. This is later than we envisaged at the start of the year. It has also become clearer as the year has progressed that the Fed intends to adopt a gradualist approach. All else equal, such an approach takes some of the sting out of what would normally be a bearish phase for bonds. Consequently, our forecasts have US 10 year bond yields rising only gradually, from current levels around 2.3% to 2.5% by the end of the year, and to 2.8% by the end of 2016.

FIGURE 3. 10YR NZGS YIELD CHANGES VS 10YR US BOND YIELD CHANGES SINCE 2000



Source: ANZ estimates, Bloomberg

As US interest rates rise, we expect New Zealand rates to rise too, albeit at a slower pace. This, in turn, reflects the tendency that bond spreads have to narrow as cash rate differentials narrow (the Fed tightening as the RBNZ eases), and the historic tendency of New Zealand interest rates to exhibit less movement than US interest rates (i.e. NZGS tend to be low beta). As a result, we expect New Zealand 10 year bond yields to rise to 3.75% by the end of this year, and to 3.9% by the end of 2016.

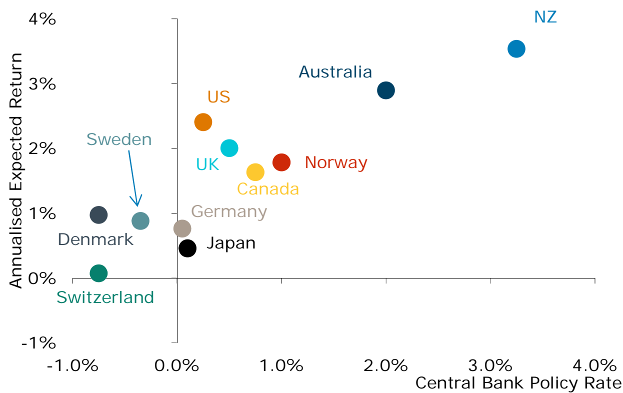
ABSOLUTE ATTRACTION, CURVE EXTENSION WILL SEE LONG BOND YIELDING 4%

The major attraction of New Zealand remains its yield, and it is notable that despite NZD weakness and all the global turmoil seen to date, official data indicate that offshore ownership of New Zealand dollar bonds (i.e. all bonds including NZGS, Kauris and corporate bonds) remains close to record levels. This may well change, but anecdotal evidence suggests most investors remain

INTEREST RATES

comfortable with New Zealand, as do credit rating agencies. Of note, New Zealand remains the only G10 bond market with bond yields anywhere near 4% (or with a yield above 3% for that matter).

FIGURE 4. G10 10 YEAR BOND YIELDS VERSUS POLICY RATES



Source: ANZ estimates, Bloomberg

We expect the upcoming launch (via syndication) of a new long bond (which will extend the NZGS curve out to 2033) to attract significant offshore demand. No details have been made available yet other than the planned maturity date of the bond. But what is likely to be of note to offshore investors is that this bond is likely to launch with a yield close to 4% (or possibly above – depending on market conditions at the time). Clearly the additional yield reflects compensation for reduced liquidity and additional term, but in a world starved of high-yielding assets, we expect the outright yield to attract attention.

NEW ZEALAND INTEREST RATE FORECASTS (END OF QUARTER)

Quarter	OCR	90-day	2-year swap	5-year swap	10-year bond	US 10-year bond	AU 10-year bond
Dec-13	**2.50**	**2.7**	**3.8**	**4.6**	**4.7**	**3.0**	**4.2**
Dec-14	**3.50**	**3.7**	**3.8**	**4.0**	**3.7**	**2.2**	**2.7**
Mar-15	3.50	3.63	3.6	3.6	3.2	1.9	2.3
Jun-15	3.25	3.62	3.5	3.6	3.6	2.4	3.0
Sep-15 (f)	2.75	2.88	3.0	3.5	3.8	2.5	3.2
Dec-15 (f)	**2.75**	**2.88**	**3.0**	**3.5**	**3.8**	**2.5**	**3.3**
Mar-16 (f)	2.50	2.63	2.9	3.5	3.8	2.6	3.3
Jun-16 (f)	2.50	2.64	3.0	3.6	3.9	2.7	3.3
Sep-16 (f)	2.50	2.67	3.2	3.7	3.9	2.7	3.4
Dec-16 (f)	**2.50**	**2.67**	**3.2**	**3.7**	**3.9**	**2.8**	**3.4**
Mar-17 (f)	2.75	3.09	3.5	3.9	4.0	2.9	3.5
Jun-17 (f)	3.25	3.42	3.6	3.9	4.0	2.9	3.7
Sep-17 (f)	3.25	3.42	3.6	3.9	4.0	3.0	3.8
Dec-17 (f)	**3.50**	**3.84**	**3.7**	**3.9**	**4.0**	**3.0**	**3.9**

ECONOMIC FORECASTS

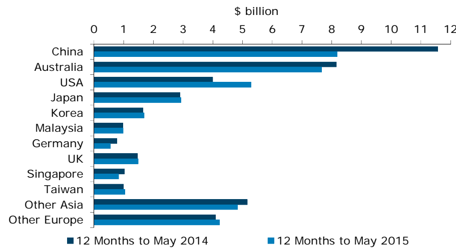
	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Real Gross Domestic Product												
Total GDP, QPC	0.2	**0.5**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**	**0.7**	**0.6**	**0.6**	**0.6**	**0.6**
Total GDP, APC	2.6	**2.4**	**2.0**	**2.0**	**2.5**	**2.7**	**2.7**	**2.7**	**2.6**	**2.6**	**2.5**	**2.5**
Total GDP, AAPC	3.2	**2.9**	**2.6**	**2.2**	**2.2**	**2.3**	**2.5**	**2.7**	**2.7**	**2.7**	**2.6**	**2.6**
Real GDP Components												
Private Consumption, QPC	0.7	**0.5**	**0.5**	**0.6**	**0.5**	**0.6**	**0.6**	**0.6**	**0.6**	**0.6**	**0.7**	**0.7**
Private Consumption, AAPC	3.7	**3.8**	**3.4**	**3.0**	**2.5**	**2.3**	**2.2**	**2.2**	**2.3**	**2.4**	**2.4**	**2.5**
Public Consumption, QPC	0.2	**0.2**	**0.1**	**0.1**	**0.1**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Public Consumption, AAPC	3.0	**2.6**	**2.1**	**1.5**	**1.0**	**0.7**	**0.6**	**0.6**	**0.7**	**0.7**	**0.8**	**0.8**
Residential Investment, QPC	0.6	**-3.8**	**0.0**	**1.0**	**1.6**	**1.6**	**1.0**	**0.6**	**0.2**	**-0.3**	**-0.6**	**-1.2**
Residential Investment, AAPC	12.3	**7.8**	**5.6**	**1.4**	**-0.3**	**0.5**	**1.4**	**3.2**	**4.5**	**3.8**	**2.4**	**0.7**
Other Investment, QPC	-2.7	**2.5**	**1.3**	**1.2**	**0.9**	**0.9**	**0.9**	**0.8**	**0.7**	**1.0**	**1.1**	**1.1**
Other Investment, AAPC	4.8	**3.8**	**2.0**	**1.3**	**2.4**	**2.9**	**4.1**	**4.4**	**3.7**	**3.5**	**3.4**	**3.5**
Gross National Expenditure, QPC	-0.2	**0.8**	**0.3**	**0.8**	**0.5**	**0.6**	**0.6**	**0.6**	**0.5**	**0.6**	**0.6**	**0.6**
Gross National Expenditure, AAPC	4.3	**3.6**	**3.0**	**2.2**	**2.0**	**2.0**	**2.3**	**2.4**	**2.4**	**2.4**	**2.4**	**2.3**
Exports, QPC	1.5	**-1.3**	**0.3**	**0.8**	**0.9**	**0.9**	**0.9**	**0.8**	**0.9**	**0.9**	**0.9**	**0.9**
Exports, AAPC	4.9	**6.5**	**6.4**	**1.4**	**0.7**	**2.9**	**3.5**	**3.5**	**3.6**	**3.7**	**3.7**	**3.9**
Imports, QPC	2.8	**1.0**	**0.9**	**0.7**	**0.8**	**0.6**	**0.6**	**0.6**	**0.6**	**0.7**	**0.7**	**0.7**
Imports, AAPC	7.9	**7.5**	**6.4**	**6.4**	**5.2**	**4.2**	**3.6**	**2.9**	**2.6**	**2.5**	**2.5**	**2.5**
Prices												
Headline CPI, QPC	-0.3	**0.3**	**0.5**	**0.2**	**0.6**	**0.4**	**0.6**	**0.2**	**0.5**	**0.6**	**0.7**	**0.2**
Headline CPI, APC	0.1	**0.2**	**0.3**	**0.7**	**1.6**	**1.7**	**1.8**	**1.8**	**1.7**	**1.9**	**2.0**	**2.0**
Non-tradable CPI, QPC	1.1	**0.2**	**0.3**	**0.3**	**0.9**	**0.3**	**0.5**	**0.3**	**0.8**	**0.5**	**0.6**	**0.4**
Non-tradable CPI, APC	2.3	**2.1**	**1.9**	**1.8**	**1.7**	**1.8**	**2.0**	**2.0**	**1.9**	**2.0**	**2.1**	**2.2**
Tradable CPI, QPC	-2.2	**0.6**	**0.8**	**0.0**	**0.2**	**0.6**	**0.8**	**0.0**	**0.1**	**0.7**	**0.9**	**0.0**
Tradable CPI, APC	-2.8	**-2.4**	**-1.8**	**-0.9**	**1.5**	**1.5**	**1.6**	**1.6**	**1.5**	**1.7**	**1.8**	**1.8**
External Accounts												
Ann. Balance on Goods, % of GDP	-0.2	**-0.7**	**-1.1**	**-1.7**	**-2.5**	**-3.0**	**-3.2**	**-3.1**	**-3.0**	**-3.0**	**-2.9**	**-2.9**
Ann. Balance on Services, % of GDP	0.9	**1.0**	**1.1**	**1.2**	**1.3**	**1.4**	**1.4**	**1.5**	**1.6**	**1.6**	**1.7**	**1.7**
Ann. Balance on Invisibles, % of GDP	-4.4	**-4.2**	**-4.2**	**-4.0**	**-4.1**	**-4.1**	**-4.2**	**-4.2**	**-4.3**	**-4.3**	**-4.3**	**-4.4**
Ann. CAB, % of GDP	-3.7	**-3.9**	**-4.2**	**-4.6**	**-5.3**	**-5.7**	**-5.9**	**-5.8**	**-5.7**	**-5.6**	**-5.6**	**-5.6**
Net Intl. Invt. Position, % of GDP	-64.2	**-65.1**	**-66.1**	**-67.4**	**-68.8**	**-69.9**	**-70.7**	**-71.2**	**-71.7**	**-72.1**	**-72.6**	**-73.2**
Terms of Trade (SNA basis)												
Export Prices, QPC	0.6	**-3.3**	**-1.4**	**-3.0**	**1.0**	**1.4**	**2.2**	**0.7**	**0.7**	**0.3**	**0.5**	**0.0**
Export Prices, APC	-8.4	**-8.1**	**-6.0**	**-7.0**	**-6.6**	**-2.0**	**1.5**	**5.4**	**5.1**	**3.9**	**2.2**	**1.5**
Import Prices, QPC	-11.8	**0.1**	**2.3**	**0.3**	**1.4**	**1.8**	**1.8**	**0.9**	**0.7**	**0.7**	**0.7**	**0.7**
Import Prices, APC	-5.3	**-4.7**	**-9.4**	**-9.4**	**4.1**	**6.0**	**5.5**	**6.1**	**5.4**	**4.2**	**3.0**	**2.8**
Terms of Trade, QPC	14.0	**-3.4**	**-3.6**	**-3.3**	**-0.4**	**-0.4**	**0.3**	**-0.2**	**0.0**	**-0.4**	**-0.2**	**-0.7**
Terms of Trade, APC	-3.3	**-3.5**	**3.8**	**2.7**	**-10.3**	**-7.5**	**-3.7**	**-0.7**	**-0.2**	**-0.3**	**-0.8**	**-1.3**
Labour Market												
Employment, QPC	0.7	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**	**0.3**
Employment, APC	3.2	**3.4**	**2.9**	**2.1**	**1.7**	**1.5**	**1.3**	**1.3**	**1.2**	**1.2**	**1.2**	**1.2**
Labour Force, QPC	0.8	**0.5**	**0.4**	**0.4**	**0.3**	**0.3**	**0.2**	**0.3**	**0.2**	**0.2**	**0.2**	**0.2**
Labour Force, APC	3.0	**3.6**	**3.2**	**2.1**	**1.6**	**1.4**	**1.1**	**1.1**	**1.0**	**0.9**	**0.9**	**0.9**
Unemployment Rate, sa	5.8	**5.8**	**5.8**	**5.8**	**5.7**	**5.7**	**5.6**	**5.6**	**5.5**	**5.5**	**5.4**	**5.4**
Participation Rate, sa	69.6	**69.6**	**69.6**	**69.5**	**69.5**	**69.4**	**69.4**	**69.3**	**69.3**	**69.2**	**69.2**	**69.1**
QES Private Sector Wages, APC	2.6	**2.6**	**2.8**	**2.8**	**2.9**	**2.9**	**3.1**	**3.1**	**3.1**	**3.2**	**3.3**	**3.3**
QES Public Sector Wages, APC	1.1	**0.6**	**1.1**	**1.1**	**1.6**	**1.0**	**1.4**	**1.7**	**2.0**	**1.2**	**1.8**	**2.2**

Forecasts in bold
QPC – quarterly % change
APC – annual % change
AAPC – annual average % change
sa – seasonally adjusted

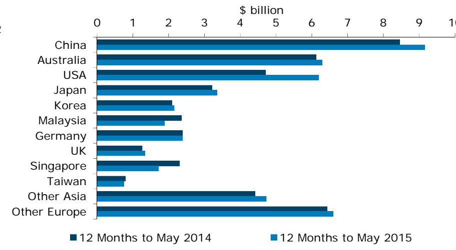
ANZ

KEY ECONOMIC INDICATORS

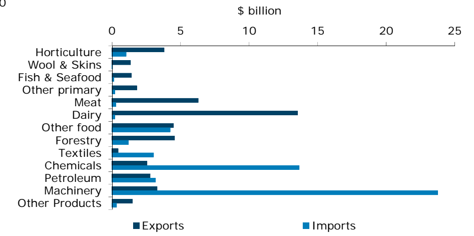
NZ EXPORTS



NZ IMPORTS



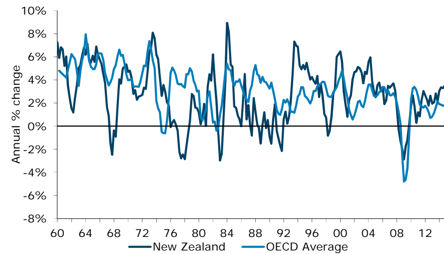
NZ EXPORTS AND IMPORTS BY SELECTED COMMODITIES 12 MONTHS TO MAY 2015



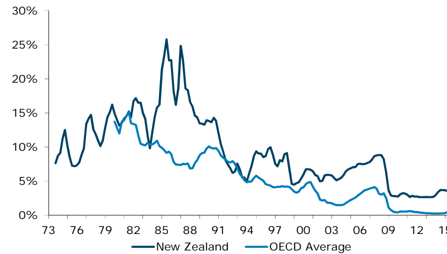
NEW ZEALAND COMPARED TO MAIN TRADING PARTNERS (LATEST AVAILABLE FIGURES)

	NZ	Australia	USA	Japan	UK	China	Germany	South Korea	Taiwan	Malaysia	Hong Kong	Singapore	Indonesia
Population, in millions	5	24	321	127	64	1,369	81	51	23	31	7	5	255
Area in 1,000 km^2	268	7,741	9,827	378	244	9,597	357	100	36	330	1	1	1,905
Inhabitants per km^2	17.1	3.1	32.6	335.8	263.2	142.6	226.7	515.0	651.6	92.6	6,604	7,847	134.1
GDP, in billion NZD	239	1,711	88,788	21,996	3,631	13,155	4,515	1,773	671	412	374	379	1,097
Change in real terms (yr-on-yr %)	3.2	2.5	2.6	-0.9	3.0	7.3	1.3	2.9	3.6	5.8	2.4	2.4	4.9
Nominal GDP per capita in NZD	52,296	71,917	276,895	173,335	56,647	9,610	55,787	34,527	28,618	13,501	51,450	69,358	4,296
NZ exports to ..., NZDm (FOB)	n/a	7,663	5,288	2,923	1,491	8,178	548	1,692	1,035	982	684	834	844
Share of NZ Exports (%)	n/a	16.5	11.4	6.3	3.2	17.7	1.2	3.7	2.2	2.1	1.5	1.8	1.8
NZ imports from , NZDm (VFD)	n/a	6,288	6,192	3,351	1,342	9,150	2,387	2,155	750	1,882	127	1,717	807
Share of NZ Imports (%)	n/a	13.6	13.4	7.2	2.9	19.8	5.2	4.7	1.6	4.1	0.3	3.7	1.7
Current Account balance (% of GDP)	-3.6	-2.7	-2.3	1.6	-6.2	2.8	7.8	6.9	13.7	3.5	2.1	21.8	-2.9

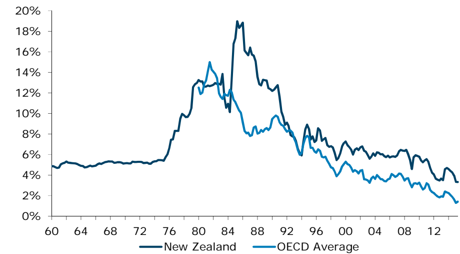
REAL GDP GROWTH



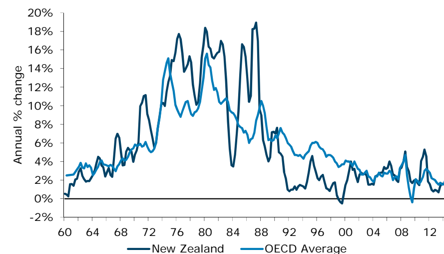
90 DAY INTEREST RATE



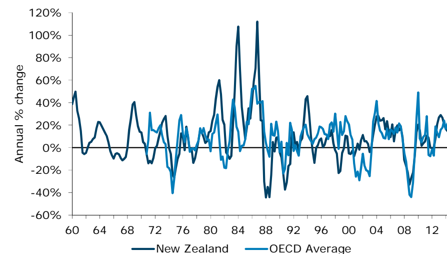
LONG-TERM GOVERNMENT BOND YIELD



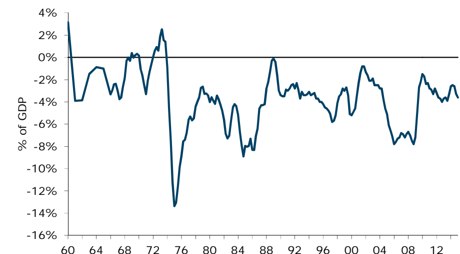
INFLATION RATE



NZX50 SHARE PRICE INDEX

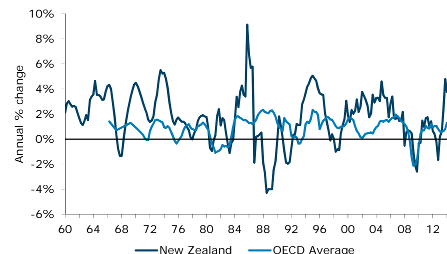


CURRENT ACCOUNT BALANCE

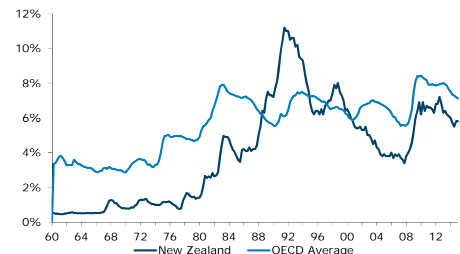


NZD/USD EXCHANGE RATE

EMPLOYMENT GROWTH



UNEMPLOYMENT RATE



Source: ANZ, Statistics NZ, Bloomberg, OECD

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