NEW ZEALAND ECONOMICS
ANZ ECONOMIC OUTLOOK

MARCH 2015

INSIDE

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NEW ZEALAND ECONOMIC OUTLOOK

The New Zealand economy is well into an economic expansion and we are picking solid growth of around 3% per year over the coming years – a leader amongst global peers. There are challenges: Mother Nature, low dairy prices, and a high NZD. Yet these are dominated by support from construction, supportive financial conditions, business investment, net migration and still-elevated terms of trade. The main downside risk stems from offshore.

GLOBAL OUTLOOK

A mixed picture remains evident for our trading partners. The US is strengthening, Europe is improving (though is still structurally challenged), yet Australia and China remain soft. The impact of US Federal Reserve tightening is a key risk. We've pencilled in modest growth over the projection period, with risks tilted to the downside and considerable volatility.

EXPORT COMMODITY PRICES

Macro drivers such as geopolitical ructions, sluggish global growth, FX volatility and lower energy/feed prices are creating a challenging environment for many primary sectors. But exposure to these forces varies significantly, implying quite diverse outlooks for 2015/16.

LABOUR MARKET

Domestic economic strength suggests solid job growth should continue, although at a more modest pace than recent experience. Supply-side strength has been important. However, with the magnitude of labour utilisation gains unlikely to be repeated, wage growth should slowly lift and the unemployment rate fall towards 5%.

FISCAL POLICY

Surpluses beckon. They won't be large, so expenditure restraint will remain a key theme. From a policy perspective, we continue to expect a focus on boosting the economy's microeconomic foundations, although the upcoming Budget should also be notable for the key focus on policies to improve social outcomes.

INFLATION

Annual inflation is expected to remain sub-1% over 2015 before drifting towards the midpoint of the inflation target as some short-term suppressants fade. Questions remain regarding whether the period of low inflation is due primarily to transitory or more enduring influences.

EXCHANGE RATE

Strong economies typically have strong currencies, and the only challenger for the New Zealand economy at present is the US. We expect US data to reaccelerate in Q2 keeping NZD/USD under gradual but persistent downward pressure. However, we expect volatility to be high. Against all other currencies we expect the NZD to remain strong.

INTEREST RATES

With little inflation to speak of outside of housing and the NZD likely to remain elevated, the RBNZ has flat-lined its projections for the OCR and shifted to a neutral stance. We also expect the OCR to remain on hold for an extended period. However, the risks around that forecast remain skewed to the downside. New Zealand bonds remain in hot demand, and we expect them to contract on a spread to other geographies and for the curve to flatten as long-end yields move below 3%.

KEY ECONOMIC FORECASTS

Calendar Years	2012	2013	2014(f)	2015(f)	2016(f)	2017(f)	2018(f)
NZ Economy (annual average % change)							
Real GDP	2.4	2.3	3.3	3.0	2.9	2.6	2.6
Employment	0.5	1.6	3.5	2.8	1.5	1.2	0.0
Unemployment Rate (Dec qtr)	6.7	6.0	5.7	5.3	5.1	5.0	5.0
Terms of trade (SNA basis)	-4.1	6.1	4.7	-6.4	0.8	-1.0	-0.7
Global Growth (annual average % change)							
US	2.3	2.2	2.4	3.2	2.7	2.5	2.5
Eurozone	-0.8	-0.4	0.9	1.7	2.1	1.8	1.5
Australia	3.6	2.1	2.7	2.5	3.2	3.2	3.2
Japan	7.8	7.7	7.4	6.7	6.5	6.5	6.5
China	3.3	3.0	3.5	3.7	2.9	3.0	2.6
Trading Partners	2.3	2.2	2.4	3.2	2.7	2.5	2.5
NZ Inflation (annual % change)							
CPI Inflation	0.9	1.6	0.8	0.6	1.8	2.0	1.9
Non-tradable Inflation	2.5	2.9	2.4	2.5	3.2	3.2	3.0
Tradable Inflation	-1.0	-0.3	-1.3	-1.8	-0.1	0.3	0.5
NZ Financial Markets (end of December quarter)							
TWI	73.8	77.3	79.4	78.7	74.2		
NZD/USD	0.82	0.82	0.78	0.70	0.68		
NZD/AUD	0.79	0.92	0.96	0.97	0.97		
Official Cash Rate	4.3	4.5	3.50	3.50	3.75	4.50	
90-day bank bill rate	4.7	4.8	3.7	3.8	4.2	4.8	
10-year bond rate	3.5	3.5	3.7	2.8	3.3	3.5	
Fiscal and External Balance							
Current Account Balance ($bn)	-8.5	-7.2	-7.7	-11.6	-12.6	-13.5	-13.9
as % of GDP	-4.0	-3.2	-3.3	-4.8	-5.0	-5.1	-5.1
Government OBEGAL ($bn)*	-9.2	-4.4	-2.6	-0.2	0.4	1.4	2.1
as % of GDP	-4.4	-2.0	-1.1	-0.1	0.2	0.5	0.8

*Operating balance excluding gains and losses, June years. Forecasts and text finalised 31 March 2015.

KEY FORECAST ASSUMPTIONS:

- The NZD is assumed to end 2015 at 70 US cents and gradually ease to 68 US cents by late 2016.
- Net annual permanent and long-term (PLT) migration inflows are assumed to peak at around 57,000 persons by mid-2015 and taper off over the projection period, ending 2017 at around 25,000 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 2½% 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.
- Average bank funding costs (as opposed to marginal funding costs) are assumed to continue to gradually decline from current levels. This will push the neutral OCR from around 4% at present towards 4½% by the end of the projection period.

NEW ZEALAND ECONOMIC OUTLOOK

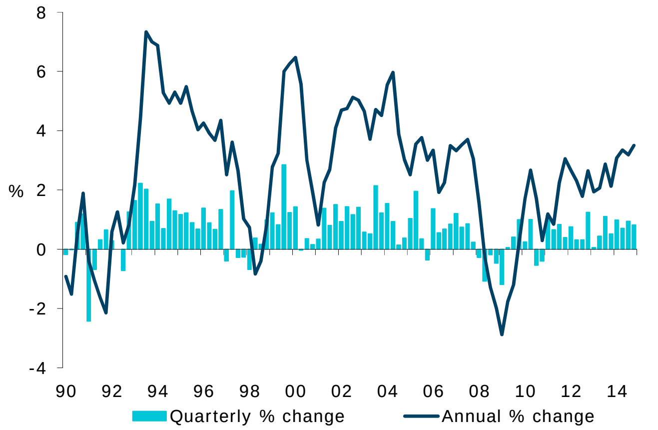
SUMMARY

The New Zealand economy is well into an economic expansion and we are picking solid growth of around 3% per year over the coming years – a leader amongst global peers. There are challenges; Mother Nature, low dairy prices, and a high NZD. Yet these are dominated by support from construction, supportive financial conditions, business investment, net migration and still-elevated terms of trade. The main downside risk stems from offshore.

GOLDILOCKS HAS MADE HERSELF AT HOME

The economy is on a roll. GDP growth averaged 3.3% over 2014 – the strongest since 2007. We forecast it to grow 3% over 2015. Consumption growth is solid, courtesy of a strong employment backdrop and rising resident population, as well as an oil-price induced cash flow boost. Tourists are pouring in thanks to the Cricket World Cup and increased connectivity with Asia. Annual net migration keeps hitting new record highs. Agricultural production will be negatively impacted by dry conditions over early 2015 (leading to some volatility in quarterly GDP outturns), but anecdotes suggest the situation has been well managed. Investment growth was 7.5% last year, underpinned by strengthening construction sector activity and wider business spending. The former has moved beyond the Christchurch earthquake-related rebuild effort and is providing support to wider sectors, whereas the latter is – importantly – boosting the economy's supply-side potential. While record net immigration inflows are adding to the labour supply, the unemployment rate has nonetheless fallen from a 2012 peak of over 7% to 5.7% at the end of last year.

FIGURE 1. NEW ZEALAND ECONOMIC GROWTH



Source: Statistics NZ, NZIER, ANZ

This is not an expansion enjoyed by just a few. Over 2014, 11 of the 17 production GDP industries classified by Statistics NZ grew by more than 2%. From a regional perspective, 13 of 14 regions grew in excess of 2% over the year (based on our Regional Trends measure). This is not just a construction-led expansion, nor is it limited to Christchurch or Auckland. While there are, as always, pockets of domestic weakness (dairy incomes and parts of retailing), the expansion is broad-based. **And when looking across an array of economic indicators (Truckometer, business and consumer confidence, financial conditions), it is clear that a decent pace of momentum has continued over early 2015.**

HARD YARDS ARE PAYING OFF

The fact we are still talking about circa 3% rates of growth as a base case is testament to the economy's resilience. The economy is entering its fifth year of expansion. But consider this: monetary policy has been tightened, and there is the prospect of further non-OCR measures to slow the housing market in addition to the high-LVR lending speed limit; fiscal drag has averaged 0.9% of GDP per year over the past three years; the NZD is hovering near post-float highs against some major trading partners; the 2014/15 dairy payout is below break-even for many farmers; and our two largest trading partners are mired in lacklustre or outright decelerating growth prospects. Yet despite all these headwinds, the domestic economic expansion marches on. **This is an economy that just does not want to roll over easily.**

There are of course some powerful forces supporting the expansion in the form of the still historically high terms of trade, rising asset prices, a construction pipeline that remains massive – even if the earthquake rebuild is perhaps closer to peaking – and population growth that is running at its fastest pace in over a decade. However, we believe this economic resilience is more deep-seated than that.

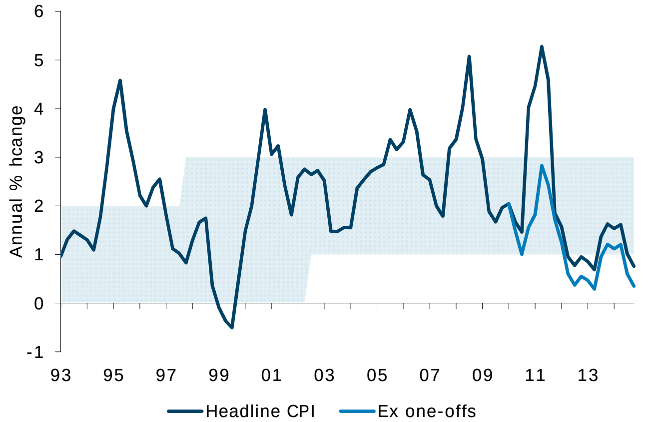
- **The national balance sheet is in much better shape.** Internal imbalances that would typically have built up at this stage of the cycle (and warn of rising risks ahead) have yet to emerge. While nationwide saving is insufficient to meet our investment needs, net external debt sits at an 11-year low as a proportion of GDP and the maturity profile of our international liabilities has lengthened considerably.
- **The supply side of the economy has shown remarkable flexibility.** In the immediate aftermath of the financial crisis the economy's rate of potential growth was around 2% (if not lower); it now sits closer to 3%. The most obvious driver has been record net migration, boosting the labour supply. But behind the scenes productivity growth has trended higher as firms have knuckled down and there has been a strong microeconomic policy

NEW ZEALAND ECONOMIC OUTLOOK

agenda. The impact of a number of small initiatives is adding up.

- **Business remains focused.** The complacency virus has not turned up, and a strong focus on productivity and cost management remains. The complacency virus typically precedes downturns by two years; recall the exuberance around 1995 and 2005, for instance.
- **Inflation is low, keeping the monetary policy party poopers at bay.** Annual inflation is set to fall to just 0.2% in the March 2015 quarter. While in part due to petrol price falls and the strong currency, non-tradable inflation adjusted for tax changes is running at just 1.7% y/y. Wage growth remains subdued. The economy is not hitting the capacity handbrakes that would typically curtail the expansion at this stage of the cycle and raise the hackles of the central bank.
- **We have a significant collection of little things that are adding up.** Unlocking New Zealand's natural resource endowment (witness irrigation activity on the Canterbury plains), a society that is pretty receptive to change, and exporters that are unlocking opportunities in Asia (witness the explosion in Chinese tourists).

FIGURE 2. HEADLINE INFLATION



Source: Statistics NZ, NZIER, ANZ

BUT TENSIONS AND RISKS EXIST

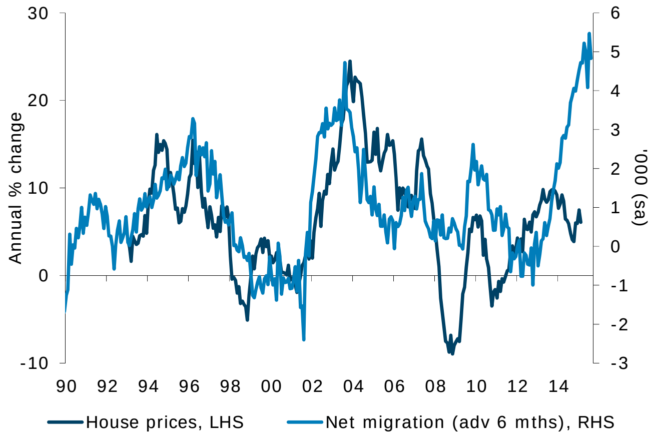
The economy is doing well and is showing a notable degree of resilience. But it is not bullet proof. A widening current account deficit (although we do believe it will be capped around 5% of GDP) is a reminder that vulnerabilities remain. We are particularly mindful of the fact that New Zealand is still an economy that needs to earn its keep and the global backdrop remains fickle. We can talk about a robust domestic expansion all we want, but we would begin to question its longevity if the demand for our exports were to weaken significantly or if household consumption growth were to outpace income growth for numerous years.

We are paying particularly close attention to performance of China. For better or worse, New Zealand is now much more reliant on the Chinese economic machine. Clearly this has proven incredibly beneficial over recent times – you need only look at the current strength in visitor arrivals and services exports to see that! But the Chinese economy is now on a slowing trajectory as it grapples with the hangover from its own credit binge. Policymakers are not sitting still, but it is a difficult job maintaining cyclical strength through a period of structural adjustment (just ask Europe!) and there remain significant downside risks from the likes of the property sector.

There are numerous other focal points around the globe that leave us cautious. Cyclically, Europe appears to be lifting, but structurally it remains a mess. The Greece problem is yet to be sorted. In Australia, despite considerable policy support, the non-mining recovery continues to disappoint. There is also the elephant in the room with regard to how financial markets (and emerging economies) handle eventual interest rate hikes from the Federal Reserve. We suspect it won't be a smooth ride.

Locally, there is considerable tension between consumer and asset price inflation. One has been a persistent undershooter relative to expectations, while the other (particularly Auckland house prices) is becoming problematic on the upside. The apparent breakdown in the relationship between capacity utilisation and inflationary pressure is causing some RBNZ head-scratching. Is inflation dead, or is it only sleeping? Is low inflation structural or transitory? And how is monetary policy to respond if CPI inflation is tame but asset price inflation a worry?

FIGURE 3. HOUSE PRICES AND NET MIGRATION



Source: Statistics NZ, NZIER, ANZ

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Re-enter macro-prudential policy. The LVR speed limit restrictions curbed the market for a time, but the Auckland market has picked up a head of steam again. The RBNZ has responded by consulting on methods of categorising "investor" housing lending – a micro-prudential step towards further macro-prudential bullets being fired. Unlike LVR restrictions, which act only on new lending, new measures could potentially be retrospective, and the RBNZ will be hoping that there will be an announcement effect on investor confidence that would bring the property market to a more even keel. **This would also take further upside pressure off OCR settings.**

Dairy sector cash-flow will be tight in the back half of 2015 and we are mindful that dairy land prices have surged 36% in the past two years. One year of a low dairy payout is manageable; it's prospects for 2015/16 that remain key and we're ho-hum on this score (refer page 8). Low dairy prices are seeing a supply-side response (less production), but the demand situation remains soft. We're expecting some isolated pocket of stress.

We do believe the economy has the resilience to withstand any potential hiccups, although we are mindful of the risk profile – the economy is certainly not fully decoupled from the global scene. **But if it can manage to navigate these tensions without being too caught in the crossfire, then we believe it can well and truly be looked upon with envy. We are quietly confident.**

KEY FEATURES OF OUR FORECASTS

Beyond our circa 3% GDP forecast for 2015 and 2016, there are some other key elements of our forecasts:

- **Sequential momentum to remain decent near-term.** While we are expecting a temporarily softer pace of growth over Q1 2015 (we have pencilled in 0.5% q/q) due to the impact of drought, unwind in inventories, and moderation in services exports following stellar Q4 growth, the underlying story is sequential growth at around a 0.7%-0.8% q/q pace over 2015 – in other words, trend or slightly above trend growth over the course of the year. Growth momentum is forecast to ease slightly beyond this as some of the current tailwinds to growth (net migration and earthquake rebuild) begin to fade, seeing growth settle closer to 2½%. But the story is one of respectability.

- **Reasonable consumption growth to continue, but to be ultimately capped by income growth.** Given the considerable growth evident in investment spending (in part earthquake related), we have long felt that the sacrificial lamb would need to be consumption in order to avoid a blow-out in the current account deficit (and inflation). That has proved to be correct and is still our core view. Household consumption is forecast to grow by 3.5% over 2015 but to ease beyond this through a combination of moderating disposable income growth (particularly rural incomes), slowing population growth, and the assumed softening in house price inflation as policy maker actions and affordability constraints bite. Ultimately, and by default, the saving buffer (albeit modest) that New Zealand households have built up over recent years is expected to be maintained.

- Despite an approaching peak in the earthquake rebuild, **the construction sector is set to remain a key contributor to growth.** While the size of the contribution is likely to moderate, we are not believers in the 'post-rebuild growth hole' story. There remains a considerable pipeline of work, from Auckland housing shortages to numerous infrastructure projects. And as the Christchurch rebuild matures, the headwind from restrictive fiscal policy fades.

- Despite the economy adding modestly to capacity pressures over the next two years, **inflation will be capped by wider disinflationary forces.** Headline inflation is eventually expected to rise gradually towards the target mid-point as some of these forces fade, but there is little pressure on the RBNZ to adjust OCR settings higher for some time.

- The domestic-centric nature of the expansion, as well as further expected falls in the terms of trade, will see the **annual current account deficit widen towards 5% of GDP.** 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-2015.

NEW ZEALAND ECONOMIC OUTLOOK

NEW ZEALAND NATIONAL ACCOUNTS FORECAST

Calendar years (average annual % change)	2012	2013	2014(f)	2015(f)	2016(f)	2017(f)	2018(f)
Total Consumption	**1.9**	**2.7**	**3.3**	**2.9**	**2.2**	**2.0**	**2.3**
Private Consumption	2.9	2.9	3.2	3.5	2.7	2.4	2.8
Public Consumption	-0.9	2.0	3.6	0.8	0.5	0.8	0.6
Total Investment	**7.9**	**8.5**	**8.7**	**6.4**	**4.9**	**3.0**	**1.8**
Residential investment	14.1	16.6	16.7	8.7	7.4	0.7	-5.2
Other investment	6.3	6.2	6.2	5.7	4.1	3.9	4.2
Stockbuilding[1]	**0.1**	**0.1**	**0.2**	**0.0**	**0.2**	**0.1**	**0.1**
Gross National Expenditure	**3.1**	**3.9**	**4.7**	**3.8**	**3.0**	**2.4**	**2.2**
Total Exports	**1.8**	**1.0**	**2.7**	**2.4**	**2.8**	**3.7**	**3.9**
Goods	4.0	0.7	1.3	3.7	2.8	3.4	3.5
Services	-3.8	1.7	6.3	-1.1	2.6	4.7	4.9
Total Imports	**2.8**	**6.1**	**8.0**	**4.9**	**3.2**	**2.8**	**2.8**
Goods	3.9	6.6	9.1	6.6	3.5	3.0	3.1
Services	-4.6	0.8	5.7	3.7	2.1	2.0	2.0
Expenditure on GDP	**2.9**	**2.5**	**3.0**	**2.9**	**2.9**	**2.6**	**2.5**
GDP (production based)	**2.4**	**2.3**	**3.3**	**3.0**	**2.9**	**2.6**	**2.6**

[1] Percentage point contribution to growth

GLOBAL OUTLOOK

SUMMARY

A mixed picture remains evident for our trading partners. A strengthening US outlook and improving signs in Europe provide cause for optimism, courtesy of considerable policy stimulus, although deeper European structural issues have yet to be addressed. The outlook is more guarded in our two largest trading partners. A huge layer of uncertainty surrounds how asset prices and emerging-market Asia will respond to the US Federal Reserve lifting rates. We've pencilled in modest growth over the projection period, with risks tilted to the downside and considerable volatility likely.

LIQUIDITY BOOST

There are encouraging signs of improvement in the global economy. The US economy is on track for solid growth despite a Q1 hiatus, and improving signs are evident in Europe. Lower oil prices are providing a boost to consumers, although it is a mixed blessing, given the impact on incomes for oil-exporting nations (a growing export market for New Zealand), and on the energy sector, with oil having been heavily financialised as an asset class when prices were high. There will be fallout.

Both policy and long-term interest rates are at historically low levels (negative in some instances), with the ECB recently joining the QE party. **This seems to have provided some calm to financial markets.** Measures of equity market volatility have eased since the start of the year (although implied FX volatility has increased). Equity indices are at, or close to, record highs. The USD bull trend has continued.

While **the Federal Reserve is likely to start raising interest rates later this year**, policy settings are set to remain expansionary for some time. **We expect turbulence** in asset and foreign exchange markets. Rates might be moving up because the US economy is stronger, but we foresee a tug-of-war as asset prices try to second-guess the Fed, and the risk-free rate moves up. The impact on emerging economies of movements in the cost of capital and USD is an even greater risk, with the likes of China having leveraged heavily during the era of low rates and QE from the Fed. The ECB might be printing more money but ultimately it is the USD that is the key funding currency.

By country and region we expect:

- **A solid US outlook.** Weather-related disruptions are impacting current data, but the pace of underlying activity is sound and a rebound is expected in Q2. Businesses and households are confident, and balance sheets are in good shape. The labour market is strengthening, although slack remains. A firmer USD will act as a headwind but modest growth still beckons.
- **Improving activity in the Eurozone but still sub-par results.** The lower euro, lower energy prices, and €1.1trn of ECB stimulus are providing demand-side support. Activity data, whilst weak, is on an improving trajectory. However, we find it difficult to entertain the possibility of solid growth give structural rigidities across the region. So growth will be off lows, but still low and sub-par.
- **Sub-trend growth in Australia.** The terms of trade have been falling for 3½ years; iron ore and other commodity prices have been hammered. The massive run-up in resources sector capital spending is now reversing, with other demand yet to fill the void, although interest-rate sensitive pockets such as housing are stronger. Structural issues (waning productivity growth and high cost structures) still need to be addressed. Political fracas is not helping. The lower AUD is assisting the transition to more export activity.
- **Slowing growth in China, with considerable questions over its underlying performance.** We have assumed the fabled soft landing, with 6-7% growth. However, addressing property market excess whilst simultaneously transitioning the economy away from export and investment towards more private consumption – not to mention the impact of prospective lifts in US interest rates – will keep China's economy front and centre. There are considerable downside risks.
- **Trading partner growth is expected to peak this year at just under 4% and then ease in later years.** The risks are tilted to the downside.

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	3.2	2.7	2.5	2.5
Australia	3.6	2.1	2.7	2.5	3.2	3.2	3.2
Japan	1.7	1.6	-0.1	1.2	1.6	1.2	1.2
Eurozone	-0.8	-0.4	0.9	1.7	2.1	1.8	1.5
China	7.8	7.7	7.4	6.7	6.5	6.5	6.5
Trading Partner Growth	**3.3**	**3.0**	**3.5**	**3.7**	**2.9**	**3.0**	**2.6**

EXPORT COMMODITY PRICES

SUMMARY

Macro drivers such as geopolitical ructions, sluggish global growth, FX volatility and lower energy/feed prices are creating a challenging environment for many primary sectors. Exposure to these forces varies significantly, implying quite diverse outlooks for 2015/16. Key for how things evolve will be local and offshore supply dynamics, as well as NZD direction. Across some soft commodity markets such as dairy, prices are below the cost of production, which will help cap production and drive price tension. But this is against a soft demand backdrop. Currently we have a milk price forecast of $4.70/kg MS for 2014/15 and $5.75/kg MS for 2015/16.

CHALLENGING ENVIRONMENT

A number of key macro drivers are providing a challenging environment for many sectors. This has us cautious heading into the 2015/16 season. These drivers include:

- **Sluggish economic and real wage growth in many markets outside the US.** This is dampening consumption growth in some key emerging economy import markets. We also get the sense that much of the fast growth seen over the last 10 years has slowed as markets mature, and consumer sophistication – and the degree of competition – increases. China has been at the heart of lower demand for many sectors during the first quarter of 2015. In more developed markets it is much more about stagnant wage growth influencing consumers' purchasing habits, with the retail channel's constant conditioning of consumers to 'specials' proving hard to shake.
- **Geopolitical ructions** disrupting trade flows and import demand in some key import regions (mainly Europe and the Middle East). Russian sanctions and the dramatic fall in the ruble continue to reverberate through many soft commodity sectors and key markets.
- **Lower feed costs for the Northern Hemisphere** boosting the competitiveness of key competing exporters and products.
- **Generally lower commodity prices for key inputs**, such as oil and fertiliser, weighing on both the cost curve and sentiment.
- **Competitors opening up more market access into the likes of China and other emerging markets.**
- **Foreign exchange volatility altering competitiveness in soft commodity markets.** The rise of the USD makes imported food products more expensive in some key emerging import markets. The flipside is a weaker NZD/USD and reduced US export competitiveness. These dynamics have varying impacts, according to the degree of FX hedging and earnings exposure to different markets. USD strength is also a function of euro weakness. This weakness boosts European exporter competitiveness for the likes of dairying, but reduces New Zealand earnings for those products such as venison, sheepmeat, pipfruit and kiwifruit that derive a significant proportion of earnings from European markets.

Exposure to these forces varies significantly across the different primary sectors, implying quite diverse outlooks for 2015/16. Some of the effects can take a while to work through due to production lifecycles and various government support programs. **Key for how things evolve will be supply dynamics.** These will be governed by inventory positions, seasonal conditions both domestically and for key competitors, and how producers respond to lower margins.

The dairy and venison sectors are finding it tough at present. We expect a Fonterra milk price of $4.70/kg MS for the 2014/15 season, below break-even for most farmers, with some potential downside depending on how things evolve. We expect a recovery to $5.75/kg MS in 2015/16, but there are lots of moving pieces at present. Better in-market returns are expected for venison, but the strong appreciation in the NZD/EUR is expected to eat up all of these gains plus some.

The outlook for sheepmeat is more neutral. We are cautiously optimistic on demand, but wary of recent weakness in European markets outside of Germany, and China. Reduced domestic and Australian supplies are expected to help rebalance key markets. **Beef prices are expected to remain strong**, driven by the continued outperformance of the US market and a slowdown in Australian supply. **In-market crossbreed wool prices are under pressure** from substantially lower synthetic and cotton prices, as well as lacklustre demand growth outside the US.

Kiwifruit prices will be lower as NZ supply improves as regrafted vines following the Psa outbreak begin to bear fruit. **Pipfruit is mixed**, with lower prices expected in Europe, but Asian prospects looking better. **A significantly smaller 2015 Sauvignon Blanc vintage** is expected to smooth supply between adjoining years, averting the need to reduce prices to shift product.

LABOUR MARKET OUTLOOK

SUMMARY

Domestic economic strength suggests solid job growth should continue, although at a more modest pace than recent experience. But it is the supply side that is, and has been, the more important story. Record net immigration and labour force participation have kept capacity pressures at bay, providing the expansion with more longevity. But with the magnitude of gains in labour utilisation unlikely to be repeated, we do see wage growth slowly lifting and the unemployment rate falling towards 5%. The onus falls on higher rates of productivity growth to cap growth in unit labour costs.

STRENGTH TO STRENGTH

The labour market has strengthened considerably. After a period of cost-cutting and pushes for efficiency gains, firms now have the confidence and the financial strength to put cash to work. Employment, at 3.5% y/y, is growing at near its fastest pace in a decade. Over the past two years, the economy has added 187K jobs, with the majority of those jobs (140K) being full-time workers. Like the expansion itself, employment is also reasonably broad based, with most sectors experiencing gains over the past year (although the construction sector continues to outperform). At the regional level, northern areas have begun to take the baton from the fast-out-of-the-blocks Canterbury region.

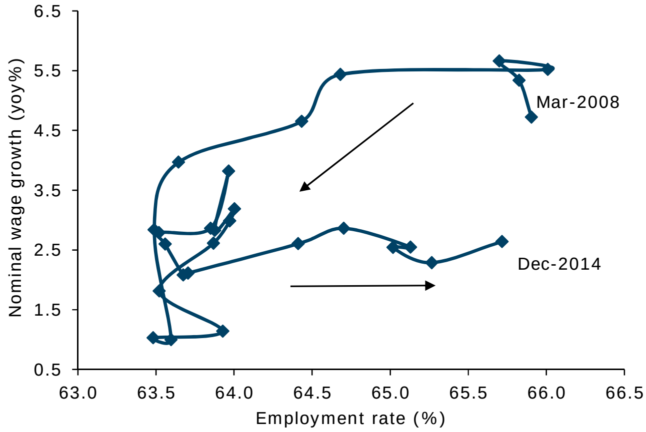
Admittedly, there is a degree of catch-up involved. The labour market is a lagging indicator after all, so the fact it has strengthened should not be surprising, given the state of the domestic economy. Nevertheless, forward gauges point to ongoing solid gains (albeit at perhaps more modest rate), with employment intentions sitting well above historical averages for each major sector of the ANZ *Business Outlook* survey.

But if anything, it is the supply side of labour market that has been – and remains – the more important story. Courtesy of record net immigration, the working age population is growing at its fastest pace since 2004. The labour force participation rate, at 69.7% (from 68.2% at the end of 2012), is at record levels, which has seen an additional 129K workers join the labour force over this time. While the unemployment rate has nonetheless fallen over this time (to 5.7%) it would have been at 3.6% without this participation boost. Under such a scenario, the economy would have easily fallen into the “overheating” camp and we can quite confidently say that the OCR would not have been at just 3.5%!

A rising participation rate puts New Zealand into a different camp to many other developed nations at present (add it to the list!). Moreover, while the ageing of the population would naturally be expected to weigh on the participation rate, a shift to later retirement of workers, balance sheet considerations, welfare reforms to encourage work, and an improving employment outlook itself all look to be behind the increase in overall workforce participation. This all fits within the economic resilience theme and helps give the current economic expansion more longevity.

As a result, wage growth has remained modest for this stage of the cycle. A rising employment rate would typically be associated with stronger wage growth, yet growth in average hourly earnings sits at just 2½%, as supply factors, low cost of living adjustments, and competition for jobs have dominated.

FIGURE 1. EMPLOYMENT RATE AND WAGE GROWTH



Source: ANZ, Statistics NZ

As the cycle matures, we naturally expect the demand for labour to moderate. Employment growth is forecast to ease to 1.5% in 2016 after 2.8% growth over 2015. However, with the gains seen in labour utilisation unlikely to be repeated (the participation rate is forecast to remain at historically high levels but not rise further), this should see the unemployment rate drift down towards 5%.

For now, spare capacity in the labour force remains. Average hours worked per person are 4% below their historical average. That said, as the unemployment rate falls capacity bottlenecks and skill shortages should begin to emerge, seeing wage growth drift higher. **Annual private sector wage growth is forecast to settle around 3½% by late 2016.** This therefore places more onus on higher productivity growth to ensure unit labour costs are contained and the gains seen in the economy’s potential growth rate can be maintained.

FISCAL POLICY

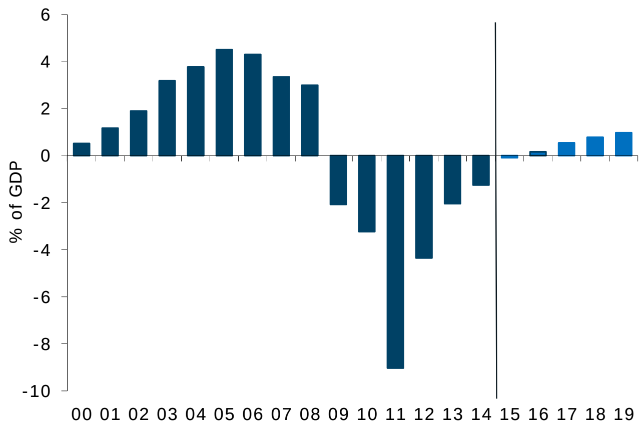
SUMMARY

Surpluses beckon. They won't be large, so the fiscal purse will remain tight with expenditure restraint a key theme. From a policy perspective, we continue to expect a focus on boosting the economy's microeconomic foundations, although the upcoming Budget should also be notable for the key focus on policies to improve social outcomes.

SURPLUSES IN SIGHT

Fiscal surpluses are within reach. **The economy has good momentum and expenditure restraint continues. The Treasury is projecting a soon-to-be reached surplus, and we concur. Net core Crown debt (as a share of GDP) is close to peaking.**

FIGURE 1. UNDERLYING OPERATING BALANCE



Source: ANZ, NZ Treasury

In terms of the numbers themselves, we forecast OBEGAL surpluses to return in 2015/16. There is still the possibility of a small surplus being achieved this year, given that tax revenue is currently running ahead of expectations. However, we don't believe the impact of the weaker terms of trade and low inflation is fully influencing the tax-take just yet. As such, this gap relative to expectations should narrow. **But beyond this, OBEGAL surpluses are forecast to lift towards 1.0% of GDP (slightly less than the Treasury forecast), and net debt looks set to peak below 28% of GDP.**

The projected fiscal buffers aren't likely to be large. A 1% of GDP OBEGAL surplus is modest and flags limited potential for an uplift in spending or tax cuts, particularly given a backdrop which is likely to become increasingly testy in the political arena – the realities of being a third-term Government will start to bite, and public wage expectations are on the ascent.

As surpluses are achieved, fiscal policy becomes progressively neutral in terms of the overall impact on growth (i.e. less restrictive). This will help mitigate some of the negative flow-on of the growth contribution from the Christchurch city rebuild peaking in around 18 months' time.

A "MORE OF THE SAME" AGENDA BUT WITH SOME TWISTS

We expect the usual high notes of building a more productive economy, managing the finances responsibly and delivering better public services to be the mainstays across the policy agenda. However, it is clear that we are going to see more head-on attempts to improve social outcomes. The likes of housing will feature heavily but it is **the education sector that is ultimately critical if a sustained push to close income inequality divergence and poverty is to be successful.** Ultimately you need to give people the skills to take on well-paying jobs (we're assuming New Zealand's economic story is good enough to create them). The world and the nature of jobs on offer are changing rapidly. You won't improve social outcomes unless you foster a responsive, fast-moving and adaptive education system. Otherwise it's a hand-out as opposed to a hand-up.

FISCAL FORECASTS

June years	2014	2015(f)	2016(f)	2017(f)	2018(f)	2019(f)
OBEGAL ($bn)	-2.6	-0.2	0.4	1.4	2.1	2.7
– as % of GDP	-1.1	-0.1	0.2	0.5	0.8	1.0
Operating Balance ($bn)	2.8	2.5	2.8	3.8	4.6	5.2
– as % of GDP	1.2	1.0	1.1	1.5	1.7	1.9
Net Core Crown Debt ($bn)	59.9	64.8	68.1	69.1	68.7	67.8
– as % of GDP	25.6	27.0	27.3	26.7	25.6	24.3
Core Crown residual cash ($bn)	-4.2	-5.1	-3.6	-1.1	0.4	0.9
Bond Tender Programme ($bn)	8.0	8.0	7.5	7.5	7.5	7.5

INFLATION

SUMMARY

Annual inflation is expected to remain sub-1% over 2015 before drifting towards the midpoint of the inflation target as some short-term suppressants fade. Questions remain regarding whether this period of low inflation is due primarily to transitory or more enduring influences. Our projections of circa 2% annual inflation from late 2016 assume that expectations of wage and price setters are aligned closely to the midpoint of the inflation target. This, along with on-trend growth, should see annual inflation settle close to 2%.

PRICING WATCH

Annual CPI inflation has remained below the midpoint of the inflation target since 2011, with measures of core inflation generally remaining sub-2% since 2010. The benign inflation backdrop has surprised not only the RBNZ, but also most private sector forecasters who had viewed the period of low inflation as temporary given that the economic expansion was well advanced, and capacity gauges were pointing to rising inflation.

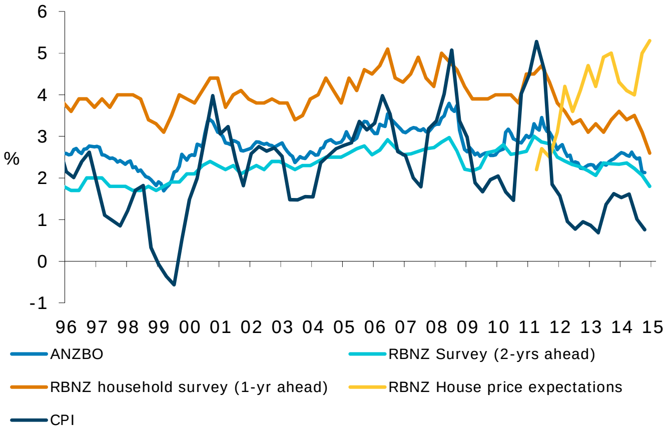
The usual reasons for low inflation outturns have been bandied about, including the impact of the high NZD, and lower oil and commodity prices. There is also the likelihood that some more enduring influences are having an impact on containing domestic inflationary pressure, including enhanced productivity, the impact of new technology, and the disinflationary impact of globalisation. Surveyed measures of inflation expectations remain at, or below, the 2% level, suggesting that the period of low inflation is expected to persist for a while yet. There is a global element to what is going on, with low inflation not specific to New Zealand.

We expect annual CPI inflation to remain below 1% for all of 2015. This reflects a combination of factors, including the lagged impact of NZD strength and lower global energy prices maintaining disinflationary pressure on tradable prices. Lower petrol prices are expected to directly shave 0.7 percentage points off annual inflation in the March 2015 year, with a strong possibility that annual CPI inflation falls below zero early this year.

Domestically generated inflation is expected to remain low over 2015, **with benign wage inflation and improved supply-side performance capping pricing pressures.** While strengthening net immigration is supporting demand, the mix is supply-side friendly and has helped to contain wage inflation and alleviate capacity bottlenecks within the economy. Pricing pressures remain acute in the construction sector, but have not filtered through to other prices. The NZD may be on the way down against the USD, but the lags are long, and the NZD is around post-float highs against the AUD and euro. Recent NZD gains against the yen are expected to lead to further falls in vehicle prices.

Annual CPI inflation is expected to gradually lift over 2016, with non-tradable inflation to rise towards 3% as pressures on capacity intensify and wages and prices firm. The foreshadowed lift in oil prices and the lower NZD/USD are expected to push annual tradable inflation back into positive territory. Administrative price changes will also affect the inflation profile; the Government have yet to announce increases in tobacco excise beyond March 2016 (an approximate 0.2 percentage point contribution to annual CPI) – our inflation projections do not build in excise tax hikes until they are announced. **Our projections also assume inflation expectations are aligned with the midpoint of the inflation target,** with confidence the RBNZ's actions will be sufficient to deliver 2% inflation. We acknowledge, however, uncertainties are considerable given the myriad of possible influences.

FIGURE 1. NZ INFLATION EXPECTATIONS



Source: ANZ, RBNZ, Statistics NZ

CPI FORECAST

Quarter	Qtr % chg	Ann % chg
Mar-15 (f)	-0.3	0.2
Jun-15 (f)	0.4	0.3
Sep-15 (f)	0.5	0.4
Dec-15 (f)	0.0	0.6
Mar-16 (f)	0.4	1.3
Jun-16 (f)	0.5	1.4
Sep-16 (f)	0.6	1.6
Dec-16 (f)	0.2	1.8
Mar-17 (f)	0.4	1.8
Jun-17 (f)	0.5	1.9
Sep-17 (f)	0.8	2.0
Dec-18 (f)	0.2	2.0
Mar-18 (f)	0.4	1.9
Jun-18 (f)	0.5	1.9
Sep-18 (f)	0.8	1.8
Dec-18 (f)	0.2	1.9

EXCHANGE RATE

SUMMARY

Strong economies typically have strong currencies, and the only challenger for the New Zealand economy at present is the US. We expect US data to reaccelerate in Q2 keeping NZD/USD under gradual but persistent downward pressure. However, we expect volatility to be high. Against all other currencies we expect the NZD to remain strong. Specifically, we expect the NZD to continue to trade at or near record levels against the EUR and AUD, and make new cycle highs against the JPY. The GBP is likely to remain weak against NZD until May's election uncertainty is removed, and the UK economy accelerates again.

A STRONG ECONOMY

Strong economies don't tend to have weak currencies, and New Zealand – in the words of the RBNZ Governor Wheeler – is in a *"different situation"* to the countries containing the 26 central banks that have eased policy 34 times since 2015 began. Paraphrasing Governor Wheeler: the NZ economy is growing at over 3%; has a positive output gap; strong employment growth (around 3.5%); record levels of net migration; and record levels of participation in the labour market (around 70%). The NZD has recently reached record levels against the EUR and AUD and is near cycle highs against the JPY. The "different situation" that New Zealand finds itself in will ensure the NZD remains elevated on a trade-weighted basis for some time yet. Our forecasts portray a strong economy. Enough said.

However, through a somewhat rhetorical question, we must ask; where does this leave the risks for the NZD? New Zealand is in the near nirvana of 3% growth and low inflation – in sharp contrast to four out of our five largest merchandise trading partners, who are facing slowdowns. But we believe the NZD is fully priced for this "different situation", and find it hard to envisage positive economic surprises given the situation in four of our five largest trading partners. **Thus we conclude that the risks lie mostly lower.** New Zealand's five largest merchandise trade partners by size are China, Australia, the US, Japan, and South Korea. Of those, China, Australia, and South Korea have all eased policy in 2015, and Japan has been engaged in QE (policy easing) since April 2013. Our third-largest trading partner, the US, like NZ is also in a "different situation" – a period of economic expansion – which we expect to continue to strengthen. This will allow the Fed to gradually normalise policy.

With risks on the downside, but a "different situation" and hefty cost of carry for shorts, the key question for NZD becomes one of timing. Also, USD strength makes the NZD/USD the only currency pair we are comfortable expressing a short bias on. Therefore, we are watching five key domestic indicators for signals that it would be time to express our short bias:

1. **Prospects for New Zealand commodities.** This is wider than just dairy prices, and is driven by broader demand in growth markets (for example China) for kiwi produce. We are watching closely for any sign of weakening global demand.
2. **Confidence.** Quite simply, economies run on confidence and New Zealand businesses and consumers have it. Should something dent prospects for the NZ economy and hence the NZD it may first show up in confidence numbers. ANZ business and consumer confidence indices are clear indicators of the "different situation" evident in New Zealand.
3. **Inflation.** Global inflation is "MIA" and the side-effect of global monetary policy is deflation being exported via currency revaluations. The ANZ Monthly Inflation Gauge is our timely indicator for underlying inflation trends in the NZ economy.
4. **Deteriorating trade and current account performance.** The mix of growth (more domestic, lower terms of trade) is denting structural trade metrics. We've pencilled a modest deterioration, but a more aggressive one would place more pressure on the NZD to adjust in line with such fundamentals.
5. **The RBNZ.** Could they follow other central banks and cut rates? Yes, but the hurdle is high. However, throw together continued low core inflation, further falls in dairy prices, the NZD hitting new highs and a prudential response to the Auckland property market, and they would be in play.

THE GLOBAL OUTLOOK

The other key dynamic for NZD/USD is the pace of the US recovery. While the US recovery remains modest and inflationary pressures mild, the pace of USD appreciation can be gradual. But if wage pressures accelerate or inflation picks up then the USD will swiftly become the strongest currency. Of course this is far from a one-way bet; there is a point at which a firm USD will dent economic momentum and stymie the Fed from lifting rates. We're not at that point yet.

EXCHANGE RATE

The news out of China remains a key source of concern for the NZD. The Chinese continue to manage a slowdown in their growth rate, and face structural challenges in transitioning from export-led to internally driven growth. This process raises questions regarding the outlook for Chinese demand for New Zealand product.

The wildcard remains how China and other harbingers of demand for commodities react to the Fed eventually lifting rates in the second half of 2015. We're circumspect.

While growth may be lifting, structurally speaking, Europe remains a weak spot for the global economy. While the latest tensions in Greece may get resolved, solutions other than full fiscal union merely kick the can down the road, storing up issues for the future. We expect EUR to remain on the back foot, driven by capital flows escaping the low yield and low growth environment in Europe.

We are also closely monitoring the signal from global commodities. There are no examples of a time where the plunge in demand and price for so many commodities has not signalled problems with global growth. This time may be different due to the unwinding of the financialisation of commodity markets (another symptom of USD leverage reduction as we approach US rate normalisation) and the supply-side boost currently evident in oil markets, but we remain wary, preferring to err on the side of caution. Hence we see downside risks to NZ commodity demand and hence NZD.

NZD/USD: USD BULL TREND

We expect NZD/USD to continue a steady decline over 2015 as the Fed begins the long road towards policy normalisation. However, we have significantly increased our expectations of volatility around this trend. We expect US data to reaccelerate in Q2 after the winter decline. We expect some further USD appreciation as this data acceleration emerges, but for USD strength to tail off rapidly as we approach lift-off, and stall as the markets move past reacting to the timing of the first hike and toward pricing the abnormally slow pace of US rate normalisation. In this period we would expect the NZD to remain fairly stable against the USD, but believe risks of further commodity price falls and weakness in global demand keep risks asymmetrical. This sees us with a tactical short bias.

NZD/AUD: TRENDING HIGHER

The RBA and RBNZ are on divergent policy paths and NZD/AUD has printed a succession of new post-float highs in the last quarter. Employment trends are divergent, as are the relative stances of the central banks. Given this, it is reasonable to expect NZD/AUD to remain elevated, and indeed possibly create further post-float highs.

While we can point to the economic cycle and the sizeable interest rate differential as a reason for the NZD/AUD remaining elevated, the story is broader. Structural metrics (terms of trade shifts, productivity growth) are in New Zealand's favour. The microeconomic trajectories of the two economies are on divergent paths too, and they are deposits on tomorrow's growth story. This has lifted fair value for the NZD/AUD from 0.85-0.88 to a couple of cents higher. It's still stretched at current levels, but the rubber band is not as taut as it could have been, and nor is the potential snap-back. We suspect we'll see a short-term blip to parity.

NZD/GBP: ELECTION RISKS

Fundamentally we expect GBP to strengthen against NZD as the BoE moves to normalise policy over the coming twelve months. **However, the May 7 election poses unique risks for the GBP and we expect NZD/GBP to remain elevated with an upward bias into that election.** At present the election is too tight to call and presents a lose/lose scenario for GBP. Traditionally a Tory win would boost the pound, but this time the Tory party may need the right wing UKIP party to form a government, and even if they don't, they have promised a referendum on EU membership, a referendum that will stall economic activity while it is determined if the UK's largest trading partner will remain an open market for it. A Labour win would likely involve a deal with the Scottish National Party, whose independent Scotland referendum caused GBP declines late last year.

NZD/EUR: STABLE, WITH RISKS

Europe continues to face many challenges that will keep this cross elevated; we forecast new highs. With the ECB committed to quantitative easing until at least September 18, we expect capital to flow from Europe to higher-yielding destinations, especially those who also have growth and real yields on offer like New Zealand. The political and fiscal problems Europe faces are by no means over either. Even if the current Greek question can be solved we see little prospect of a solution doing anything but delaying the inevitable fiscal square up that Europe faces. We maintain a sell bias on EUR, until progress toward fiscal union is made.

EXCHANGE RATE

NZD / JPY: ELEVATED

Japan is undergoing the largest expansion of its monetary base (relative to its balance sheet) in modern history. This commitment to reflating the Japanese economy should ensure JPY remains weak over the foreseeable future, and that investment flows will seek high-yielding assets such as the NZD. We expect this to keep the NZD/JPY elevated, with any periodic bouts of weakness an opportunity to buy NZD with JPY assets.

The process of Abenomics may have also passed the point of no return: any attempts to back away from reform at this stage would also see JPY continue to decline, as the BoJ is well on its way to fully monetising Japanese government debt.

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(e)	**0.78**	**0.96**	**93.6**	**0.50**	**0.64**	**79.4**
Mar-15(f)	0.73	0.96	88.3	0.49	0.70	78.7
Jun-15(f)	0.72	0.97	88.6	0.49	0.71	79.1
Sep-15(f)	0.70	0.96	86.8	0.47	0.71	77.8
Dec-15(f)	**0.70**	**0.97**	**87.5**	**0.45**	**0.74**	**78.7**
Mar-16(f)	0.69	0.97	86.9	0.45	0.69	76.7
Jun-16(f)	0.69	0.97	87.6	0.45	0.66	75.8
Sep-16(f)	0.68	0.97	87.4	0.44	0.62	74.0
Dec-16(f)	**0.68**	**0.97**	**88.4**	**0.44**	**0.62**	**74.2**

INTEREST RATES

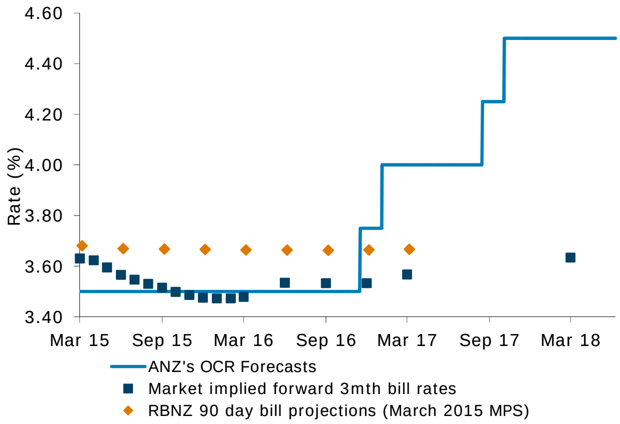
SUMMARY

With little inflation to speak of outside of housing and construction, and the NZD likely to remain elevated, the RBNZ has flat-lined its projections for the OCR and shifted to a neutral stance. We also expect the OCR to remain on hold for an extended period. However the risks around that forecast remain skewed to the downside in the near term. Policy easing by trading partners has added upward pressure to the NZD, global inflation pressures are still low, and China-centric risks abound. New Zealand bonds remain in hot demand, and we expect them to contract on a spread to other geographies, and for the curve to flatten as long-end yields move below 3%.

SHORT RATES STEADY/LOWER AS RBNZ FLAT-LINES ITS BILL PROJECTIONS

We expect short-end interest rates to remain fairly stable in coming months, albeit with a downside bias. This expectation is based on the RBNZ's newfound "steadfastly on-hold" stance, which the Bank has expressed via the flat-lining of its 90-day bank bill projections. By contrast, markets have close to a full RBNZ cut priced in by the end of the year.

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



Source: ANZ, Bloomberg

Our forecasts have the RBNZ keeping the OCR on hold until late 2016, at which time we expect the OCR to be lifted gradually. Our core economic projections are still upbeat, which also comes with the bias for interest rates to move up – at some stage. That's the "happy-clappy" scenario, so it's subject to a lot of developments unfolding as forecast. The near-term risk profile is different; it's pointed lower (courtesy of low inflation here and abroad, slumping commodity prices, China risks and the elevated TWI), and markets are naturally pricing some chance of cuts near-term.

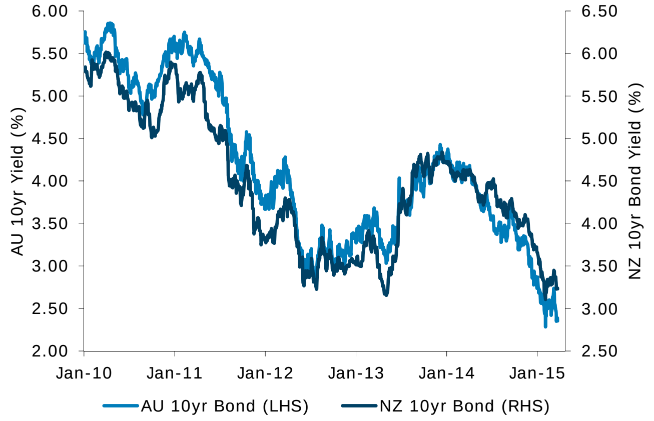
The hurdle to a rate cut might be high but we cannot rule out the possibility. Unless the RBNZ actually does cut, there is a limit to how much lower key rates like the 2 year swap rate can go. The obvious catalyst for a cut is something from offshore, which is certainly a risk but not something we are forecasting at present. This brings us to the question of what it could take locally to get the RBNZ in play, remembering that the economic story we've detailed earlier is reasonably solid. Our impression is that the RBNZ is not seriously entertaining the idea of a lower OCR yet, but we can identity "four pronged" criteria for bringing them into play. Briefly, these are:

1. **Continued elevation in the NZD TWI.** This condition is basically met.
2. **A continued period of subdued inflation.** We're watching our ANZ monthly inflation gauge closely – core prices were flat in February and tend to corroborate the story that outside of housing and government charges (tobacco taxes, tertiary fees and the like), inflation is well below target. The RBNZ appears to be viewing low inflation as driven more by cyclical/transitory forces; we view both transitory and structural forces as being at play. Inflation expectations surveys will provide key insights on how pricing behaviour is evolving, but one problem here is that such surveys tend to be strongly influenced by current inflation rates. The longer core inflation is low, the more pressure will come on the RBNZ. Remember, they have an inflation target, not a growth or a housing one!
3. **A failure of dairy prices to rebound materially, which would dent both the economic outlook and the outlook for inflation.** GDT auction prices recovered well in December and January, but have declined in March. There's not much wiggle room left for dairy farmers and we can ill-afford another season of low prices.
4. **A substantial non-OCR response to rising house prices.** The RBNZ is certainly hinting at action, but momentum in the market is strong.

There are other permutations too, but the above captures a simple framework for thinking about a localised story that could bring the RBNZ into play.

INTEREST RATES

FIGURE 2: AUSTRALIAN AND NEW ZEALAND 10-YEAR GOVERNMENT BOND YIELDS

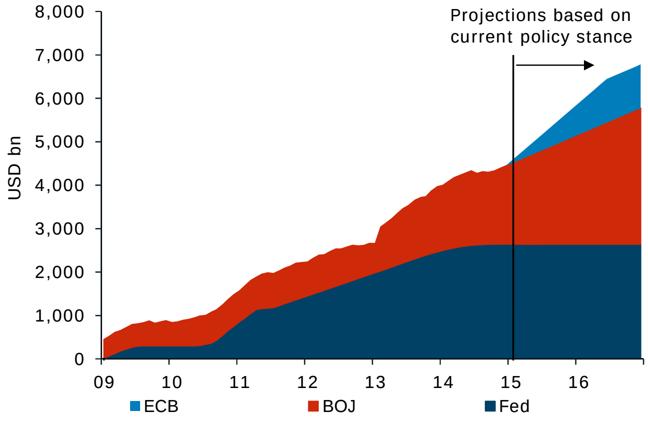


Source: ANZ, Bloomberg

LONG-END RATES LOWER, CURVE FLATTER

While the short end of the yield curve is anchored to the OCR, the long end is not. The long end is also more heavily influenced by global yield moves than domestic policy settings. **Global bond yields therefore hold the key.** With the European Central Bank (ECB) engaging in €60bn of QE per month from March, and the Bank of Japan (BOJ) committed to its circa USD 55bn per month QE programme, we expect global bond yields to remain under sustained downward pressure, and global yield curves to continue flattening.

FIGURE 3. G3 SOVEREIGN BOND PURCHASES



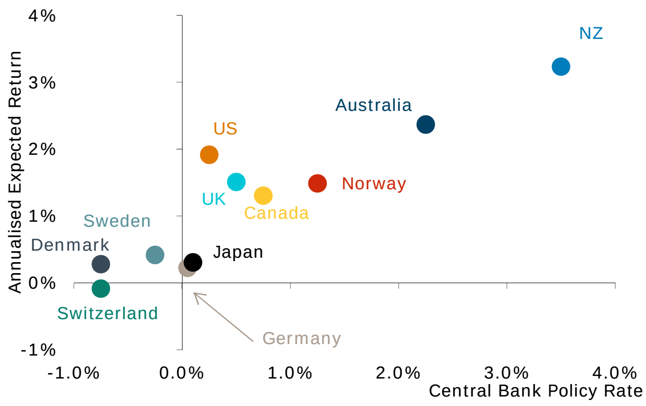
Source: ANZ estimates, Bloomberg

Although the Fed has ended its QE programme, the ECB and BOJ are basically stepping in where the Fed left off.

ABSOLUTE VERSUS RELATIVE

Our forecasts have US bond yields holding steady at around 2%, and Australian 10-year bond yields falling from their current level of around 2.4% to 2.1% by the end of the year. **We expect New Zealand bond yields to narrow in against both the US and Australia, and the yield curve to flatten as 10-year yields fall from around 3.2% currently to 2.8% by year-end.**

FIGURE 4. G10 10 YEAR BOND YIELDS VERSUS POLICY RATES



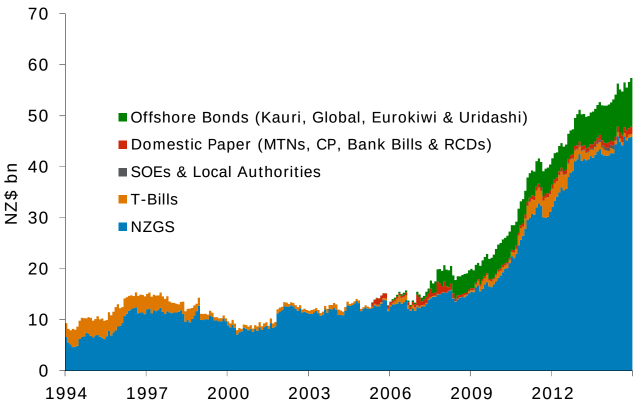
Source: ANZ estimates, Bloomberg

Our expectation of much lower yields and a flatter curve is reasonably aggressive, particularly with New Zealand 10-year yields already close to historic lows and trading below the OCR. However, while they are low relative to their own history, they are significantly higher than in other developed markets – particularly now that 10-year bond yields in key markets like Germany and Switzerland are either close to, or below, zero. New Zealand bonds – and other assets such as equities and commercial property yields – are not being driven by local absolutes, it is about offshore relativities as the search for yield and return continues.

SOLID DEMAND

Partly as a consequence of their high yields, offshore demand for New Zealand dollar bonds is running hot, with non-resident holdings at a record high in February.

FIGURE 5. NZD DEBT SECURITIES HELD BY NON-RESIDENTS



Source: ANZ, RBNZ, Bloomberg

INTEREST RATES

Domestic demand for long-end bonds is also likely to be solid into mid-April, when the April 2015 bond matures, lengthening the duration of the ANZ NZX Government Bond Index by approximately 0.56 years. Analysis of past NZGS maturities going back to 2005 shows a fairly consistent pattern of bond outperformance in the weeks leading up to the maturity (see table below). Indeed, bonds tend to perform strongly on an outright basis, on a spread to both Australia and the US. While there has been some variability around individual outcomes, as a general rule, the bonds performed better over the two weeks prior to maturity than they did over the both the week prior and the maturity day itself. With the April 2015 bond set to mature on the 15th of April, if a similar pattern is observed this year, expect NZGS yields to drift lower, spreads to narrow, the curve to flatten, and swap spreads to widen.

TABLE 1. 10 YEAR NZGS PERFORMANCE AROUND BOND MATURITIES – PAST DECADE (BPS CHANGE)

Period	NZGS Yield	NZ/AU Spread	NZ/US Spread	vs. Swap	Average
2 week change	-20	-7	-18	-12	-14
1 week change	-10	-9	-14	-5	-9
1 day change	-3	0	-4	-2	-2

Source: ANZ estimates, Bloomberg

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 (e)	3.50	3.8	3.6	3.4	3.0	2.0	2.4
Jun-15 (f)	3.50	3.8	3.6	3.3	2.8	2.0	2.4
Sep-15 (f)	3.50	3.8	3.7	3.3	2.8	2.0	2.3
Dec-15 (f)	**3.50**	**3.8**	**3.7**	**3.3**	**2.8**	**2.0**	**2.1**
Mar-16 (f)	3.50	3.8	3.8	3.4	2.9	2.1	2.4
Jun-16 (f)	3.50	3.8	3.8	3.5	3.1	2.3	2.8
Sep-16 (f)	3.50	3.8	3.9	3.6	3.2	2.4	3.0
Dec-16 (f)	**3.75**	**4.2**	**4.0**	**3.7**	**3.3**	**2.5**	**3.3**
Mar-17 (f)	4.00	4.3	4.1	3.8	3.4	2.5	3.3
Jun-17 (f)	4.00	4.3	4.1	3.9	3.4	2.5	3.4
Sep-17 (f)	4.25	4.7	4.3	3.9	3.5	2.5	3.5
Dec-17 (f)	**4.50**	**4.8**	**5.0**	**4.0**	**3.5**	**2.5**	**3.5**

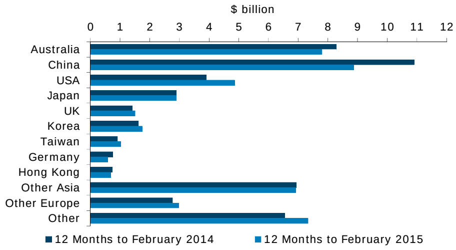
ECONOMIC FORECASTS

	Mar-14	Jun-14	Sep-14	Dec-14	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16
Real Gross Domestic Product												
Total GDP, QPC	1.0	0.7	0.9	0.8	0.5	0.7	0.9	0.8	0.7	0.6	0.6	0.6
Total GDP, APC	3.1	3.3	3.2	3.5	3.0	3.0	3.0	3.0	3.2	3.1	2.8	2.6
Total GDP, AAPC	2.5	2.9	2.9	3.3	3.3	3.2	3.1	3.0	3.0	3.0	3.0	2.9
Real GDP Components												
Private Consumption, QPC	0.3	1.2	1.4	0.6	0.8	0.8	0.7	0.8	0.6	0.6	0.6	0.6
Private Consumption, AAPC	2.9	2.8	3.0	3.2	3.7	3.9	3.6	3.5	3.2	3.0	2.9	2.7
Public Consumption, QPC	1.2	1.0	0.4	0.6	-0.2	0.0	0.1	0.1	0.1	0.2	0.2	0.2
Public Consumption, AAPC	2.7	3.5	3.5	3.6	3.1	2.2	1.6	0.8	0.4	0.3	0.4	0.5
Residential Investment, QPC	10.7	-0.4	0.2	5.2	0.2	3.1	3.0	2.0	1.6	1.6	1.0	0.6
Residential Investment, AAPC	16.7	18.1	16.3	16.7	12.6	10.2	10.5	8.7	9.9	9.7	8.3	7.4
Other Investment, QPC	-0.4	2.5	3.9	-1.4	2.3	1.1	1.4	1.2	0.9	0.9	0.9	0.8
Other Investment, AAPC	8.5	8.9	7.4	6.2	5.9	5.9	5.4	5.7	5.0	4.6	4.7	4.1
Gross National Expenditure, QPC	1.0	2.3	0.9	0.5	0.9	1.0	0.9	0.9	0.9	0.9	0.9	0.9
Gross National Expenditure, AAPC	4.6	5.0	4.5	4.7	4.7	4.2	4.1	3.8	3.8	3.8	3.8	3.8
Exports, QPC	3.1	-3.8	-0.1	6.1	-1.6	-1.3	-0.3	0.5	0.7	0.8	0.8	0.8
Exports, AAPC	2.6	1.3	1.6	5.1	0.4	3.0	2.8	-2.6	-0.3	1.8	2.8	3.1
Imports, QPC	0.2	1.9	3.0	0.3	3.0	0.2	1.2	0.9	0.8	0.7	0.7	0.7
Imports, AAPC	6.1	8.0	8.9	8.0	8.0	7.5	6.3	6.2	4.9	4.2	3.8	3.2
Prices												
Headline CPI, QPC	0.3	0.3	0.3	-0.2	-0.3	0.4	0.5	0.0	0.4	0.5	0.6	0.2
Headline CPI, APC	1.5	1.6	1.0	0.8	0.2	0.3	0.4	0.6	1.3	1.4	1.6	1.8
Non-tradable CPI, QPC	1.1	0.4	0.5	0.3	0.9	0.5	0.6	0.5	1.0	0.6	0.9	0.6
Non-tradable CPI, APC	3.0	2.7	2.5	2.4	2.2	2.3	2.4	2.5	2.7	2.8	3.1	3.2
Tradable CPI, QPC	-0.7	0.2	0.1	-0.8	-1.8	0.2	0.3	-0.5	-0.4	0.3	0.3	-0.3
Tradable CPI, APC	-0.6	0.1	-1.0	-1.3	-2.3	-2.3	-2.1	-1.8	-0.4	-0.3	-0.3	-0.1
External Accounts												
Ann. Balance on Goods, % of GDP	1.2	1.3	1.3	0.5	-0.5	-0.9	-1.1	-1.3	-1.3	-1.4	-1.4	-1.5
Ann. Balance on Services, % of GDP	0.5	0.6	0.6	0.8	0.9	1.0	1.0	1.0	1.0	1.1	1.1	1.2
Ann. Balance on Invisibles, % of GDP	-4.3	-4.4	-4.5	-4.5	-4.5	-4.4	-4.5	-4.5	-4.5	-4.6	-4.6	-4.6
Ann. CAB, % of GDP	-2.6	-2.5	-2.6	-3.3	-4.1	-4.4	-4.6	-4.8	-4.8	-4.9	-4.9	-5.0
Net Intl. Invt. Position, % of GDP	-65.5	-64.5	-64.2	-64.7	-65.7	-66.6	-67.1	-67.5	-67.8	-68.1	-68.5	-68.9
Terms of Trade (SNA basis)												
Export Prices, QPC	0.1	-3.1	-7.9	5.2	-4.5	-1.6	1.3	1.0	1.2	0.8	1.1	1.1
Export Prices, APC	11.5	6.6	-7.9	-6.0	-10.3	-8.9	0.2	-3.8	1.9	4.4	4.3	4.3
Import Prices, QPC	-9.8	-0.5	7.6	-0.1	0.1	-3.8	-0.6	-0.2	-4.7	0.5	1.2	1.2
Import Prices, APC	-2.5	-3.6	-4.7	-3.5	7.0	3.5	-4.3	-4.5	-9.1	-5.0	-3.3	-3.3
Terms of Trade, QPC	11.0	-2.6	-14.4	5.3	-4.5	2.3	1.8	1.2	6.3	0.3	-0.1	-0.1
Terms of Trade, APC	14.4	10.6	-3.4	-2.6	-16.2	-12.0	4.7	0.7	12.0	9.9	7.8	7.8
Labour Market												
Employment, QPC	1.0	0.4	0.9	1.2	0.6	0.5	0.4	0.4	0.3	0.3	0.3	0.3
Employment, APC	3.7	3.7	3.2	3.5	3.1	3.3	2.9	2.1	1.8	1.5	1.4	1.2
Labour Force, QPC	1.0	0.0	0.7	1.5	0.4	0.5	0.4	0.3	0.2	0.3	0.3	0.3
Labour Force, APC	3.4	2.7	2.4	3.2	2.6	3.1	2.8	1.6	1.4	1.2	1.1	1.1
Unemployment Rate, sa	6.0	5.6	5.4	5.7	5.5	5.4	5.4	5.3	5.2	5.1	5.1	5.1
Participation Rate, sa	69.3	68.8	69.0	69.7	69.6	69.6	69.6	69.6	69.5	69.5	69.5	69.5
QES Private Sector Wages, APC	2.9	3.1	2.9	3.0	3.1	3.1	3.2	3.2	3.3	3.3	3.3	3.4
QES Public Sector Wages, APC	1.8	1.3	1.0	2.0	1.8	2.1	2.0	1.8	1.6	1.7	1.6	1.8

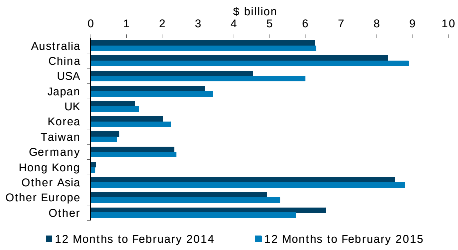
Forecasts in bold
QPC – quarterly % change
APC – annual % change
AAPC – annual average % change
sa – seasonally adjusted

KEY ECONOMIC INDICATORS

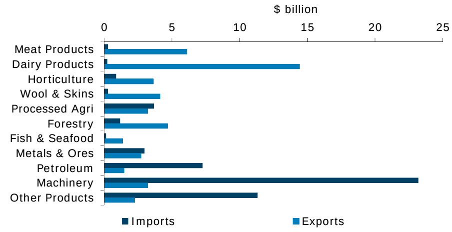
NZ EXPORTS



NZ IMPORTS



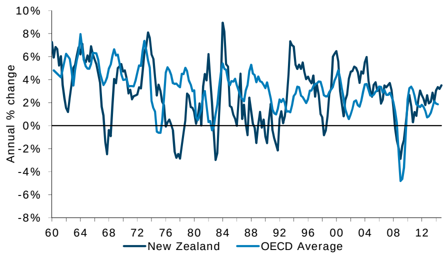
NZ EXPORTS AND IMPORTS BY SELECTED COMMODITIES 12 MONTHS TO FEBRUARY 2015



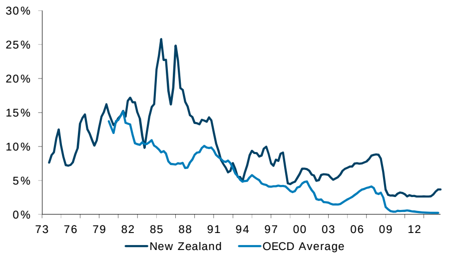
NEW ZEALAND COMPARED TO MAIN TRADING PARTNERS (LATEST AVAILABLE FIGURES)

	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	238	1,726	84,765	21,896	3,558	13,155	4,593	1,684	640	393	353	371	1,071
Change in real terms (yr-on-yr %)	3.3	2.7	2.4	-0.1	2.5	-4.2	1.6	3.4	3.6	6.0	2.3	2.9	5.0
Nominal GDP per capita in NZD	52,055	72,556	264,347	172,548	55,509	9,610	56,757	32,807	27,285	12,868	48,620	67,913	4,194
NZ exports to ..., NZDm (FOB)	n/a	7,801	4,856	2,897	1,505	8,870	591	1,749	1,024	988	691	910	903
Share of NZ Exports (%)	n/a	16.5	10.3	6.1	3.2	18.8	1.3	3.7	2.2	2.1	1.5	1.9	1.9
NZ imports from , NZDm (VFD)	n/a	6,305	5,998	3,402	1,348	8,890	2,390	2,239	735	2,113	125	2,073	848
Share of NZ Imports (%)	n/a	12.3	11.7	6.6	2.6	17.3	4.7	4.4	1.4	4.1	0.2	4.0	1.7
Current Account balance (% of GDP)	-3.3	-2.4	-2.3	0.5	-5.6	2.1	7.3	6.1	12.5	5.5	2.5	19.1	-3.0

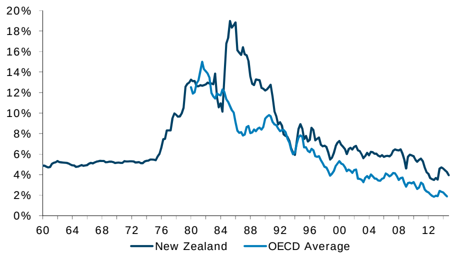
REAL GDP GROWTH



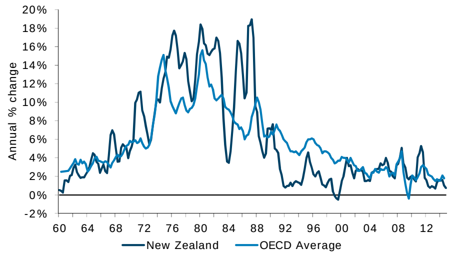
90 DAY INTEREST RATE



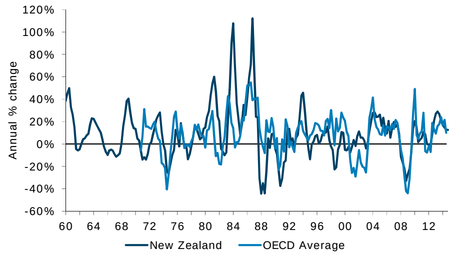
LONG-TERM GOVERNMENT BOND YIELD



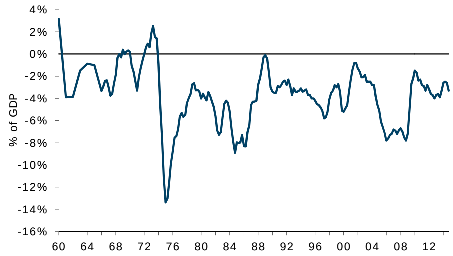
INFLATION RATE



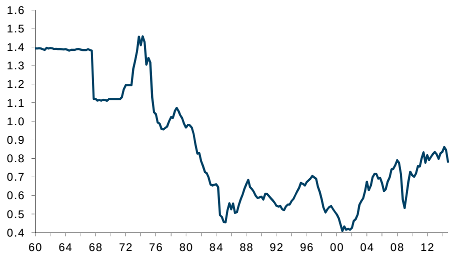
NZX50 SHARE PRICE INDEX



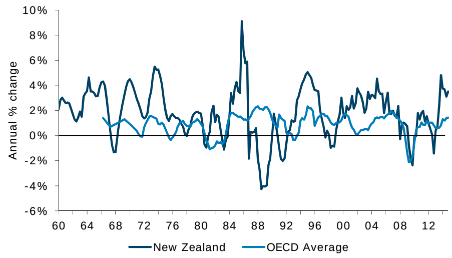
CURRENT ACCOUNT BALANCE



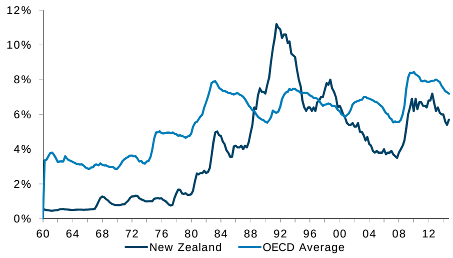
NZD / USD EXCHANGE RATE



EMPLOYMENT GROWTH



UNEMPLOYMENT RATE



Source: ANZ, Statistics NZ, Bloomberg, OECD

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