ANZ RESEARCH

# NEW ZEALAND ECONOMICS
# ANZ ECONOMIC OUTLOOK

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INSIDE




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# JUST WHAT I NEEDED

## NEW ZEALAND ECONOMIC OUTLOOK

Momentum in the economy is strong and the expansion has some legs yet. But late-cycle challenges are emerging. A natural balance sheet constraint will require credit growth to ease up, and this – in association with capacity constraints – is a key reason we expect GDP growth to ease from a strong to solid pace over the coming two years.

## INTERNATIONAL OUTLOOK

Our global economic forecasts portray a world growing at a modest rate. Yet tensions and risks remain as elevated as ever. Populist rhetoric – which is bad for microeconomic policy – is on the rise at the same time central banks are running out of policy tools. This is a potent mix. While our base case is largely of the ongoing 'muddle through' variety, the risks remain downwardly skewed.

## PRIMARY SECTOR OUTLOOK

The dichotomy across key primary sectors is expected to continue into 2017. Dairy farmers are now looking at a 'breakeven plus' season due to the improvement in international prices and other farm management changes. The operating environment looks tougher for some of the other livestock sectors. Horticulture is the growth story, which is expected to continue. Forestry returns look solid due to better export and domestic returns.

## FINANCIAL MARKETS OUTLOOK

Excess liquidity is distorting traditional market drivers, pushing many markets to extremes. While we ponder the endgame, the reality is we don't see the environment changing any time soon, which should keep the NZD elevated and local interest rates low. Both short and long-term interest rates are expected to fall further in the coming months.

| Calendar Years | 2013 | 2014 | 2015 | 2016(f) | 2017(f) | 2018(f) |
|---|---|---|---|---|---|---|
| **New Zealand Economy** | | | | | | |
| Real GDP (annual average % change) | 2.4 | 3.7 | 2.5 | 3.4 | 3.3 | 2.3 |
| Real GDP (annual % change) | 2.0 | 4.1 | 2.3 | 3.6 | 2.9 | 2.1 |
| Unemployment Rate (Dec quarter) | 5.6 | 5.5 | 5.0 | 5.0 | 4.9 | 4.5 |
| CPI Inflation (annual %) | 1.6 | 0.8 | 0.1 | 0.7 | 1.7 | 2.0 |
| Terms of Trade (OTI basis; annual %) | 20.2 | -5.0 | -3.2 | 1.6 | 3.5 | 0.8 |
| Current Account Balance (% of GDP) | -3.1 | -3.1 | -3.1 | -3.0 | -3.3 | -3.4 |
| Government OBEGAL (% of GDP) | -2.0 | -1.2 | 0.2 | 0.3 | 0.2 | 0.8 |
| **Global Growth (annual average %)** | | | | | | |
| US | 1.7 | 2.4 | 2.6 | 1.5 | 2.2 | 2.1 |
| Australia | 2.0 | 2.7 | 2.4 | 3.1 | 3.2 | 3.3 |
| China | 7.7 | 7.4 | 6.9 | 6.7 | 6.5 | 6.3 |
| Trading Partners | 3.0 | 3.6 | 3.5 | 3.5 | 3.5 | 3.5 |
| **NZ Financial Markets (end of Dec quarter)** | | | | | | |
| TWI | 77.3 | 79.4 | 73.7 | 75.4 | 68.9 | 69.8 |
| NZD/USD | 0.82 | 0.78 | 0.69 | 0.71 | 0.64 | 0.67 |
| NZD/AUD | 0.92 | 0.96 | 0.94 | 0.93 | 0.94 | 0.88 |
| Official Cash Rate | 2.50 | 3.50 | 2.50 | 1.75 | 1.50 | 1.50 |
| 10-year Bond Rate | 4.7 | 3.7 | 3.6 | 2.3 | 2.4 | 2.7 |

* Forecasts and text finalised 3 October 2016

# NEW ZEALAND ECONOMIC OUTLOOK


## SUMMARY

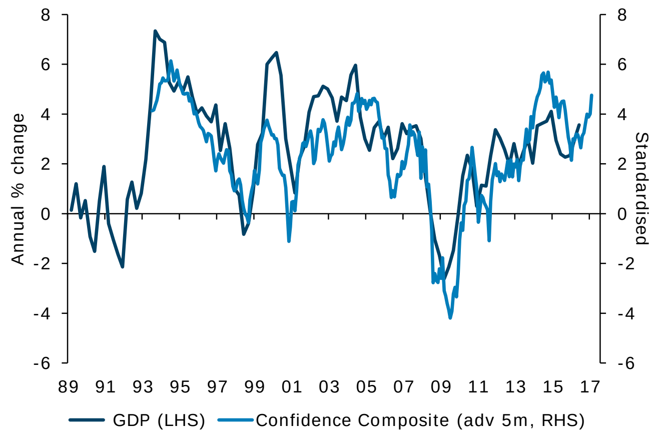
Momentum in the economy is strong and the expansion has some legs yet. But with the cycle entering a mature phase, key focal points and challenges will be attracting (and retaining) skilled labour and ensuring late-cycle excesses (credit and housing) are not the precursors to a downturn. The latter requires credit growth to ease up, and this – in association with capacity constraints – is a key reason we expect GDP growth to ease from a strong to solid pace over the coming two years. Despite a robust growth picture where capacity is being absorbed, the high NZD and lack of inflation mean the OCR is still heading lower even though the economy doesn't really need it.


## LET THE GOOD TIMES ROLL

**Momentum across the New Zealand economy is strong.** The latest GDP figures for Q2 confirmed a continuation of what has been a decent pace of quarterly growth for around the past 12 months. Annual growth, which has lifted to 3.6%, is not only historically strong and above trend, but right in the top echelons of growth performance across the developed world. Even annual per capita GDP growth, which has been more lacklustre, is also now accelerating again.

**Forward indicators suggest this decent growth performance has some legs yet.** Despite the elevated NZD, financial conditions remain supportive. Business sentiment is strong (and rising). Stronger profitability expectations are increasingly seeing firms want to go out and hire and invest. Our job ads series has risen for seven consecutive months, adding further weight to a theme of increasing demand for labour. Talk of skill shortages is becoming more widespread. This stronger labour market is supporting consumer sentiment, which also sits at solid levels. And our on-the-ground anecdotes certainly aren't inconsistent with any of this.

**FIGURE 1. GDP VS CONFIDENCE COMPOSITE**



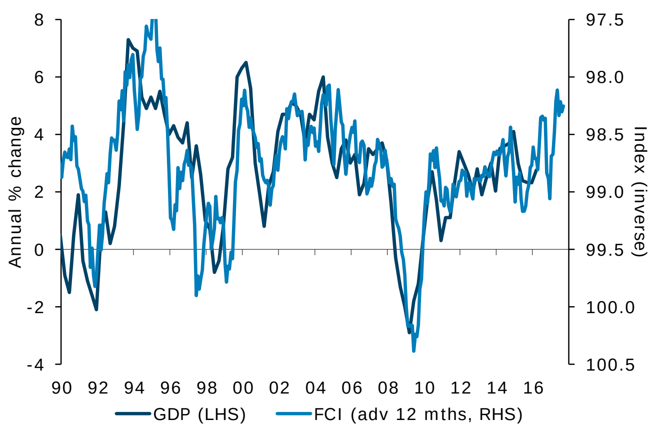

Source: ANZ, Statistics NZ

**The underlying drivers of this strong growth picture are now reasonably well appreciated, and by and large we expect them to continue.** While we are mindful of capacity constraints, the construction sector should remain a key contributor. The pipeline of work is large and relative price signals and demographics are still highly supportive. With net migrant inflows unlikely to fall meaningfully, population growth should remain at 2% or thereabouts for some time yet, supporting demand. Tourists continue to flood in as new airlines arrive and new routes are developed.

**A strengthening labour market, net wealth gains, historically low interest rates and the competitive retail environment are all supporting consumption growth** both at an overall level and more recently on a per capita basis. Non-dairy agricultural sectors are generally performing well (see page 7) despite a fragile global scene and strong NZD. And firms continue to display a 'just get on with it' attitude irrespective of global fragilities, structural challenges and disruptive technologies in a number of industries. Success is in turn breeding more success, which fits in with the theme of the economy's microeconomic fundamentals being in good health. It is the combination of small things that is complementing the broader macroeconomic story. The dairy sector cost recalibration, kiwifruit industry rebound, Manuka honey boom, flourishing IT sector in Wellington, better targeted use of the fiscal purse via a more surgical investment approach, and more airlines flying to New Zealand are just a few examples.

**We don't buy into the chatter that this is as good as it's going to get for the economy.** In fact, the likes of our Financial Conditions and Confidence Composite gauges point to annual GDP growth perhaps accelerating to 4% within the next 12 months.

**FIGURE 2. GDP VS FINANCIAL CONDITIONS INDEX**



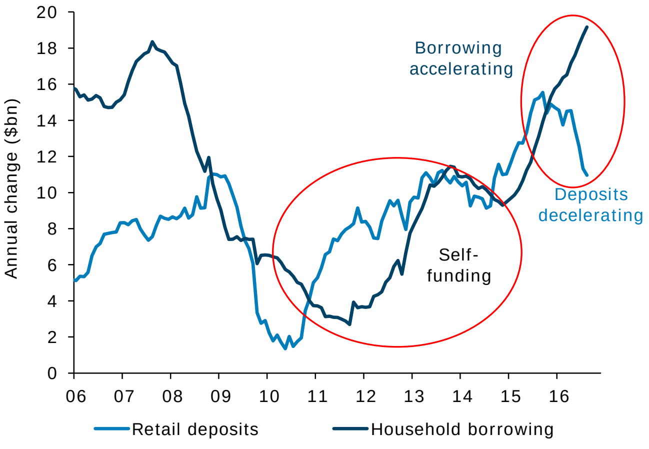

Source: ANZ, Statistics NZ

**Challenges are accompanying this strong growth.** But they are generally of the 'nice to have' variety.

# NEW ZEALAND ECONOMIC OUTLOOK

- **Capacity constraints are evident and will act as a natural handbrake.** If we do get growth north of 4% (though we think that's a step too far), the economy won't be able to sustain it for long. Pressures are already evident in construction, but this is not an isolated case. Finding the right staff is becoming the biggest issue for businesses economy-wide, according to surveys such as our Small Business Microscope. Capacity utilisation is sitting near historic highs. Importantly though, we expect these constraints to spur additional investment from firms, with additional capital investment (capital deepening) eventually expected to assist in an improvement in the economy's underlying productivity growth picture.
- **A strong NZD.** The NZD looks stretched on many valuation metrics, but it is hard to see that situation changing when the New Zealand economy continues to look strong on many relative measures (barring a dramatically different global picture – which is, to be fair, a key risk; the situation is fluid!). A lower currency would obviously be welcomed by the export sector, but the sector has coped remarkably well to date. The tourism sector would normally be expected to suffer from a strong NZD, and we do see average spend per visitor falling modestly over the next 12 months or so. However, this should be outweighed by the sheer number of arrivals, which we expect to continue trending higher. And while the NZD is also creating a disinflation headache for the RBNZ, its response, a lower OCR, will only serve to support domestic growth prospects further – although we doubt borrowers will see the full amount passed on.
- **Migration inflows are creating tension.** In the first instance, we view strong migration as a response to the economic backdrop rather than a primary driver of it, although clearly it has both demand and supply side consequences. And while we generally view migration in a favourable light given the economy's need for skills that will only grow as the population ages, strong migration nevertheless creates pressures on housing and infrastructure, and currently looks to be dampening wage growth. There are also plenty of questions over whether the current 'mix' is right when measures like labour underutilisation remain at elevated levels yet firms are telling us it is more difficult to find staff. The current framework does need to be tweaked.
- **Overvalued house prices.** A strong housing market is also symptomatic of the strong general economy. That said, there are of course other factors at play and the strength in house price growth goes beyond what is justified by underlying economic fundamentals alone. Whichever way you cut it, houses are overvalued (particularly in Auckland where prices are more than 9 times incomes), and that increases the risk of a correction in the future. That said, it is hard to envisage a material correction (at least driven by domestic forces) when significant support remains in the form of strong migration, low (and lower) interest rates and a slow, though ongoing, supply response. The RBNZ has responded with additional LVR restrictions (and more macro-prudential measures in the form of debt-to-income limits seem likely), and early anecdotes suggest some traction. Yet the big uncertainty is the longevity of any impact. Financial intermediaries are taking a more medium-term view, tightening risk appetites. We view leaning against a boom as a good thing for the longevity of the economic expansion.
- **Conditions are gradually ripening for housing largesse and late-cycle excesses to weaken the national balance sheet and force a downturn.** Credit growth is outpacing incomes; household debt-to-income has risen to an all-time high of 165%. The household savings rate has deteriorated. With borrowing accelerating and deposit growth waning, we have the recipe for the current account deficit to widen. It is this combination, in association with overvalued house prices, which is worrying. The economy is at a juncture where it can take one of two paths: a) let the party continue and risk a hangover; banks look increasingly offshore for funding (less stable than domestic funding from a financial stability perspective) and let the current account widen; or b) ration the drinks; focus more on savings and see credit growth cool. From a sustainability perspective, the latter is far more favourable.

**FIGURE 3. BANK FUNDING AND CLAIMS GROWTH**




Source: ANZ, RBNZ

# NEW ZEALAND ECONOMIC OUTLOOK

**We are, critically, assuming late-cycle excesses do not take hold.** Retail spending runs in line with incomes. The household saving rate stabilises and even rises slightly as people use stronger incomes courtesy of a tighter labour market to actually boost savings. Credit growth slows towards 5% and the current account does not widen materially. We consider it important that the RBNZ is being far more proactive in managing housing-related risks than in the past. It is the containment of excesses, together with the impact of capacity constraints, which will act as a natural handbrake on activity. **If we are incorrect in this assumption, growth will be more volatile over the coming years: higher highs and lower lows.**

## DRIVE

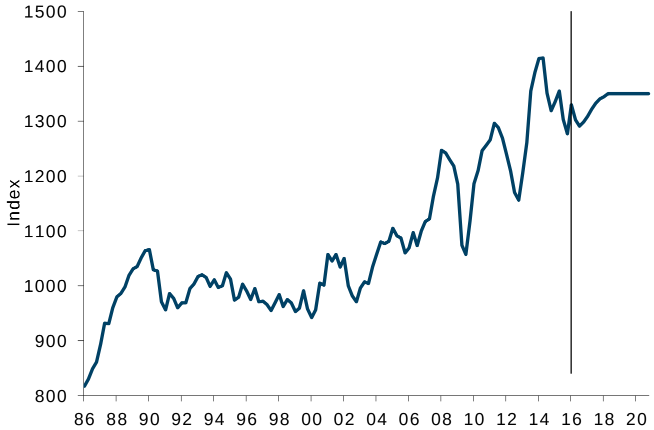
**We project annual GDP growth to hold in a 3½% to 4% range for the next 12 months or so.** While the vagaries of the inventory cycle and the impact of the latest LVR restrictions could see quarterly GDP figures swing around a bit in the near term (which is nothing new for New Zealand), the underlying story is expected to remain strong. On a full-year calendar basis, GDP growth is forecast to average 3.3% in 2017 after estimated growth of 3.4% in 2016. Annual GDP growth (a more volatile but timelier portrayal of the cycle) softens to under 3% y/y over 2017, although that's still hugely respectable.

**With regard to the composition of this growth, domestic demand leads the charge.** Private consumption is forecast to grow at a similar pace over 2017 as that seen in 2016 (~3½%), with growth roughly stable at 1.5% in per capita terms. While residential investment growth is likely to moderate from 2016's strong pace (estimated at close to 12%), other fixed asset investment is forecast to lift, with total investment forecast to grow 4.5% in 2017 after 2.7% growth in 2016. Final domestic demand is forecast to expand at a 3.6% pace in both 2016 and 2017. Despite an elevated NZD and strong domestic growth backdrop, the contribution to growth from net exports is forecast to remain roughly flat over the next few years.

**Prospects for the dairy sector have improved.** Low dairy prices and the transmission through falling land values and tight cash-flow (losses) have been key headwinds. Challenges remain. Positive cash-flow for the typical dairy farmer will not be restored until 2017/18 (breakeven beckons this season), but the outlook is now less dire with dairy prices up off lows (refer page 7).

**More broadly, New Zealand's terms of trade** (export prices relative to import prices – a measure of purchasing power), **remain at an elevated level.** Deflationary forces in the form of excess capacity in manufacturing and technological advancement are bringing down the costs of imported products. Conversely, soft commodities are holding at respectable levels, with some signs of increases of late. After a further fall in the very near term, we assume the terms of trade rises modestly over the next 12 or so months before stabilising at an historical strong level.

**FIGURE 4. GOODS TERMS OF TRADE (OTI)**




Source: ANZ, Statistics NZ

**Fiscal policy is expected to remain in yawn mode over the projection period.** There will no doubt be some election goodies on offer but we are not expecting them to be significant enough to alter the economic landscape. More broadly, the thrust of domestic fiscal policy settings is expected to be neutral/contractionary with a focus on paying down debt. The kitchen sink will be thrown at the Auckland property market, but it's difficult to see the supply situation changing soon.

**The global scene remains the key source of risk that could alter the solid domestic picture.** While the New Zealand economy is in a better place structurally than it has been in the not-too-distant past, and has ability to fight any fires with fiscal and monetary policy, New Zealand is still a small, open, commodity-exporting nation dependent on global creditors to fund a domestic saving shortfall. History is littered with episodes when a global event alters the domestic economic picture quite rapidly. There is no shortage of candidates to be this potential event. The world is still highly indebted, with emerging Asia (China especially) now at the epicentre. The actions of central banks in trying to stimulate global growth are arguably now fostering bigger problems in the future (excessive leverage, overvalued asset prices, capital misallocation, bank profitability problems, moral hazard etc), and policymakers are running low on options. Globalisation and economic integration is being replaced by the antithesis, which risks even poorer policy outcomes at a time when the globe is crying out for stronger ones.

## ALL MIXED UP

**Conventional factors are pointing towards stronger New Zealand inflation being around the corner.** We have above-trend growth, elevated construction cost inflation, a falling unemployment rate, positive output gap and increased difficulty finding labour.

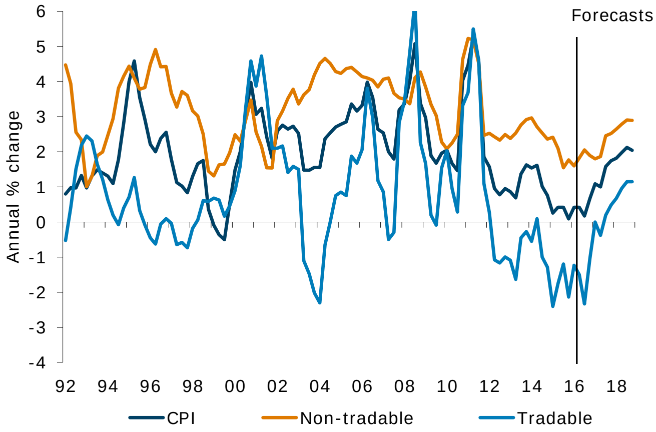
**Yet outside of housing, domestic inflation pressures have remained benign for some time**. And while tradable inflation has clearly been low too – due to the well-documented forces of the strong NZD, soft commodity prices and global deflationary pressures – it is the softness in domestic inflation that has been the bigger surprise.

**Some of the factors behind this softness in domestic inflation look set to persist.** Benign underlying trends within our Monthly Inflation Gauge hint at some structural element to this low inflation. Whether that be due to disruptive technologies (think the likes of Uber and Airbnb), online competition forcing retail sector margin compression, 'leakage' from low tradable sector inflation, or falling inflation expectations, it all points to a flatter Phillips Curve, where shifts in the domestic economic picture have less of an impact on domestic price tension. There is a global element to all this as well, with almost all central banks facing challenges in getting inflation up – a complete U-turn from the historical tendency of trying to keep it down.

**Nevertheless, we still forecast domestic inflation to lift.** Non-tradable inflation is forecast to drop to a historically low 1.8% y/y in early 2017, in large part due to one-off influences such as reduced ACC levies in Q3. But it is then forecast to lift towards 3% over the remainder of the forecast period, albeit gradually, as some of the 'traditional' inflation drivers gain some traction, notably in the labour market. The Phillips Curve may be flatter, but we are not convinced that it is now completely obsolete.

**Headline inflation is also expected to rise, but the risk profile has a downward skew.** Low inflation is a global phenomenon and it's hard to see that picture altering. However, after dropping to just 0.2% y/y in Q3, headline inflation is expected to begin to rise in Q4 as some large negative quarters (influenced by weaker oil prices predominantly) fall out of the annual calculation. However, our forecasts do not have headline inflation returning to the mid-point of the target band until mid-2018 – and that is based on the assumption that the NZD falls modestly over the coming 18 months or so. Continued NZD strength (which is a real risk given the growth picture we are painting for the economy relative to a muddle-through world) would likely delay the return of inflation to the target mid-point.

**FIGURE 5. HEADLINE, TRADABLE AND NON-TRADABLE INFLATION**




Source: ANZ, Statistics NZ

# INTERNATIONAL OUTLOOK


## SUMMARY

Our global economic forecasts portray a world growing at a modest rate. Yet tensions and risks remain as elevated as ever. Populist rhetoric – which is bad for microeconomic policy – is on the rise at the same time as central banks are running out of policy tools. This is a potent mix, particularly with asset values extended and investment misallocation – courtesy of interest rates being too low – rife. While our base case is largely of the ongoing 'muddle through' variety, the risks remain downwardly skewed.


## MUDDLE THROUGH

**At face value, our forecasts depict an improving backdrop for the global economy.** After estimated growth of 3.2% in 2016 (which has effectively been the average since 2008), growth is forecast to lift to 3.7% in 2017, which would be the strongest rate since 2011. The acceleration is led by the US, but they are joined by a number of emerging economies.

**But this forecast masks considerable tension and risks. There are numerous issues, but in particular we note:**

- **The global economy tends to run in a 10 year cycle of large shocks:** 1987, 1997 (Asian crisis), 2008 (GFC). Statistically, we are 'due'.
- **Debt levels are still high, and the build-up in corporate debt in China is a focal point.**
- **There is no shortage of geopolitical challenges or hot spots.**
- **Productivity growth around the globe is weak.** That makes growth sub-par, and it's harder to mask debt problems. Europe still faces profound structural issues.
- **Investment misallocation is rife.** That's what incredibly low – and in a lot of cases, negative – interest rates do. You are forced out the credit (risk) curve. The yield on a 30-year JGB recently went from 0.05% to 0.55%; that's a 15% capital loss and shows just how toxic the environment for investing has become when yields are chased to such levels. You can only make money buying a negative yielding instrument if someone is silly enough to push the price even higher / yield even lower. You lose big if they go the other way.
- **Liquidity is trumping economic fundamentals.** Bad economic news has become good for asset values simply because it keeps markets attuned to interest rates being lower for longer. **That's plain silly.**
- **Central banks are low on firepower and arguably pushing on a string anyway.**
- **Fiscal policy needs to step up to the plate, but that is hard to envisage in practice.** While the likes of the G20 continue to hit all the right notes when talking about the policy direction from here (less monetary and more fiscal and structural reform), we are yet to see these words being put into meaningful action. We need group interest to supersede self-interest.
- **Populism is gaining a greater footing and politics is now arguably replacing central banks as the more important focus.** Society is pushing back against globalisation and economic integration, which speaks to increased protectionism and barriers. At a time when many economies are crying out for stronger policy options and leadership, a swing to populism and anti-globalisation spells the opposite. That won't derail the global economy overnight, but more barriers will mean slower growth over time.

**So where is the good news?** The US economy is looking okay, with full employment at hand and positive vibes for wage growth, although it is still stuck in a mediocre growth phase. Australian GDP growth is forecast to hold above 3% as it continues to successfully transition away from mining-led growth. While China's growth rate is easing, it is forecast to remain above 6% and that's helping drag Asia along for the ride.

**It's an environment with such a profound array of issues that are difficult to incorporate in any set of forecasts. The spirit is of a 'muddle through' type backdrop for the global economy.**

| Calendar Years (annual average % change) | 2012 | 2013 | 2014 | 2015 | 2016(f) | 2017(f) | 2018(f) |
|---|---|---|---|---|---|---|---|
| United States | 2.2 | 1.7 | 2.4 | 2.6 | 1.5 | 2.2 | 2.1 |
| Australia | 3.6 | 2.0 | 2.7 | 2.4 | 3.1 | 3.2 | 3.3 |
| Japan | 1.7 | 1.4 | -0.1 | 0.6 | 0.6 | 0.5 | 0.8 |
| Euro Zone | -0.8 | -0.2 | 1.1 | 1.9 | 1.6 | 1.7 | 1.6 |
| China | 7.8 | 7.7 | 7.4 | 6.9 | 6.7 | 6.5 | 6.3 |
| **Trading Partner Growth** | **3.3** | **3.0** | **3.6** | **3.5** | **3.5** | **3.5** | **3.5** |

# PRIMARY SECTOR OUTLOOK

## SUMMARY

The dichotomy across key primary sectors is expected to continue into 2017. Dairy farmers are now looking at a 'breakeven plus' season due to the improvement in international prices and other farm management changes. The operating environment looks tougher for some of the other livestock sectors, with reduced supply the main support for prices in many cases. Horticulture is the growth story, which is expected to continue for at least the next three years. Forestry returns look solid due to better export and domestic returns.

**Offshore dynamics remain challenging.** Some of the key themes include:

- **Sluggish economic and real wage growth in many markets is limiting organic growth** and the ability to pivot between markets.
- **The downstream implications of falls in energy prices and the broader commodity complex** continue to reverberate through the soft commodity complex.
- **Geopolitical ructions continue to disrupt trade flows** and import demand in some key import regions (mainly Europe, Russia and the Middle East). Chinese trade risks continue to appear on a regular basis too.
- **Government support for competitors continues, including in China.** Some recent developments have been positive, with Europe targeting the supply side for dairying. However, other initiatives continue to support less-efficient supply for other policy reasons (i.e. environmental and self-sufficiency). This reduces restructuring and artificially supports inefficient supply.
- **Low global feed costs are boosting the competitiveness of key competing Northern Hemisphere exporters and products.**
- **Key competitors are improving their market access** into China, US, UK and other emerging markets.
- **Foreign exchange movements are altering competitiveness.** A weaker USD doesn't appear to have lifted soft commodity prices to the same extent as normal. An expected firmer USD courtesy of a strong US economy and higher interest rates means the NZD/USD should ease, benefiting some sectors. We're not so hopeful of something similar happening versus the EUR, JPY or GBP.

**Where New Zealand is the main global supplier, and there is more limited competitive pressure, there should be gains from tighter supply.** For other sectors where there is more competition, abundant stocks and/or greater earnings exposure to countries experiencing political uncertainty and economic growth challenges, it will be a tougher trading environment, capping potential gains.

**For dairy, the recent rally in international prices looks more durable than those seen in the prior two years.** The improvement has been driven by tightening milk supply in key export regions, low carry-over inventory from last season locally, improved Chinese import demand, and fairly steady import requirements elsewhere. The extent to which prices can further extend will depend on milk supply dynamics, with both weather conditions and feed prices crucial swing elements. All up, cash flow forecasts for the average dairy farmer in 2016/17 are back near breakeven due to the lift in international prices, improved productivity metrics and cost reductions.

**The outlook for red meat and fibre is mixed and depends on the mix of livestock being farmed.** There are downside risks for sheepmeat returns from Brexit impacts, but this will be somewhat offset by tighter tradable supplies. The beef market is finely balanced: Australasian supply is set to fall, but this is offset by increased US supply. Demand indicators look solid, but beef is going head-to-head with softer pork and poultry prices. Wool prices look steady, but have recently been softer due to a lack of Chinese interest. Venison prices are being supported by lower local supply and some success in growing demand in non-European markets, and for products outside the game season in more traditional markets.

**Horticulture is the growth story, and this is expected to continue.** The pipfruit sector has had another good export season, which marks four years of strong, profitable returns. Despite a large 2016 vintage, a supply imbalance is not expected. Looking forward, the Northern American and domestic markets are expected to remain buoyant, while Australia and the UK are likely to be tougher. Kiwifruit volumes continue to increase, led by higher Gold3 volumes. Prices and returns remain very attractive. Green prices have come under pressure due to higher local volumes, which have required some crop management.

**Forestry returns look solid.** Wharf-gate returns for export logs are well above the 5-year average. Local market pricing continues to trend up, driven by construction activity and the storage of pruned logs.

# FINANCIAL MARKETS OUTLOOK

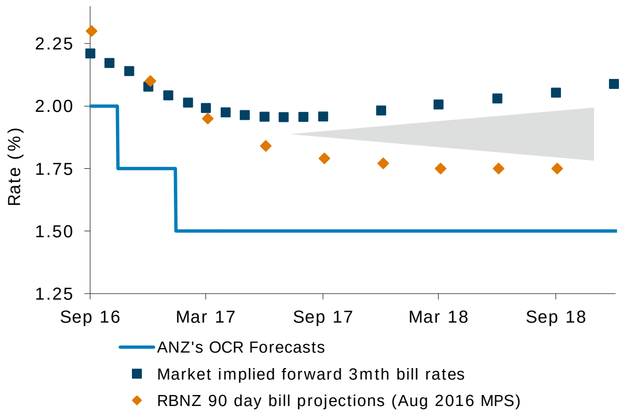
## SUMMARY

A muddle-through world amidst easy monetary policy remains a key feature across global markets, driving the theme of NZD divergence (from fundamentals) requiring interest rate convergence (to global rates). Excess liquidity is distorting traditional market drivers, pushing many markets to extremes. While we ponder the endgame and consequences of a liquidity-driven mind-set (eg a mispricing of risk), the reality is we don't see the environment changing any time soon, which should keep the NZD elevated and interest rates low. We expect New Zealand short-end interest rates to remain under downward pressure; with our forecast for two more 25bps OCR cuts not yet fully incorporated into market pricing. More global bonds now sport negative yields than ever before, and we expect New Zealand bond yields to continue moving lower in coming months. An eventual move higher beckons, conditional on Fed policy, US growth, and global inflation moving sustainably higher. That won't take place in an orderly fashion.

## NZD NEEDS TAMING SO TWO MORE RBNZ OCR CUTS COMING; SHORT END BIASED LOWER

**We expect two more OCR cuts over the next six months (November and February)**. Market pricing remains shy of this despite the Reserve Bank's reiteration in September that its "projections and assumptions indicate that further policy easing will be required". Given the 'wedge' that exists between the RBNZ's projections and market pricing (Figure 1), this suggests that local short-term interest rates will remain under downward pressure.

**FIGURE 1: ANZ OCR FORECAST, MARKET FORWARD 90 DAY RATES AND RBNZ 90 DAY RATE PROJECTIONS**




Source: ANZ, RBNZ, Bloomberg

**The economy doesn't need a lower OCR but the inflation profile does.** It's debatable whether the RBNZ should be cutting given strength across the broader economy and lacklustre response so far of the NZD to 75bps of rate cuts over the past year. Since then, NZD/USD has risen around 10 cents!

**So why waste your bullets?**

- The RBNZ might not be able to get the NZD down, but **if it didn't cut it would be a lot higher.** Cash rate parity with Australia (1.50%) would also be helpful given how stretched the NZD/AUD is.
- **NZD strength looks partly like a portfolio shock;** you need to cut a long way to offset such a shock. The RBNZ had a high NZD scenario (ironically, with a TWI around current levels) in its August *MPS*, which had the OCR falling to below 1%.
- **Inflation has been below the 2% mid-point of the RBNZ's target for 5 years.**
- **Inflation expectations** – which the RBNZ says are stable – **have drifted lower** in the past 6 months and risk being embedded in price-setting behaviour.

**We expect short-end rates to grind lower,** although, as has been the case in recent months, we expect them to 'follow' rather than 'lead' the OCR lower. This simply reflects a natural expectation that should the Fed finally deliver on promised rate hikes (we discuss this in more detail later); that would take pressure off the RBNZ to cut.

## GLOBAL RATES HOLDING LOW AND STEADY; SUPPORTED BY FED, ECB AND BOJ POLICY

**Global long-term interest rates have returned to a state of relative calm.** Global bond markets experienced a mild 'tantrum' late in Q3, but have since been soothed by a more relaxed tone from the US Federal Reserve (the 'Fed'). This included a lowering of the Fed's projections for future interest rates (Figure 2). Although these projections clearly signal a hike in December if the outlook evolves as expected, markets will struggle to firm up odds ahead of the US Presidential elections on 8 November (and even then, market perceptions will be shaded by the outcome). Of note, the projections are consistent with just two further hikes in 2017, and are the latest in a string of downgrades. This should give the market comfort, as will Fed Chair Yellen's repeated reiterations that the pace of tightening will be very gradual. The global scene makes anything else unpalatable and even then it is questionable if rates can actually move up, despite US employment and inflation numbers saying 'get on with it'.

**European Central Bank (ECB) policy remains very stimulatory and President Draghi has**

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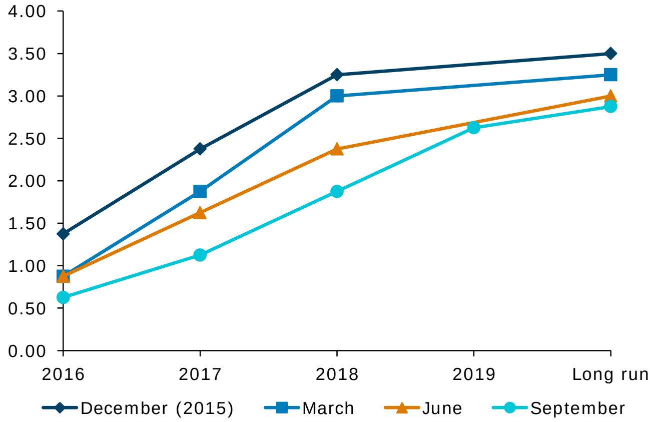
**reaffirmed that the Governing Council 'stands ready to act'.** This is not new and markets won't react to the ECB unless, or until, it changes tack. Our forecasts assume the ECB will hold policy steady for the foreseeable future, anchoring yields.

**FIGURE 2: THE EVOLUTION OF FOMC DOT PLOTS**




Source: ANZ, Federal Reserve

**We regard the Bank of Japan (BoJ)'s recent shift in focus as a significant development, one that will help anchor G3 yields and drive further peripheral spread compression.** By shifting to a policy of targeting a yield of 0% for the 10-year JGB yield, the BoJ has not just taken away the upside risk to yields in this key market, but it has effectively drawn a line under further capital gain too. For real-money end investors, this basically removes the incentive to own them. This is because 10-year JGBs now have no potential to provide capital gains (their yields are stuck) or accrued interest (their yield is zero). In turn, this strongly incentivises current holders to switch into much higher-yielding markets – such as New Zealand, which has comparatively much higher yields (Figure 3).

**FIGURE 3: G10 SOVEREIGN BOND YIELD "HEAT MAP"**

| Country | 2-3 Year | 5 Year | 10 Year | Average |
|---|---|---|---|---|
| Switzerland | -1.04 | -0.87 | -0.56 | -0.82 |
| Germany | -0.70 | -0.58 | -0.12 | -0.47 |
| Denmark | -0.60 | -0.41 | -0.03 | -0.35 |
| Sweden | -0.68 | -0.36 | 0.17 | -0.29 |
| Japan | -0.26 | -0.24 | -0.09 | -0.20 |
| UK | 0.07 | 0.19 | 0.72 | 0.33 |
| Canada | 0.49 | 0.57 | 0.95 | 0.67 |
| Norway | 0.70 | 0.88 | 1.19 | 0.92 |
| USA | 0.74 | 1.11 | 1.56 | 1.14 |
| Australia | 1.59 | 1.67 | 1.97 | 1.74 |
| New Zealand | 1.92 | 1.98 | 2.33 | 2.08 |

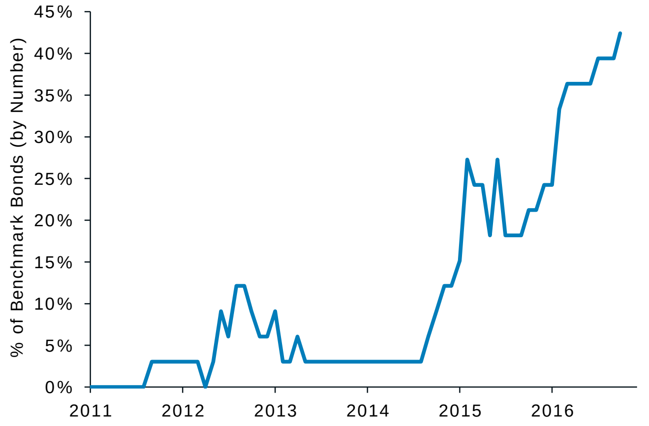
Source: ANZ, Bloomberg

## GLOBAL POLICY ENVIRONMENT STILL NET SUPPORTIVE OF LOW NZ LONG-END YIELDS

**Our forecast of broadly stable US Treasury bond yields,** the easy policy backdrop in Europe and Japan, and the capital flows that will result from that **underline our forecast for lower New Zealand long-end rates and further NZ/US 10 year bond spread compression.**

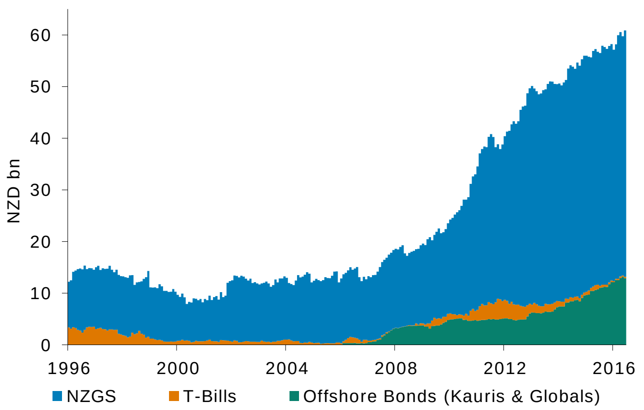
**In an environment where the 'body count' of negative-yielding bond yields continues to rise (Figure 4), we expect investor demand for relatively high-yielding New Zealand government bonds to remain strong.** Investor demand has been evident in offshore ownership statistics showing that foreigners own record amounts of NZD-denominated bonds (Figure 5).

**FIGURE 4: ESTIMATED PROPORTION OF BENCHMARK G10 SOVEREIGN BONDS WITH NEGATIVE YIELDS**




Source: ANZ, Bloomberg

**FIGURE 5: NZD WHOLESALE DEBT SECURITIES HELD BY NON-RESIDENTS**



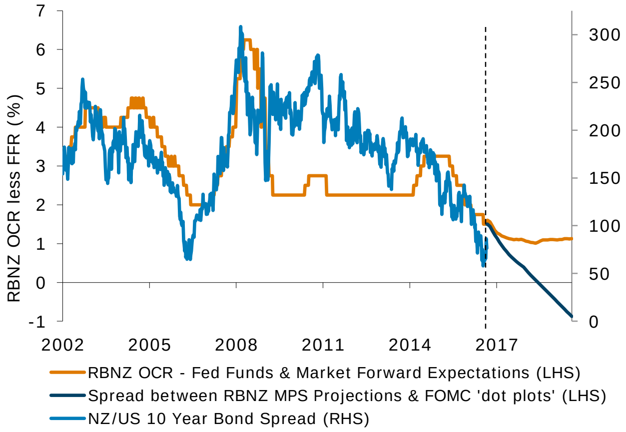

Source: ANZ, Bloomberg

**Our forecasts have the NZ/US 10-year bond spread narrowing to around 40bps.** That's almost half as wide as the spread was at the end of September (~75bps). But when compared to where

# FINANCIAL MARKETS OUTLOOK

the respective central banks of the two countries are flagging their policy intentions (Figure 6), this is a reasonably conservative forecast. There is an element of doubt around both central bank forecasts (few in the market can conceive of the RBNZ OCR being below the Fed Funds rate), but our expectation is that opposing policy biases will be supportive of the NZ/US bond spread.

**FIGURE 6: RBNZ AND FOMC PROJECTIONS VS NZ/US 10-YEAR BOND SPREAD**




Source: ANZ, RBNZ, Federal Reserve, Bloomberg

**We harbour real concerns over the side effects of record-low interest rates**, negative yields, and what that implies for capital allocation, the pricing of risk and investment largesse. But these are longer-term considerations, and over the next few quarters, our baseline assumption and projections assume the global economy muddles through.

**Recent price action in some markets late in Q3 had some 'Groundhog Day' characteristics reminiscent of 2008.** While the New Zealand bond market has traded as somewhat of a safe haven, it can be a small exit door when all are running for it. That's a risk if 'muddle through' is replaced by an explosion in risk aversion.

## NZD ELEVATION

**Our heat map (Figure 3) highlights the allure of the yield on offer.** In a world of zero (or negatively priced) liquidity, this is a clear proof-point, and is well understood by most. It's not just about the level of interest rates (historically low), but where relative interest rates sit (NZ's are low, but there is still a glaring gap). This is exacerbated by the fact that interest rate spreads now represent a much larger proportion of base rates (i.e. 100bps might be an acceptable NZ/US bond spread when the Fed Funds rate is 4%, but it's comparatively gargantuan when the Fed Funds rate is 0.5%).

**The New Zealand dollar has multiple other legs of support**, namely:

- Growth: New Zealand has it in spades. The US is projected to sustain 2% growth over the next 3 years. New Zealand's growth is tracking at 3.6% and our projected moderation is still above that expected for the US.
- Commodities: The dip in the terms of trade was shallower than initially feared and dairy prices are now on the up.
- Political stability: It's chalk and cheese comparing the fragmentation we are seeing globally relative to NZ. We have had one Prime Minister for 8 years here and there are few signs of an anger vote appearing – though housing affordability could be the local lightning rod.
- Fighting fit: New Zealand ranks highly across international surveys on measures like ease of doing business and transparency. Such forces are coming more to the fore in a world where politics and microeconomics become more relevant.
- Nominal growth: migration and investment are going gangbusters.

**Taken together these factors suggest that the NZD will remain elevated for the time being.** The NZD tends to do well in a 'muddle through' environment as it accentuates New Zealand's credentials. When the USD itself is neither a buy nor a sell, 'buy the dip' sentiment towards the NZD tends to trump 'sell on rallies' sentiment, underscoring our forecast for the NZD to end the year at 0.71.

**Nonetheless, localised support factors are pushing strongly against global-centric factors.**

- Valuations: The NZD is overvalued on PPP and equilibrium exchange rate models. It has been for some time. The rubber band is taut.
- Central banks are showing more signs of digging in their toes over the path (desire) for even lower rates as medium-term considerations (misallocated and mispriced capital) come to the fore and the unintended consequences of extraordinarily loose policy are considered.
- The skittish nature of markets: risk appetites are flaky; the current bout of Brexit-related unease needs to be respected. New Zealand is not immune. A key risk going forward is to what degree Brexit and growing moves towards populism impact on global growth, particularly in the emerging market world, which is export-centric and has built up considerable debt. Recent weakness in the RMB is a worrying sign.

# FINANCIAL MARKETS OUTLOOK

- Cyclical extensions: The NZD tends to undershoot just as it overshoots; it can be a small exit door. Downside movements can be sharp.
- Circularity: The more global forces push the NZD against fair value, the more the RBNZ will need to lower the OCR, closing out the interest rate gap, which has been a key pillar of support.

**The local economic story is also expected to be less picture-perfect over 2017 as quarterly growth slips below 3% annualised.** It's not enough to foster a sustained lower trend for the NZD but might knock the top off.

**We expect global forces to hold the greater sway over time. This means a slight downwards bias for the NZD within the forecasts but high levels maintained overall.** The cycle we envisage is mild and shallow in terms of historical experience, but this critically assumes the global economy remains in muddle through mode. As noted on page 6, the risks are skewed lower for the global economy with no shortage of candidates at the ready.

## INDIVIDUAL CURRENCY PAIRS

**NZD/USD: Stable (and elevated) near term, but ultimately lower.** Wide interest rate differentials, solid growth and a 'muddle through' global environment point to ongoing NZD support. But the Fed is back in play (turmoil notwithstanding), and the NZD is expensive on valuations. The market has under-priced the extent of RBNZ easing that lies ahead, under-priced the degree of Fed tightening, and has taken a ride on the coat-tails of easy global monetary policy settings.

**NZD/AUD: Parity push?** Cyclical relativities and fair value analysis have been firmly in New Zealand's favour for some time now. They do justify an elevated cross, but they do not point to an imminent break of parity (although we would not rule out a push towards it).

**NZD/GBP: Keep calm and carry on.** NZD/GBP snapped higher into a new trading range following the Brexit vote. But the fillip the UK economy has seen from the weaker sterling has calmed nerves, as has the measured approach to formally moving to exit the Union. With more easing in store in New Zealand and the BoE now on hold, this cross is toppy.

**NZD/EUR: Turndown.** EUR is expected to weaken substantially over coming quarters, with ongoing QE, low yields and recent banking sector wobbles all weighing on confidence. An ultimately softer NZD will weigh on the cross, particularly further out, when EUR is forecast to rebound as NZD bases.

**NZD/JPY: Follow the money.** Our forecasts assume that USD/JPY bottoms out at 100, before rising gradually. Further yen strength can't be ruled out, but JPY does risk being undermined by capital outflows as short-end interest rates fall further. NZD is likely to fall further, taking NZD/JPY to a low of 64.

| Forecasts (end of quarter) | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| **FX Rates** | **Dec-16** | **Mar-17** | **Jun-17** | **Sep-17** | **Dec-17** | **Mar-18** | **Jun-18** | **Sep-18** |
| NZD/USD | 0.71 | 0.69 | 0.67 | 0.65 | 0.64 | 0.64 | 0.65 | 0.66 |
| NZD/AUD | 0.93 | 0.93 | 0.93 | 0.93 | 0.94 | 0.89 | 0.88 | 0.88 |
| NZD/EUR | 0.66 | 0.66 | 0.64 | 0.62 | 0.60 | 0.57 | 0.58 | 0.58 |
| NZD/JPY | 74.6 | 69.0 | 67.0 | 65.0 | 64.0 | 67.2 | 71.5 | 72.6 |
| NZD/GBP | 0.57 | 0.56 | 0.54 | 0.51 | 0.48 | 0.46 | 0.46 | 0.46 |
| NZD/CNY | 4.79 | 4.67 | 4.56 | 4.44 | 4.38 | 4.39 | 4.47 | 4.55 |
| NZ$ TWI | 75.4 | 73.7 | 72.1 | 70.1 | 68.9 | 67.5 | 68.5 | 69.0 |
| **Interest Rates** | **Dec-16** | **Mar-17** | **Jun-17** | **Sep-17** | **Dec-17** | **Mar-18** | **Jun-18** | **Sep-18** |
| NZ OCR | 1.75 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 | 1.50 |
| NZ 90 day bill | 1.98 | 1.82 | 1.82 | 1.82 | 1.82 | 1.75 | 1.75 | 1.75 |
| NZ 2-yr swap | 1.97 | 1.96 | 2.00 | 2.03 | 2.08 | 2.16 | 2.22 | 2.23 |
| NZ 10-yr bond | 2.25 | 2.20 | 2.20 | 2.30 | 2.40 | 2.60 | 2.70 | 2.70 |

# KEY ECONOMIC FORECASTS

| Calendar Years | 2012 | 2013 | 2014 | 2015 | 2016(f) | 2017(f) | 2018(f) |
|---|---|---|---|---|---|---|---|
| **NZ Economy (annual average % change)** | | | | | | | |
| Real GDP (production) | 2.6 | 2.4 | 3.7 | 2.5 | 3.4 | 3.3 | 2.3 |
| Private Consumption | 2.8 | 2.9 | 2.7 | 2.3 | 3.5 | 3.4 | 2.8 |
| Public Consumption | -0.4 | 1.7 | 2.7 | 1.9 | 1.8 | 3.0 | 2.2 |
| Residential investment | 13.3 | 12.9 | 14.6 | 5.1 | 11.8 | 4.4 | -4.4 |
| Other investment | 5.2 | 2.9 | 9.7 | 2.0 | 2.7 | 4.5 | 3.2 |
| Stockbuilding[1] | 0.1 | 0.1 | 0.0 | -0.3 | -0.2 | 0.3 | 0.0 |
| Gross National Expenditure | 3.1 | 3.2 | 4.4 | 2.0 | 3.5 | 3.8 | 2.3 |
| Total Exports | 1.9 | 0.8 | 3.0 | 7.0 | 2.8 | 1.3 | 2.8 |
| Total Imports | 2.8 | 6.2 | 7.9 | 3.7 | 2.8 | 3.0 | 2.7 |
| Employment (annual %) | 0.1 | 2.9 | 3.6 | 1.3 | 4.0 | 1.7 | 1.4 |
| Unemployment Rate (sa; Dec qtr) | 6.3 | 5.6 | 5.5 | 5.0 | 5.0 | 4.9 | 4.5 |
| Labour Cost Index (annual %) | 1.8 | 1.6 | 1.7 | 1.5 | 1.7 | 2.1 | 2.1 |
| Terms of trade (OTI basis; annual %) | -8.9 | 20.2 | -5.0 | -3.2 | 1.6 | 3.5 | 0.8 |
| **Prices (annual % change)** | | | | | | | |
| CPI Inflation | 0.9 | 1.6 | 0.8 | 0.1 | 0.7 | 1.7 | 2.0 |
| Non-tradable Inflation | 2.5 | 2.9 | 2.4 | 1.8 | 1.9 | 2.5 | 2.9 |
| Tradable Inflation | -1.0 | -0.3 | -1.3 | -2.1 | -1.0 | 0.5 | 1.1 |
| **Fiscal and External Balance** | | | | | | | |
| Current Account Balance ($bn) | -8.4 | -7.0 | -7.4 | -7.7 | -7.6 | -8.7 | -9.4 |
| as % of GDP | -3.9 | -3.1 | -3.1 | -3.1 | -3.0 | -3.3 | -3.4 |
| Government OBEGAL ($bn)* | -9.2 | -4.4 | -2.8 | 0.4 | 0.7 | 0.5 | 2.3 |
| as % of GDP | -4.3 | -2.0 | -1.2 | 0.2 | 0.3 | 0.2 | 0.8 |
| **NZ Financial Markets (end of December quarter)** | | | | | | | |
| TWI | 73.8 | 77.3 | 79.4 | 73.7 | 75.4 | 68.9 | 69.8 |
| NZD/USD | 0.82 | 0.82 | 0.78 | 0.69 | 0.71 | 0.64 | 0.67 |
| NZD/AUD | 0.79 | 0.92 | 0.96 | 0.94 | 0.93 | 0.94 | 0.88 |
| NZD/CNY | 5.12 | 4.98 | 4.86 | 4.45 | 4.79 | 4.38 | 4.62 |
| NZD/EUR | 0.62 | 0.60 | 0.64 | 0.63 | 0.66 | 0.60 | 0.59 |
| NZD/JPY | 70.8 | 86.3 | 93.6 | 82.5 | 74.6 | 64.0 | 73.7 |
| NZD/GBP | 0.51 | 0.50 | 0.50 | 0.46 | 0.57 | 0.48 | 0.47 |
| Official Cash Rate | 2.50 | 2.50 | 3.50 | 2.50 | 1.75 | 1.50 | 1.50 |
| 90-day bank bill rate | 2.69 | 2.84 | 3.68 | 2.75 | 1.98 | 1.82 | 1.75 |
| 2-year swap rate | 2.67 | 3.85 | 3.80 | 2.85 | 1.97 | 2.08 | 2.25 |
| 10-year government bond rate | 3.52 | 4.72 | 3.67 | 3.57 | 2.25 | 2.40 | 2.70 |

[1] Percentage point contribution to growth

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