ANZ RESEARCH

NEW ZEALAND ECONOMIC OUTLOOK

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INSIDE

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SOME HARDER YARDS

NEW ZEALAND ECONOMIC OUTLOOK

Some clear headwinds are being navigated right now that have increased the odds of a growth wobble. However, we are not ready to call time on the cycle just yet. There are still enough positive forces that should see growth returning to broadly around trend over the next couple of years (but probably not much more). It is admittedly a more nuanced economic story, but one that still has a positive hue to it overall.

INTERNATIONAL OUTLOOK

Our global growth forecasts again depict a steady and reasonably positive picture heading into 2018, although it is arguably 'as good as it is going to get'. While we are positive overall, some tests are looming, and in particular the impact of a turn in the global liquidity cycle and the impact on asset prices at a time when many households appear more vulnerable.

PRIMARY SECTOR OUTLOOK

Dairy markets look tentative heading into the first half of 2018, but most other sectors look steadier at what are currently historically high farm-gate prices. While local supply conditions are set to improve for most sectors they remain constrained by historical standards.

FINANCIAL MARKETS OUTLOOK

Near-term stability, before a gradual lift from around the middle of 2018, remains our overarching view on New Zealand short- and long-term interest rates. Consistent with our broader global forecasts, moves in New Zealand rates are forecast to be modest. Perhaps with the exception against the AUD, where we see some modest downside, the NZD is expected to strengthen a little on most crosses out to the middle of 2018. However, as financial market volatility picks up on a more pronounced turn in the global liquidity cycle, we expect this to put the NZD back on the defensive again.

Calendar Years	2014	2015	2016	2017(f)	2018(f)	2019(f)
New Zealand Economy						
Real GDP (annual average % change)	3.4	2.5	3.0	2.4	2.7	3.0
Real GDP (annual % change)	4.5	2.2	2.6	2.3	3.2	2.6
Unemployment Rate (Dec quarter)	5.5	5.0	5.3	4.7	4.4	4.4
CPI Inflation (annual %)	0.8	0.1	1.3	1.9	1.5	2.1
Terms of Trade (OTI basis; annual %)	-5.0	-3.2	6.7	2.9	-2.1	0.4
Current Account Balance (% of GDP)	-3.2	-3.1	-2.5	-2.7	-3.2	-3.1
Government OBEGAL (% of GDP)	-1.2	0.2	0.7	1.5	0.6	0.7
Global Growth (annual average %)						
US	2.6	2.9	1.5	2.2	2.5	2.1
Australia	2.6	2.5	2.6	2.3	2.9	3.0
China	7.4	6.9	6.7	6.8	6.5	6.3
Trading Partners	3.6	3.6	3.4	3.7	3.7	3.5
NZ Financial Markets (end of Dec quarter)						
TWI	79.2	73.6	76.1	70.5	69.7	67.2
NZD/USD	0.78	0.68	0.69	0.68	0.67	0.65
NZD/AUD	0.95	0.94	0.96	0.89	0.91	0.93
Official Cash Rate	3.50	2.50	1.75	1.75	2.00	2.50
10-year Bond Rate	3.7	3.6	3.3	2.8	3.4	3.6

* Forecasts and text finalised 19 December 2017

NEW ZEALAND ECONOMIC OUTLOOK

SUMMARY

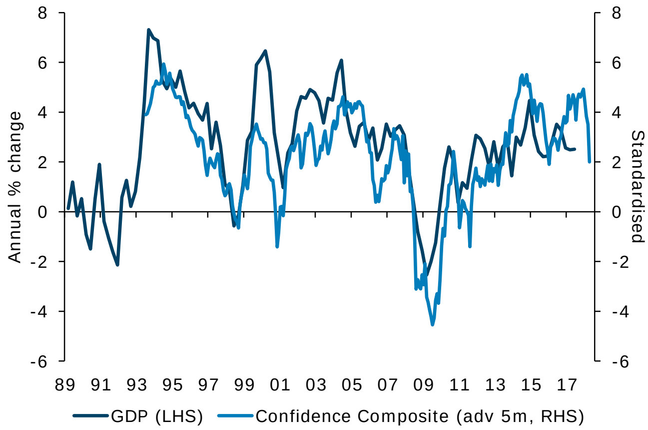
Some clear headwinds are being navigated right now that have increased the odds of a growth wobble, leaving the economy somewhat delicately placed. However, we are not ready to call time on the cycle just yet. The drivers of growth are shifting, and such transitions are often not smooth, but there are still enough positive forces that should see growth returning to broadly around trend over the next couple of years (but probably not much more). In itself, trend growth is unlikely to be enough to get domestic inflation pressures up in a sustainable fashion, but signs of more cost-push pressures from the labour market are something that we think the RBNZ will eventually respond to, albeit in a tip-toe fashion. That said, the timing of that response is highly uncertain and skewed towards later as opposed to earlier. It is admittedly a more nuanced economic story, but one that still has a positive hue to it overall.

GROWTH WOBBLE

Right now the economy is navigating some clear headwinds:

- **The housing market is soft.** While the past few months have shown some stabilisation (and even modest recovery), turnover is still low and house price growth more modest. Even though the RBNZ is now loosening its LVR restrictions, we see soft housing market activity persisting, especially with proposed measures from the new Government set to further alter the metrics and incentives for investing in residential property, but also on affordability constraints. While we actually view a cooler market as a positive thing from a medium-term growth sustainability perspective, history has taught us that a softer housing market can have broader spill-overs to confidence and spending, and we are hearing more anecdotes to that effect.
- **Growth drivers are transitioning.** Beyond the housing market, it has become clear that the likes of construction and migration (two previous key growth drivers) have peaked or are peaking. The construction sector is grappling with pressures from the 'three C's' (capacity, costs and capital constraints), which are limiting its ability to grow further. Net migrant inflows have started to ease even ahead of possible policy changes as increased departures of non-New Zealand and Australian citizens speaks to a natural cycling effect from previous strong arrivals growth. While we do expect other growth drivers to emerge eventually, such transitions can cause some wobbles.
- **Political change has caused some unease.** While we don't think the plunge in business sentiment can be solely blamed on the election outcome, it is clear that businesses are nervous about the new policy direction. Firms' own activity expectations are the weakest they have been since 2009. At a time when the economy was already facing headwinds, the risk is that heightened policy uncertainty sees firms retrench and hold off on spending, investment and hiring decisions. Sentiment can be vulnerable through periods of transition. The risk is that it can then create negative feedback effects on activity and become self-fulfilling.

Figure 1: Confidence Composite and GDP growth



Source: Statistics NZ, ANZ Research

- **Productivity growth is poor.** It is not a story unique to New Zealand, and it is also a typical late-cycle phenomenon, but it is hard to put a positive spin on the fact that average annual labour productivity growth has been negative since 2013 (whether calculated using hours worked, hours paid or on an FTE basis). It is a clear signal that the economy has not been firing on all cylinders and is the main reason why the economy's per capita growth performance has been mediocre to say the least.

It leaves us somewhat circumspect towards the near-term growth picture. While it is admittedly a little historical now, we see Q3 GDP growth of just 0.4% q/q, which points to a small contraction in per capita terms. Sequential growth in Q4 and Q1 is seen at just 0.5-0.6%. If our Business Outlook survey is taken at face value, then growth over early 2018 could be even weaker. Moreover, the recent run of dry weather is something that also needs to be watched, as pasture growth is now beginning to suffer. **Indeed, we are certainly left with the impression that the economy is delicately placed right now.**

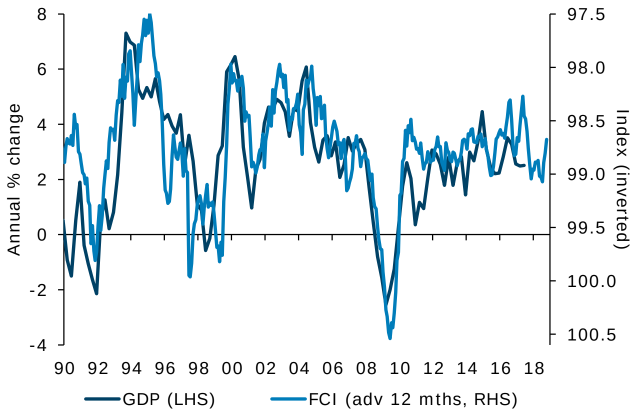
BUT WE'RE NOT READY TO CALL TIME ON THE ECONOMIC CYCLE JUST YET

Given these headwinds, it would be easy to start to spout 'Chicken Little' type prognoses. But one of our key views is that any growth wobble will not turn into something longer-lasting. Yes, the economic cycle is reasonably mature; firms are telling us that finding skilled staff is still a huge problem. Statistically we are 'due' for something untoward – years ending in '8' have not been kind to the New Zealand economy, and 2018 is obviously on our doorstep. As mentioned, housing market weakness looks set to persist, and hence so too the risks of broader spill-overs to the rest of the economy. For all that though, we are not forecasting large outright falls in house prices. That would require a lift in forced sales in our view, via declining debt serviceability, which we don't expect.

There are still reasons for optimism regarding the medium-term outlook.

- **Financial conditions have eased.** The lower NZD, together with a record high in the terms of trade, are powerful stimulatory forces. Global liquidity conditions remain favourable and local mortgage rates have started to tick lower again (albeit only modestly). Our Financial Conditions Index is giving a signal of accelerating growth from around the second half of 2018.

Figure 2: Financial conditions versus GDP growth



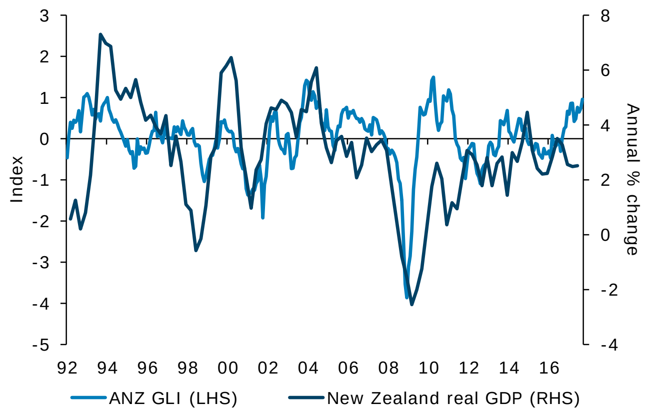
Source: Statistics NZ, ANZ Research

- **Fiscal policy is set to turn far more stimulatory, at least over the next 12 months.** We believe it is underappreciated that over the past six years, fiscal drag has averaged 1.0% of GDP per year. That was necessary to return the fiscal accounts to health and rebuild the rainy day coffers. But with the starting point for the accounts now in a strong position, the new Government has options and it is clear that it plans to exercise those, even if some of the additional operating and capital expenditure is funded out of the cancellation of the previous Government's personal tax cuts. Based on the Half-year Update figures, the fiscal impulse is estimated to be 1.4% and 0.7% of GDP over 2017/18 and 2018/19 respectively.

- **The terms of trade should remain elevated.** It is currently at all-time highs and reflects both positive cyclical and structural forces. While our forecasts do have the terms of trade easing modestly over the next year, largely reflecting recent dairy price moderation (see page 7 for a broader discussion of the export commodity price outlook), the elevated level should not be underestimated in terms of its positive purchasing power benefits.

- **The global economic backdrop is solid.** Yes, there are risks in pockets of global financial markets, but right now the global economy is experiencing its strongest and most broad-based period of growth since the financial crisis (see page 6). It would be unusual for the New Zealand economy to embark on an entirely different path.

Figure 3: ANZ Global Leading Indicator and NZ GDP



Source: Statistics NZ, ANZ Research

- **Credit cycle headwinds should become less intense.** The RBNZ is already starting to ease back on its LVR restrictions as financial stability risks have reduced. But over the past 12 months or so, banks have restrained credit and competed more aggressively for domestic deposits as they have attempted to close a funding gap. Timely measures of that 'gap' suggest it has closed a great deal. While we are not expecting the credit flood-gates to open by any means (things like the RBNZ's review of bank capital are still lingering in the background), as a cyclical driver, credit dynamics should turn more neutral.

NEW ZEALAND ECONOMIC OUTLOOK

- **Importantly, structural metrics are in far better shape than they have typically been at this point in the cycle.** The current account deficit is contained (and is expected to remain so), net external debt levels have fallen, prudential measures have helped cool financial stability risks, and there is no over-supply of houses. These factors don't remove the possibility of a cyclical downturn. However, when imbalances are at extremes, they can certainly exacerbate swings. Those risks are relatively low right now.

So for now we are happy to retain a broadly positive medium-term expectation, with growth returning to more or less trend rates. Notwithstanding the near-term risks, and some quarterly variability in GDP outturns, we forecast annual growth up towards 3% by the end of 2018, and averaging 2½-3% over the next couple of years overall. That is effectively the average rate of growth experienced since 2010. In other words, a 'respectable if not stellar' story, although one that arguably has more risks attached to it.

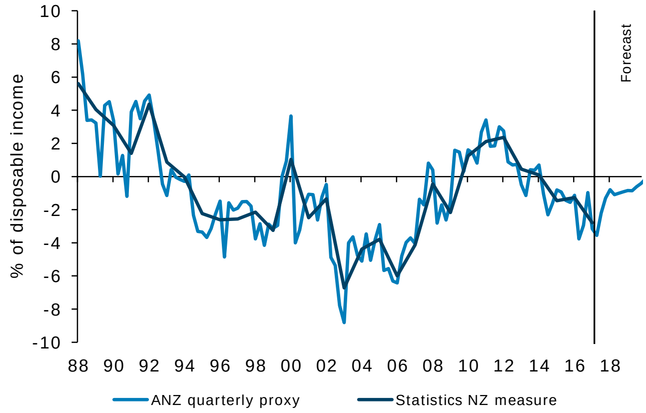
TREND, BUT NOT MUCH MORE

So we are certainly not negative overall. Growth averaging around trend is hardly a poor message. But it does mean we are less upbeat than some. Indeed, the likes of the RBNZ and Treasury see growth accelerating above trend over 2018/19. We'd of course like to share that view. However, we feel there are some factors that limit the upside to a degree.

First and foremost, **history has proven that it is difficult for the New Zealand economy to grow above trend when the most cyclical sector (housing) is expected to remain soft.** One could argue that 'this time is different' in that this housing slowdown is not the result of higher interest rates, which slow other activity at the same time as slowing housing. However, whatever the cause of the housing market cooling, changes in capital gains do affect households' actual and perceived wealth and hence willingness to spend.

In particular, we see households rebuilding precautionary saving. Household income growth has been running at a reasonable rate, and the outlook remains positive. We see the unemployment rate falling a little further to 4.4%, wage growth lifting, and secondary income sources should be boosted by some Government initiatives. However, at a time when the asset side of household balance sheets is looking less rosy, we believe that not all of that income windfall will be spent (i.e. the household saving rate will lift) implying that consumption growth won't be as strong as it would have been otherwise.

Figure 4: Household saving rate



Source: Statistics NZ, ANZ Research

Accordingly, we forecast real consumption growth to slow from today's solid rate of around 4%, averaging 2.7% and 2.5% growth in 2018 and 2019 respectively. In fact, with our forecasts having the household saving rate getting back to only around zero, we think the risk is that we are underestimating the degree of saving rebuild.

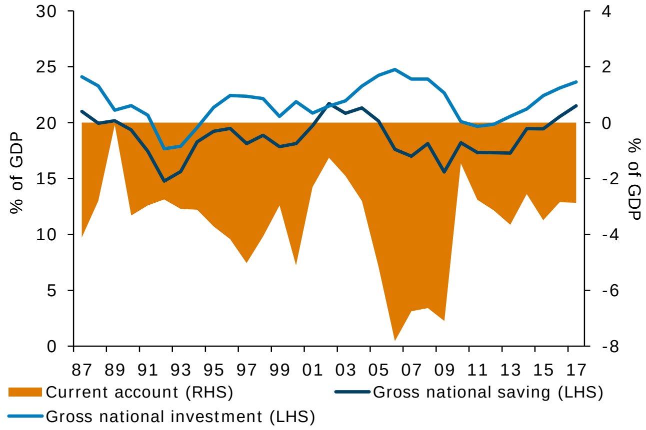
There are also a number of other factors at play that imply growth will be harder work from here:

- **There are offsets to how stimulatory fiscal policy can be.** The reality of an economy already facing capacity constraints means it is likely that private sector activity will be crowded out by increased public sector work, particularly in the construction space. In addition, the likes of increased environmental restrictions, measures targeting housing demand, migration policy changes and a more restrictive foreign investment landscape, also have the potential to offset the positive growth impact of higher public operating and capital expenditure. Simply adding the amount of new public spending to growth forecasts is too simple by half. There are a number of moving parts. But perhaps most importantly, we don't think the Government will have as much to work with as fiscal projections currently show. That will set up the likelihood of it needing to reprioritise its spending plans in order to remain within its own fiscal targets.
- **Net migrant inflows should slow further.** We assume annual net migration slows to 45k by the end of 2019. At this stage we have not incorporated any impact of possible policy changes. While it is possible that policy changes could be growth enhancing if they get the mix

right and free up resources for capacity constrained sectors, that is easier said than done. Ultimately, lower net migrant inflows put more onus on productivity growth to step up to the plate. The recent track record means it is hard to have much conviction in that occurring.

- **There is an effective current account constraint in play.** The economy's previous modus operandi of meeting a domestic saving shortfall by ramping up overseas borrowing is now facing more challenges, either through increased regulatory scrutiny of the banking sector or from warnings by credit rating agencies. In spirit, this is effectively a current account constraint (or even an external balance sheet constraint). It basically means that in order for our national investment needs to be met, the onus is more squarely on national saving. This is in fact exactly what has been seen over recent years, with the national saving rate rising to 8.8% – the highest since 2014. We see this theme persisting (and, as mentioned, we see household saving lifting). More saving typically means less growth.

Figure 5: Gross saving and investment



Source: Statistics NZ, ANZ Research

INFLATION TO LIFT ONLY GRADUALLY

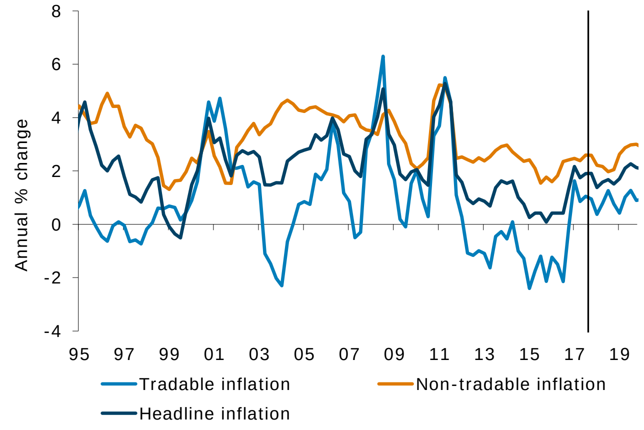
All else equal, growth around trend will not dramatically alter the domestic inflation outlook. As our Monthly Inflation Gauge attests, evidence of broad-based price pressures remains tentative and mixed. On top of this, secular global forces (technology, increased global brand penetration and winner-takes-all business models, deleveraging, and a more mobile labour force) are continuing to alter the inflation-generating process in poorly understood ways.

But we do still forecast a gradual lift in domestic inflation, in large part due to a likely lift in cost-push inflation from the labour market. With headline inflation up off lows and skill shortages prevalent, some of the traditional drivers of wage inflation were already pointing upwards (within the context of secular forces like technology continuing to have an offsetting influence). Now, in addition, some of the policies of the new Government (minimum wage hikes and possible work place relations changes) are likely to accentuate moves. We forecast annual nominal LCI private sector wage growth to lift to 2.1% by the end of 2018. There are offsetting policies from an inflation perspective, like the one year of free tertiary education, which we estimate will knock 0.2%pts off headline inflation in Q1, but the stronger wage growth backdrop should still contribute to non-tradable inflation rising towards 3% by the end of 2019.

There should be a little more tradable inflation too. While structural deflationary forces persist, the lower NZD, recent lift in global commodity prices, and some signs that global inflation is finally showing signs of lifting tentatively as labour markets tighten, should correspond into a little more imported inflation. After averaging zero since 2010, annual tradable inflation is forecast to average 0.8% and 0.9% in 2018 and 2019 respectively.

Overall, headline inflation should sit around 2%. We see headline inflation averaging 1.5% in 2018 and 2.1% in 2019. **That leaves us with a bias towards the next move in the OCR being a hike.**

Figure 6: CPI inflation



Source: ANZ, Statistics NZ

But the timing of moves is highly uncertain. We have pencilled in a hike from late-2018. However, we see the risk skewed towards later than this. What is certainly clear is that when hikes do eventually get underway, policy will be tightened in a tip-toe fashion. A lower neutral rate (perhaps only around 3%), means the tightening cycle will be a modest one.

INTERNATIONAL OUTLOOK

SUMMARY

Our global growth forecasts again depict a steady and reasonably positive picture heading into 2018, although it is arguably 'as good as it is going to get'. While we are positive overall, some tests are looming, and in particular the impact of a turn in the global liquidity cycle and the impact on asset prices at a time when many households appear more vulnerable.

AS GOOD AS IT GETS?

The global growth backdrop has strengthened further and the breadth of growth has been impressive. In November, the ANZ Global Lead Index rose to its highest level since 2011, with growth broadly based across regions. It is consistent with above-trend industrial activity. In addition, businesses and consumers remain upbeat, unemployment rates are generally still falling and financial market volatility remains historically low.

Our global growth forecasts generally depict this relatively positive backdrop continuing. After estimated growth of 3.8% in 2017, we see global growth at 3.9% in 2018 and 3.8% in 2019. In other words, at face value at least, it is a picture of stability at generally positive rates of growth.

But at the risk of sounding overly negative, we do believe that some tests for the global growth story are looming. In fact, we expect rates of growth to moderate as 2018 progresses. The global recovery thus far has been helped by some serendipity. Political risks in Europe have diminished and Trump hasn't done much damage to global trade (at least so far). China has again managed its leverage issues well (to the surprise of many). Asset prices have held up despite indications from central banks that they intend to ease off the accelerator. And consumers have continued to spend despite low income growth. While the global economy does look quite stable, these pillars will need to continue to hold in 2018 for that to remain the case.

That is not a negative message, but it should be acknowledged that there are already a few more signs of the odd wobble. Already the political news looks to have passed its high water mark. Germany, the US, UK, Australia and Spain, among others, appear more politically fractious. The deleveraging efforts from China's policy authorities should reach their peak impact over the next six to nine months. The flattening in yield curves implies the recovery in bank lending, which has been important to the global upswing, will struggle to accelerate, at least in the US.

More broadly, there are some big themes we are watching:

- **The robustness of household balance sheets.** Household saving rates have substantially retraced their post-crisis rises when consumers hunkered down. In fact, household saving rates in Europe, the US and Australia (and New Zealand for that matter) are all around their lowest rates since the financial crisis. Consumers now seem ill-prepared for any negative shocks to asset prices.
- **Whether wages and inflation lift sustainably.** While activity growth suggests an ongoing slow absorption of spare capacity, secular deflationary suppressants, especially technology, remain in place. Ultimately, we suspect the profile for inflation will be the most critical driver of financial markets and therefore financial conditions and the longevity of the cycle.
- **The impact of a turn in the global liquidity cycle.** Despite ongoing questions over the inflation outlook, we do see the global monetary policy tightening cycle broadening to encompass more countries. The Fed is expected to deliver a further three hikes in 2018. The tightening will be modest by historical standards. But in a world where debt levels are high, savings rates low, nominal growth is modest and risky assets seemingly quite fully valued, even modest tightening is likely to represent a reasonably significant reduction in liquidity, particularly in conjunction with ongoing tapering in central bank asset purchases. This is likely, in turn, to have some asset price impacts, which should encompass prices, volatility and spreads.

So while our forecasts present a steady global growth picture, risks are downwardly skewed. Perhaps another way to say this is that we believe the global economy is at the point where this is probably 'as good as it gets'.

Calendar Years (annual average % change)	2013	2014	2015	2016	2017(f)	2018(f)	2019(f)
United States	1.7	2.6	2.9	1.5	2.2	2.5	2.1
Australia	2.2	2.6	2.5	2.6	2.3	2.9	3.0
Japan	2.0	0.3	1.4	0.9	1.5	1.0	1.0
Euro Zone	-0.2	1.4	2.0	1.8	2.3	1.9	2.0
China	7.7	7.4	6.9	6.7	6.8	6.5	6.3
Trading Partner Growth	3.1	3.6	3.6	3.4	3.7	3.7	3.5

PRIMARY SECTOR OUTLOOK

SUMMARY

Dairy markets look tentative heading into the first half of 2018, but most other sectors look steadier at what are currently historically high farm-gate prices. While local supply conditions are set to improve for most sectors they remain constrained by historical standards.

Outside some moderation in dairy prices since mid-2017 the picture for most other New Zealand export prices has been very rosy. Combined with a softer NZD this has supported local earnings despite constrained output volumes in many cases. Looking to 2018 the picture remains similar for most sectors over at least the first half of the year. Dairy markets look the most tentative with a risk of further downward pressure from increasing milk supply by all major export regions and EU policy changes. For most other sectors, outside normal seasonal patterns, a steadier approach is expected as the upward cycle for prices that started in early 2016 matures.

Key themes to watch include:

- **Local supply conditions, which are generally expected to improve from recent lows in 2018.** However, in most cases supply is expected to remain constrained by historical standards and low inventory levels provide exporters flexibility. If the recent dry patch extended into the New Year period this would decrease milk supply, increase short-run meat production and likely produce high quality kiwifruit, pipfruit and grape crops as long as the dry snap isn't too sever and irrigation maintained.
- **Trade developments – the renegotiation of NAFTA** and knock-on impacts to North American soft commodity markets remain important for all. Reshaping of Common Agricultural Policy in the EU remains a must watch, especially for dairy in 2018.
- **Currency movements – a contained USD has supported emerging market purchasing power** of soft commodities through 2017. A change in dynamics would pressure in-market prices, but the offset would be a lower NZD/USD.
- **Higher wholesale prices feeding through to end consumer prices** moderating demand for some products (i.e. butter, lamb and venison).
- **China and broader Asia demand remaining robust.** With constrained local supply carryover into 2018 this should continue to fuel inter-market competition, especially with a lifting performance from Europe and solid activity in the US.

In the dairy sector there has been broad-based downward pressure with a synchronised upswing in global milk supply. Wholemilk powder has managed to remain above the key US$2,800/t level so far, but could retest this during the first half of 2018 if both European and NZ milk supply is strong. Skim milk powder prices will remain pinned down with high European production and a likely change to a tendering system for their intervention scheme. Milkfat prices have come under pressure recently as seasonal demand for butter moderated, some substitution effects kicked in with higher retail prices, and global milk supply lifted. The demand picture remains rosy, but higher Northern Hemisphere milk supply could push prices lower through early 2018. We continue to forecast a $6.25 to $6.50/kg MS range for 2017/18.

On the revenue front, milk supply expectations have been lower with dry conditions. Cash-flow remains robust until the end of 2017/18, but future forecasts for 2018/19 have tightened with the lowering of predicted farm-gate returns. Costs are moving higher too due to higher supplementary feed prices and needs – reducing expected margins.

Farm-gate lamb prices are expected to remain historically high beyond the normal seasonal pullback. Support driven by tight exportable supplies, a lower NZD/GBP/EUR, and solid demand from most major markets. The only soft spots appear to be a softer UK market and affordability challenges for some cuts in certain markets. **Venison prices are at all-time highs and set to stay there as supply remains tight (20 year low) and demand hot**, especially from diversification into the US. **Beef prices have moderated with some more to come.** While there is robust demand in major markets, an increase in domestic supply will moderate procurement pressure, alongside increased supply from the US. Strong wool prices are set to continue to struggle as local supply increases and there remains an overhang of inventory. In contrast fine wool prices a rocketing with high demand for 'athleisure' and outdoor garments.

Kiwifruit orchard revenue for Green growers is expected to be $55,800/ha (+4% y/y) for the 2017 crop. Higher per-tray returns help to offset lower yields. **Average orchard revenue for Gold is expected to lift to $110,500/ ha (+12% y/y).** A higher per-tray return provides the boost, with yields steady. **In the pipfruit sector a 5-10% y/y increase in the 2018 crop is forecast. Pipfruit prices have remained fairly steady in 2017/18.** Frosts reduced the European crop by 21% y/y in 2017, which will mean less supply carried forward into the start of NZ's 2018 selling window supporting prices.

Domestic and export log/lumber prices continue to be supported by Chinese and local construction demands. Looking forward, the largest new risk (China slowdown aside) would appear to be a more sustained slowdown in New Zealand construction activity as housing (read Auckland) prices cool. This is probably more a 2018 story if it does occur. That said, export opportunities in China and US should continue to provide support.

FINANCIAL MARKETS OUTLOOK

SUMMARY

Near-term stability, before a gradual lift from around the middle of 2018, remains our overarching view on New Zealand short- and long-term interest rates. Consistent with our broader global forecasts, moves in New Zealand rates are forecast to be modest. Perhaps with the exception of against the AUD, where we see some modest downside, the NZD is expected to strengthen a little on most crosses out to the middle of 2018. However, as financial market volatility picks up on a more pronounced turn in the global liquidity cycle, we expect this to put the NZD back on the defensive again.

STABILITY BEFORE GRADUAL LIFT

The range-trading environment that has defined movements at the short end of the local curve over the past six or so months is expected to persist into the first half of 2018. If anything, we do see some scope for yields to fall a little in the near term given our more circumspect views on the growth picture. However, with signs of more cost-push inflation emerging, we continue to expect that the next move in the OCR will be a hike, which we have pencilled in for late 2018. That will not only ensure the downside in yields is limited, but see yields move gradually higher as that first hike approaches.

But the timing of OCR hikes is highly uncertain. While we don't believe the introduction of an employment mandate and formal committee structure will dramatically change the way the RBNZ conducts policy, the possible relaxation of the 2% midpoint target perhaps could. And together with what is already a relatively cautious central bank, a likely mixed monetary policy picture (growth around trend at best, a soft housing market, but perhaps cost-push inflation), we see the risks to our views on the timing of hikes skewed to later.

What is far clearer than the timing is the fact that when a tightening cycle does get underway it will be gradual and modest. We'd currently put the neutral OCR around 3%, if not slightly below. It's hard to see the OCR moving up beyond that. Lower trend growth, subdued inflation, higher debt levels, a lift in precautionary saving, the credit channel of monetary policy doing the work of the RBNZ, and the impact of prudential policy (LVR restrictions) are powerful forces. Together they mean the neutral rate is far lower than in the past.

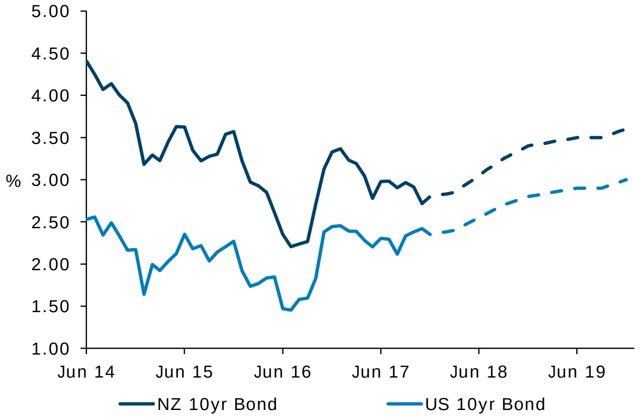
SPREAD IT ON

Over the course of 2017, global interest rate markets have not experienced the parallel shift higher that many had expected. Indeed, while the US has seen rate hikes and the start of the balance sheet tapering, 10-year yields have actually fallen (yet again). In Europe, where signals of a paring of balance sheet asset purchases have been keenly awaited, yields have risen in the core markets. This has occurred in the face of significant QE bond buying and has been a result of euro area economic data, which has surprised to the upside.

Looking to 2018, the ECB is likely to flag to the market that it is getting closer to a slowdown in its asset purchase program. But we expect yields will struggle to rise meaningfully. Likewise, the attraction of US yields as a rotation away from the euro area and Japanese markets is likely to keep US yields in check, given the current level of cross-market bond spreads. However, we do expect that US front-end yields will continue to rise in line with further Fed rate hikes, balance sheet unwind and a rise in net bond supply. **In time, and with the emergence of inflation gains, we expect some rise in the term structure.**

At the longer end of the local curve, one of the main stories over recent years has been spread compression. However, we believe that story has now run its course. We are certainly not expecting spreads to widen back to anywhere near historical norms, but with the new Government's higher spending plans, together with some likely slippage versus current fiscal targets, we suspect a ramp-up in local gross bond supply will present a slightly less favourable local bond market environment, and drive a modest widening in swap spreads. With US rates expected to gradually lift over the course of 2018, we forecast New Zealand 10-year yields to more or less follow suit.

Figure 1: ANZ NZ and US 10-year bond yield forecasts



Source: ANZ, Bloomberg

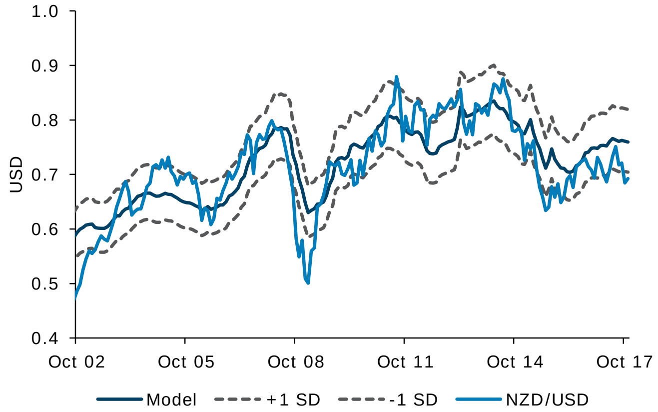
FINANCIAL MARKETS OUTLOOK

SUPPORTED FOR NOW

We believe much of the bad news that has propelled the NZD lower over recent months is now 'in the price'. While we are circumspect on the near-term growth picture as the economy grapples with a soft housing market and weaker business sentiment (as a new political direction creates some unease), and as it transitions in terms of its growth drivers with capacity pressures biting, we believe these factors are now reasonably well appreciated.

In fact, we see modest upside for the NZD from here over the next quarter or two. We remain constructive on the global growth outlook, and not only should that mean any domestic growth hiccup is not long-lasting; historically a positive global picture has been consistent with a rising NZD. Favourable global liquidity and volatility conditions right now should ensure a reasonable environment for carry remains. In addition, with the terms of trade at all-time highs (and expected to hold at an elevated level over the next few years), the NZD is now below our estimates of structural fair value, making a valuation case for further moves lower hard to justify at present.

Figure 2: NZD fair value

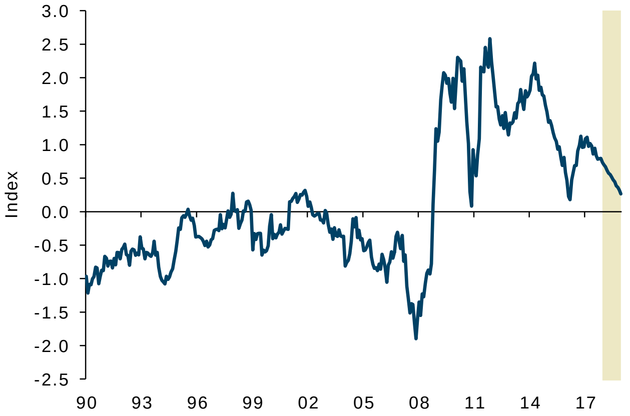


Source: ANZ, Bloomberg

But we do believe that we are on the cusp of somewhat of a regime shift in global currency markets. Indeed, we think that for the first time in 10 years, the direction of the US Dollar index (ie their TWI) will retreat in terms of its importance as a driver of the broader currency market. Instead, volatility is likely to become the primary focus.

The dominance of the USD over the past decade was generated by the fact that the US monetary policy cycle was uncoordinated with the rest of the world. This is now coming to an end. As the tightening policy stance of the US Federal Reserve is increasingly replicated across other economies, we think that monetary policy differentials will provide only tactical trading opportunities, rather than driving strategic trends. As this drives the influence of the broad USD back to more normal levels, we expect that risk appetite will take its place, and as such, a focus on volatility and its drivers is critical to forming accurate views on direction in broader currency markets in 2018.

Figure 3: ANZ Official Liquidity Index



Source: ANZ, Bloomberg

At the same time, the absolute level of growth remains solid but its variability is starting to pick up. The variability of the data makes the market more sensitive to any downturn in economic data. As such, as we move into 2018 we think that FX markets are highly leveraged to the growth cycle.

It all speaks to higher levels of volatility that will eventually put the NZD on the defensive. However, given the gradual nature of the decline expected in liquidity and the strong near-term outlook for global growth, it could be some time still before the regime shift occurs. It looks to be more of a story for the second half of 2018.

INDIVIDUAL CURRENCY PAIRS

NZD/USD: Supported for now. A solid global picture will see a lift to 0.72 by mid-2018, but a more pronounced turn in the global liquidity cycle leading to a lift in benign volatility conditions will weigh on risk currencies, seeing a move towards 0.65.

NZD/AUD: Under a little pressure. Expected to face some modest downward pressure over 2018 as New Zealand growth struggles and the RBA ultimately tightens before the RBNZ. This relative monetary policy divergence story is not yet priced by the market.

NZD/EUR: ECB still reluctant. Recent EUR/USD strength is not expected to be maintained, in large part due to ongoing subdued inflation and concern

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over currency strength expected to see the ECB remain ultra-reluctant to withdraw stimulus. That should bias this cross higher until a more pronounced turn in the global liquidity cycle sees NZD underperform.

NZD/GBP: Making progress. Brexit negotiations are making progress, but plenty of uncertainty and room for disappointment remains. We see a little bit of upside to this cross before a more sustained move lower occurs.

NZD/JPY: Watching risk appetites. Because Japan is a major capital exporter the yen has always been driven by risk appetite. This means that the change in regime that we highlighted above will be particularly important for the JPY. As with other crosses, we see some upside strength in NZD/JPY before a clear move south.

Forecasts (end of quarter)								
FX Rates	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
NZD/USD	0.71	0.72	0.69	0.67	0.66	0.65	0.65	0.65
NZD/AUD	0.89	0.88	0.90	0.91	0.92	0.93	0.93	0.93
NZD/EUR	0.62	0.65	0.62	0.58	0.56	0.54	0.52	0.50
NZD/JPY	83.8	83.5	77.3	69.7	68.6	65.0	65.0	65.0
NZD/GBP	0.53	0.53	0.50	0.49	0.48	0.47	0.47	0.47
NZD/CNY	4.71	4.75	4.54	4.39	4.31	4.23	4.21	4.19
NZ$ TWI	74.0	75.2	72.4	69.7	68.5	67.2	66.4	65.7
Interest Rates	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
NZ OCR	1.75	1.75	1.75	2.00	2.25	2.25	2.25	2.50
NZ 90 day bill	1.95	1.97	2.07	2.34	2.50	2.50	2.59	2.75
NZ 2-yr swap	2.23	2.31	2.44	2.61	2.69	2.72	2.77	2.87
NZ 10-yr bond	2.85	3.05	3.25	3.40	3.45	3.50	3.50	3.60

KEY ECONOMIC FORECASTS

Calendar Years	2013	2014	2015	2016	2017(f)	2018(f)	2019(f)
NZ Economy (annual average % change)							
Real GDP (production)	2.2	3.4	2.5	3.0	2.4	2.7	3.0
Private Consumption	3.3	3.1	2.9	4.2	4.0	2.7	2.5
Public Consumption	1.4	3.3	2.6	2.2	3.7	3.5	3.7
Residential investment	17.5	10.9	2.0	11.0	1.0	0.7	-0.3
Other investment	5.2	7.5	2.2	3.6	3.4	2.6	4.7
Stockbuilding[1]	-0.2	0.4	-0.3	0.0	-0.3	0.4	0.0
Gross National Expenditure	3.6	4.2	2.3	4.1	3.3	3.2	3.0
Total Exports	0.8	3.1	7.0	1.5	2.4	2.1	3.2
Total Imports	6.2	7.9	3.8	3.2	4.9	3.1	3.0
Employment (annual %)	2.9	3.6	1.4	5.8	2.8	1.6	1.2
Unemployment Rate (sa; Dec qtr)	5.6	5.5	5.0	5.3	4.7	4.4	4.4
Labour Cost Index (annual %)	1.6	1.7	1.5	1.6	1.9	2.1	2.2
Terms of trade (OTI basis; annual %)	20.2	-5.0	-3.2	6.7	2.9	-2.1	0.4
Prices (annual % change)							
CPI Inflation	1.6	0.8	0.1	1.3	1.9	1.5	2.1
Non-tradable Inflation	2.9	2.4	1.8	2.4	2.6	2.0	3.0
Tradable Inflation	-0.3	-1.3	-2.1	-0.1	0.9	0.8	0.9
REINZ House Price Index	8.4	7.7	14.7	14.6	2.9	0.5	2.0
Fiscal and External Balance							
Current Account Balance ($bn)	-7.0	-7.7	-7.7	-6.6	-7.5	-9.1	-9.4
as % of GDP	-3.1	-3.2	-3.1	-2.5	-2.7	-3.2	-3.1
Government OBEGAL ($bn)*	-4.4	-2.8	0.4	1.8	4.1	1.6	2.2
as % of GDP	-2.0	-1.2	0.2	0.7	1.5	0.6	0.7
NZ Financial Markets (end of December quarter)							
TWI	77.3	79.2	73.6	76.1	70.5	69.7	65.7
NZD/USD	0.82	0.78	0.68	0.69	0.68	0.67	0.65
NZD/AUD	0.92	0.95	0.94	0.96	0.89	0.91	0.93
NZD/CNY	4.98	4.84	4.43	4.81	4.50	4.39	4.19
NZD/EUR	0.60	0.64	0.63	0.66	0.57	0.58	0.50
NZD/JPY	86.5	93.4	82.1	81.1	76.8	69.7	65.0
NZD/GBP	0.50	0.50	0.46	0.56	0.50	0.49	0.47
Official Cash Rate	2.50	3.50	2.50	1.75	1.75	2.00	2.50
90-day bank bill rate	2.84	3.68	2.75	2.00	1.93	2.34	2.75
2-year swap rate	3.85	3.80	2.85	2.46	2.17	2.61	2.87
10-year government bond rate	4.72	3.67	3.57	3.33	2.80	3.40	3.60

[1] Percentage point contribution to growth

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