ANZ RESEARCH

NEW ZEALAND ECONOMIC OUTLOOK

September 2017

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DRIVER SWAP

NEW ZEALAND ECONOMIC OUTLOOK

We expect GDP growth to hold in a 2½-3% range going forward. A necessary turn in the housing cycle, weak productivity growth and capacity constraints cap the upside. At the same time, the drivers of the economic expansion are evolving; we are at peak construction and net migration, but commodity prices, solid household income prospects and fiscal policy are set to provide impetus. While tighter, financial conditions also remain supportive. We retain a bias that the OCR will head higher in time, but it is not a strongly held view.

INTERNATIONAL OUTLOOK

Our global growth forecasts depict a broad-based, steady picture heading into 2018, with growth at the upper-end of recent experience. However, ongoing structural headwinds mean a further acceleration in growth is unlikely. Central banks are inching towards the stimulus exit door. That’s an environment where fundamentals will eventually be eyed and they are not great: debt is high, productivity weak, demographics unfavourable and policy uncertain.

PRIMARY SECTOR OUTLOOK

Some moderation in export prices is on the cards into the first half of 2018, but a lower NZD will provide some offset. While demand indicators remain robust, improved local supply conditions, increased competitive tensions and higher end-consumer prices flag moderation. Dairy farm cashflow is very healthy, but there could be downside to the milk price from higher export supply if it materialises.

FINANCIAL MARKETS OUTLOOK

With the RBNZ firmly on hold, short-end yields should remain anchored around current levels until at least early 2018. We have a gradual tightening cycle pencilled in from late 2018. Globally, yields should rise slowly as QE is wound back, and while that will lift local long-end yields, spread compression will offset. The NZD is likely to remain elevated into 2018 before a modest retracement.

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	2.6	2.9	2.8
Real GDP (annual % change)	4.5	2.2	2.6	2.9	3.0	2.6
Unemployment Rate (Dec quarter)	5.5	4.9	5.2	4.7	4.4	4.3
CPI Inflation (annual %)	0.8	0.1	1.3	1.3	2.1	1.9
Terms of Trade (OTI basis; annual %)	-5.0	-3.2	6.7	4.4	-1.5	0.4
Current Account Balance (% of GDP)	-3.2	-3.2	-2.8	-2.8	-2.9	-2.7
Government OBEGAL (% of GDP)	-1.2	0.2	0.7	1.1	1.0	1.2
Global Growth (annual average %)						
US	2.6	2.9	1.5	2.2	2.3	2.0
Australia	2.8	2.4	2.5	2.3	2.9	3.0
China	7.4	6.9	6.7	6.7	6.5	6.3
Trading Partners	3.7	3.6	3.4	3.6	3.6	3.4
NZ Financial Markets (end of Dec quarter)						
TWI	79.2	73.6	76.1	74.3	70.5	
NZD/USD	0.78	0.68	0.69	0.73	0.68	
NZD/AUD	0.95	0.94	0.96	0.90	0.92	
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	3.3	3.3

* Forecasts and text finalised 28 September 2017

NEW ZEALAND ECONOMIC OUTLOOK

SUMMARY

We expect GDP growth to hold in a 2½-3% range going forward. A necessary turn in the housing cycle to curb financial stability risks, weak productivity growth and capacity constraints cap the upside. At the same time, the drivers of the economic expansion are evolving; we are at peak construction and net migration, but commodity prices, solid household income prospects and fiscal policy are set to provide impetus. While tighter, financial conditions also remain supportive. We retain a bias that the OCR will head higher in time, but it is not a strongly held view, and we are sympathetic to the idea of the OCR being on an extended holiday – if not an indefinite one.

CAPPED

Forward indicators generally remain positive. Our confidence composite gauge is elevated and the Truckometer is trending higher. Additionally, the unemployment rate is inching lower, the pipeline of construction work is massive, and the terms of trade are effectively at all-time highs. Net migration inflows remain strong, supporting both the economy's demand and supply-side potential, and the starting point for the fiscal position is strong, which not many countries can attest to right now.

But while the economy is performing solidly, it's a more mediocre story under the bonnet. The latest GDP figures for Q2 showed activity expanding 0.8% q/q (2.5% y/y). That represents a nice bounce from a lacklustre performance over late-2016, early 2017. But it's a step down from the 3%-plus pace seen over 2016. It's also mediocre given that activity over the prior six months was weighed down by some temporary weather and earthquake-related disruptions. The case could easily be made for expecting an even larger rebound. It is also hard to put much of a positive spin on per capita growth, which has effectively stalled (0.4% y/y). Productivity growth has been anaemic.

The economy is grappling with some material growth headwinds, many of them unsurprising given the economy is in its eighth year of expansion.

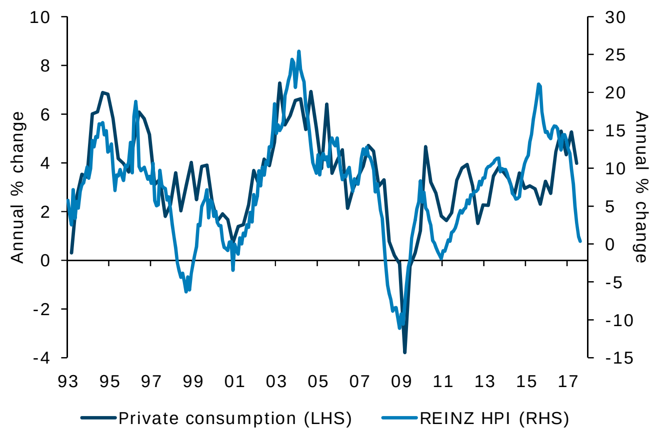
- **Finding skilled labour is the biggest problem facing firms** according to our Small Business Microscope, and capacity pressures are evident in a number of sectors. In many ways, it is not demand that is the issue, it is accommodating that demand.
- **Financial stability considerations have necessitated a turn in some pro-cyclical pockets of the economy.** The combination of LVR restrictions, restrained credit, a turn in the interest rate cycle, stretched affordability and reduced interest from offshore buyers has slowed housing market momentum, especially in Auckland.
- **Banks have paid attention to a sizeable funding gap (too few deposits and too much lending) and slowed up credit growth.** That has dampened activity. But it's also helped keep structural metrics in check, and this mitigates boom-bust cycle risks.
- **Productivity growth is weak.** This has been a global phenomenon post the GFC. Measurement may be an issue; the service sector is now two thirds of GDP and hard to measure. New Zealand has also been battered by natural disasters, which have destroyed capital stock and led to a less efficient operation. That situation is correcting. Nonetheless, the story is still disappointing.

All of that is a handful to manage, so it is little wonder that growth is struggling to accelerate.

In the near term there are also two immediate challenges:

- **The risk that softer housing market activity proliferates across the wider economy.** Auckland house prices are now falling modestly, and we expect weaker activity to persist given affordability constraints, the end of the interest rate tailwind (both here and abroad), and continued restrictive lending conditions. Historically, where the housing market has gone, sentiment and spending growth have not been far behind, and we do expect the likes of spending on big-ticket items (vehicle sales especially) to be negatively impacted to a degree. But right now, signs of broader spill-overs appear reasonably limited. Consumer confidence is high, reinforcing the benefits of a strong labour market. Our base case is that spill-overs will remain modest, but we're watchful.

Figure 1. House prices and private consumption growth



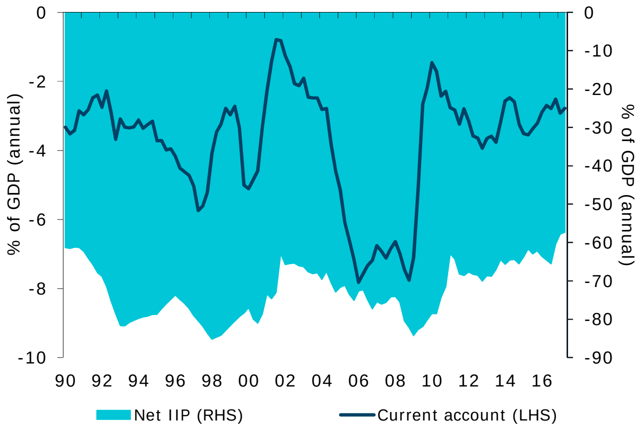
Source: ANZ, Statistics NZ, REINZ

- **The potential impact of rising policy and political uncertainty.** We've seen globally that when there is heightened policy uncertainty, the time value option for firms is to defer investment and hiring plans. As we go to print, it is still unclear who the next Government will be, with coalition talks only just getting underway. Now the wheels haven't fallen off the UK and US economies and their political situations look far more volatile. However, heightened policy uncertainty could result in somewhat of a growth air-pocket over the coming months. We're watching the likes of business confidence closely. It has already eased off elevated levels.

These factors highlight that the risk profile around the domestic economic outlook has shifted a little. We have recently lowered our views on sequential GDP growth over the second half of 2017 and into early 2018, trimming quarterly growth by 0.1-0.2%pts to a modest 0.6-0.7% pace.

Encouragingly, however, late-cycle excesses are less apparent than we've tended to see historically. The current account deficit is in check, net external debt is declining as a share of GDP and inflation is low. **These developments are a tick in the column for the economic expansion continuing by ensuring a visit from the Grim Reaper can be averted.** The historical tendency has been a build-up in imbalances that have ultimately required purging, seeing growth slow sharply.

Figure 2. Current account and net international investment position



Source: ANZ, Statistics NZ

SWAPPING OUT THE DRIVERS

This is all occurring at the same time as the economy is transitioning in terms of its growth drivers. We believe that a number of the economy's erstwhile drivers have either peaked, or are peaking.

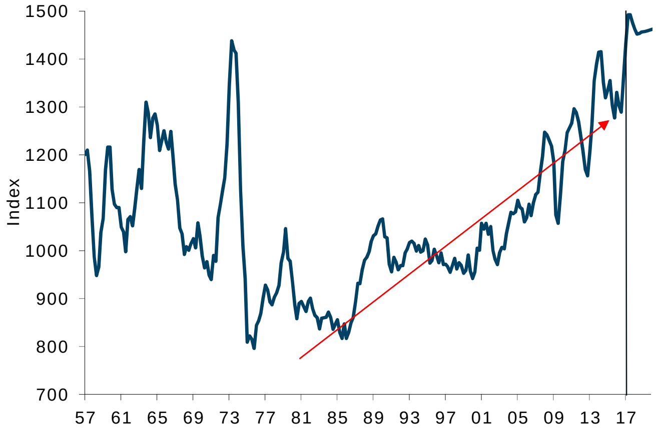
- **The construction sector is battling capacity constraints.** While the pipeline of work is large, meeting that demand is proving to be a challenge given difficulties finding staff, more restrictive credit conditions and cost escalation that has made the viability of some projects questionable. Margin pressure in the sector is intense, and the combination of rising construction costs and falling house prices in Auckland will certainly be an uncomfortable situation for some developers. In saying that, we see the level of activity plateauing rather than falling, implying its growth contribution moving from an average of 0.1%pts per quarter over the past 3½ years, to something around zero. Annual dwelling consent issuance is assumed to broadly hold around 30k.
- **Growth in international tourist arrivals is slowing.** The sector's recent performance has been strong, in part due to recent sporting events. However, the rate of underlying growth had starting slowing ahead of this, and we suspect that that reflects capacity issues more than anything. We are not necessarily negative on the tourism sector's prospects overall, as a further fall in the NZD would likely boost average spend per visitor and keep total spending elevated, but its contribution to growth is turning less positive.
- **Net migrant inflows looked to have topped out.** Now this is different to saying that inflows are set to fall sharply – we don't see that as particularly likely. But annualised net inflows have been stable at around 72k for the past year now. And it is notable that the number of departures of non-New Zealand and Australian citizens has started to increase, which we suspect reflects the natural cycling effect of those who arrived in New Zealand on, say, a work or student visa a few years ago, and are now leaving as those visas expire. The recent (and proposed) tightening up of residency conditions further reinforces that point.

There are thus a number of drivers that appear likely to have done their dash, in growth terms at least. However, other factors are set to step into the driver's seat.

- **The benefits of a lift in the terms of trade are still flowing through.** While our forecasts have the terms of trade actually easing a little over the coming 12 months, it is still up 12% over the past year and within a whisker of all-time highs. There are both cyclical and structural elements to this, with the latter reflecting clear gains on the value-added front. Our ball-park estimate is that for every 1% lift in the terms of trade, real GDP growth is boosted by 0.15%pts (all else equal) over the subsequent two years. So the terms of trade lift seen over the past year alone could add close to 2%pts to future GDP growth.

NEW ZEALAND ECONOMIC OUTLOOK

Figure 3: Terms of trade (OTI basis)

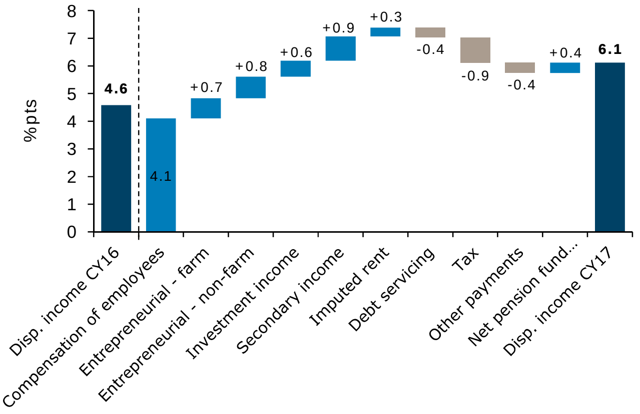


Source: ANZ, Statistics NZ

- **Fiscal policy is turning more expansionary.** Irrespective of how coalition discussions play out, what is clear is that more public money looks set to be sloshing about. Society is demanding change and there is money in the kitty (though we don't think there is quite as much as flagged in the Pre-election Economic and Fiscal Update – the Treasury's growth forecasts are too optimistic, in our view). We'll be watching the policy concessions required to get a coalition ultimately formed. However, after being a drag on growth of around 1% of GDP per year over the previous five years on average, some of the numbers being bandied about point to a positive impulse of close to 2% over 2018 and 2019.

- **Household income growth should remain solid.** Despite low nominal wage growth, we estimate that household disposable income is currently growing around 7% y/y, supported by strong employment and a sharp lift in farm incomes. Although employment growth is forecast to moderate, wage growth should lift as skill shortages bite, on top of the impact (and potential spill-overs) from the likes of the aged-care gender equality settlement. In addition, secondary income growth (welfare payments predominantly) should also continue to grow, given the way election promises have gone. We forecast disposable incomes to grow 6.1% and 5.2% in 2017 and 2018 respectively. And with the household saving rate assumed to hold broadly steady (at about zero admittedly), this solid income growth picture should correspond to an ongoing reasonable pace of household consumption growth, which we see as averaging 4.0% and 2.9% in 2017 and 2018 respectively.

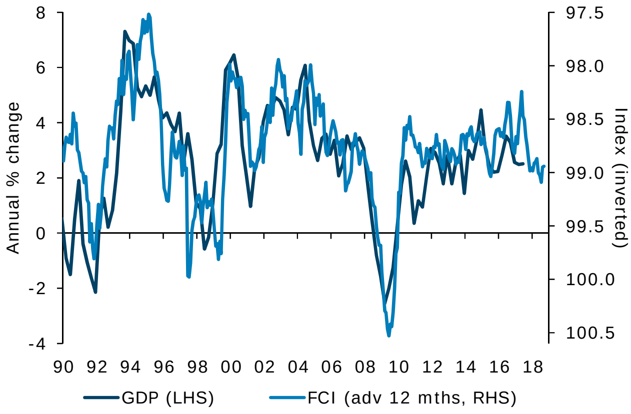
Figure 4: Contribution to CY17 household disposable income growth



Source: ANZ, Statistics NZ

In addition to these 'new' growth drivers, financial conditions are still supportive. Yes, they have tightened as the housing market has cooled, interest rates have risen and credit growth has slowed, but not to a burdensome level. As such, we are not ready to call time on the economic expansion just yet.

Figure 5. GDP and Financial Conditions Index



Source: ANZ, Statistics NZ

We also continue to like the nuances and direction in a microeconomic sense too. Microeconomics is the small things firms and individuals do, which are perhaps hard to distinguish on their own, but as a collective make quite a difference. For example, the pipfruit industry isn't getting a 30% price premium on new apple varieties by accident or courtesy of macroeconomics (though a lower NZD would help!). There is a reason New Zealand's labour force participation rate is 5 percentage points above Australia's; some of it can be put down to demographics, but most to better policy.

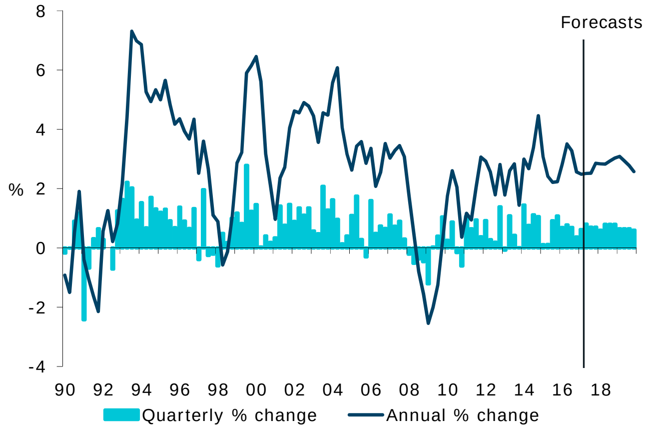
NEW ZEALAND ECONOMIC OUTLOOK

We are also assuming New Zealand's economic policy direction will remain reasonably centralist. There is heightened uncertainty over the next few weeks and there may be some initial angst about any specific policy concessions that are required to get a coalition formed. Migration, superannuation, foreign direct investment and regional development could perhaps be titchy issues. However, we do see pragmatism ultimately prevailing and are not expecting a significant lurch in policy direction. That is the beauty of MMP. It keeps policy near the centre and it's notable how the fringe party vote has collapsed of late. There will be change, and more attention will need to be paid to fiscal policy. But change is not likely to be of the radical variety. We expect the mantra from businesses to still be "just get on with it".

FUELLED UP AND READY TO GO

We remain constructive on growth overall. Growth transitions of the sort we outline above are hardly ever smooth. There will be the odd bump along the way, and as mentioned we are a little mindful of the risk of a late-2017, early-2018 soft patch. Risks are arguably more negatively skewed than they have been for a while. But we still see enough in the way of positive forces for activity growth to maintain a 2½-3% pace over the next couple of years – in other words, holding broadly around trend. It should be enough to see the unemployment rate continue to inch lower; we see it at 4.4% by the end of 2018.

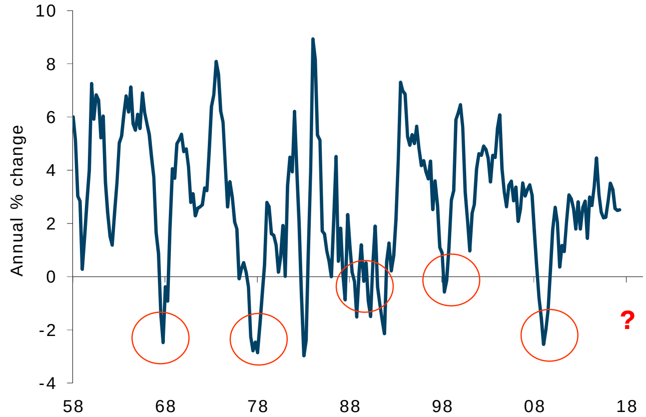
Figure 6: Real GDP growth



Source: ANZ, Statistics NZ

Strong growth has more often than not been accompanied by a build-up of imbalances like a large current account deficit, strong credit growth, stretched asset valuations, strained balance sheets and rising domestic inflation pressures. In other words, the economy has been left vulnerable to shocks. And either through the RBNZ being forced to respond to inflationary threats, or something untoward occurring globally, the economy has subsequently slowed abruptly (or even gone into reverse). The bad years have tended to end in the number 8 and 2018 is just around the corner!

Figure 7: Long-term real GDP growth



Source: ANZ, Statistics NZ, RBNZ

While most imbalances look to be in check, we do have some imbalances that have built up. With a ratio of debt to income at all-time highs of 168%, households are susceptible to any interest rate or unemployment rate shock. The Auckland housing market is overvalued on whatever fundamental metric you use (although we don't have the oversupply situation that we've seen in previous cycles). Global economic risks remain.

However, late-cycle excesses are being more actively managed currently than they've been in the past. LVR restrictions, while biting, have cooled housing extremes. Private sector credit growth has eased back to 6% y/y – on par with national income growth – as banks have tightened lending conditions. External imbalances (the current account deficit and net external debt) are far from the problem-children they typically are this late in the cycle. Moreover, with inflation subdued, the RBNZ is still some way away from having to contemplate policy tightening.

While growth is not hitting the speeds that could be possible (and there are some near-term challenges to navigate), the growth that is being achieved is more sustainable. The exception to this is growth from the tradable sector, which needs a lower NZD. That's on the cards from late 2018 as the global liquidity cycle turns and real interest rates rise around the globe. Figure 6 is notable for the elongated expansion we've seen and the reduced volatility across the economic cycle; low volatility is good for business decision-making and investment. To be fair, though, we haven't seen a global accident and we are due!

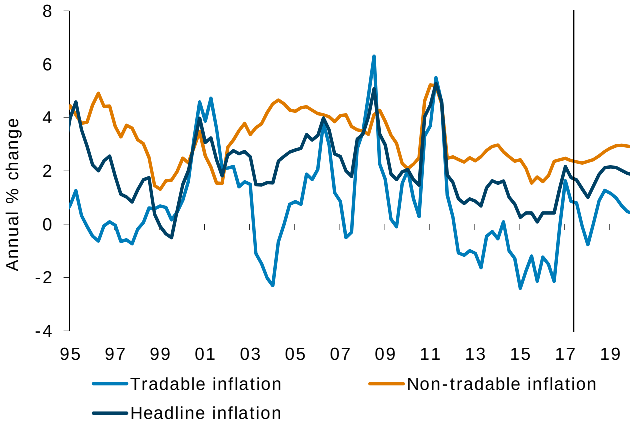
NEW ZEALAND ECONOMIC OUTLOOK

NOT THE TURBO-BOOST THE RBNZ NEEDS

Steady growth broadly around trend (which we place at roughly 2¾%) is not enough to dramatically alter the inflation outlook. As our Monthly Inflation Gauge attests, evidence of broad-base price pressures is already relatively limited. And the one clear area where inflation pressures have been evident – housing – is now turning south. 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.

We see inflation creeping higher, but only gradually. After averaging just 0.6% over 2016, headline inflation is forecast to average 1.7% and 1.6% over 2017 and 2018 respectively. Non-tradable inflation is forecast to hold around its current 2½% level for a while longer, before inching up towards 3% by the middle of 2019. Tradable inflation will be thrown around by moves in oil prices and the NZD, but ultimately is expected to average only a little above zero.

Figure 8: CPI inflation



Source: ANZ, Statistics NZ

That highlights the clear challenge facing the RBNZ. It would prefer core inflation closer to 2% (versus around 1½% currently), but growth only at trend is not going to deliver it.

Is this really an issue? We'd argue it isn't. Whether inflation is at 1.5% or 2% is a moot point; it's low. A rigid inflation-targeting central bank could detail the case for a rate cut. Amidst financial stability risks and the risks associated with pouring more fuel on the housing fire, now is the time for central banks to be flexible inflation targeters, not strict ones. Inflation settling slightly below 2% is likely the least-bad option. It's still within the 1-3% policy band.

Our bias is still that the next move in the OCR will be a hike, and probably late next year. That is predicated on a belief that the NZD will come under pressure as the global central bank liquidity tap is slowly turned off, that wage growth slowly picks up off lows as skill shortages bite, and that fiscal policy becomes more expansionary. **However, it is not a strongly held view. We're reasonably sympathetic to the idea that monetary policy is on an extended holiday – if not an indefinite one.**

INTERNATIONAL OUTLOOK

SUMMARY

Our global growth forecasts depict a steady picture heading into 2018, with growth at the upper-end of recent experience. The broad-based nature of the expansion should continue. However, ongoing structural headwinds mean a further acceleration in growth is unlikely. Central banks are inching towards the stimulus exit door as financial stability concerns mount. That's an environment where fundamentals will eventually be eyed and the world's economic fundamentals are not great: debt is high, productivity is weak, demographics are unfavourable and we have huge policy uncertainty. Solid growth is expected, but the confidence interval around that is wide.

STEADY AS SHE GOES, BUT CLOSE TO A PEAK

Confidence in the global economic expansion is looking more assured. Business and consumer sentiment in a number of countries is elevated. Unemployment rates are generally falling. Equity markets are stable at elevated levels, and market volatility is low. Growth has recently surprised on the upside in China and to lesser degree in Australia. A broader-based expansion is underway in Europe (with reform being mooted) and Japan, and the US continues to record steady growth despite the lengthy nature of the expansion.

This confidence is reflected in our global growth forecasts, which are largely unchanged from three months ago. We see global growth at 3.6% in 2017 and 3.8% in 2018. Regionally, it is a 'continuation' message. While this rate of growth is below the average seen between 1998 and 2007, it is at the upper end of the post-GFC experience, and a little above trend. As such, unemployment rates should continue to fall and central banks increasingly look towards an exit from ultra-stimulatory policies.

Critically, however, we don't envisage much in the way of acceleration in global growth from here. China especially is expected to continue to slow as the adjustment from a credit-heavy model progresses. The recent tightening in liquidity continues present headwinds for an economy with significant levels of debt. The export-led wave that has been boosting Asian growth more generally of late is also now looking more mature.

There are broader global headwinds too. Productivity growth is poor. Policy manoeuvrability is weak, with fiscal positions often strained. Leverage is high. Demographics are unfavourable. Political and geopolitical risks remain. The threat of protectionism is still present.

Key themes we are watching include:

- **Whether wages and inflation can lift sustainably.** While solid activity growth suggests the ongoing slow absorption of spare capacity, secular deflationary suppressants – especially technology – remain. Ultimately, the profile for inflation will be the most critical driver of financial conditions and the longevity of the cycle.
- **Political polarisation.** In part due to a lack of wage growth (but a falling share of labour income more generally), society wants change, although of what form is unclear. Mainstream governments that are being re-elected are often facing reduced majorities. In some cases, non-mainstream candidates are being favoured. This political unease creates a leadership hole at the same time as policy manoeuvrability is already strained.
- **The tension between policy uncertainty and market volatility.** The former is elevated, while the latter is not. But the longer the former remains elevated, the more likely firms will defer hiring and investment plans, leading to negative growth outcomes and a spike in volatility.
- **A turn in the global liquidity cycle.** Despite questions over the inflation outlook, central banks are turning more hawkish as deflation risks have receded and financial stability concerns rise. Central banks are inching towards the QE exit door. While this will occur only gradually, it presents a vastly different operating environment for markets (and economies) that have become arguably too dependent on the liquidity sugar pill.

So while our forecasts present a steady global growth picture, caution is warranted, with a wide confidence interval around the projections.

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	2.3	2.0
Australia	2.1	2.8	2.4	2.5	2.3	2.9	3.0
Japan	2.0	0.2	1.1	1.0	1.4	0.8	1.0
Euro Zone	-0.2	1.4	1.9	1.8	2.1	1.8	1.9
China	7.7	7.4	6.9	6.7	6.7	6.5	6.3
Trading Partner Growth	3.1	3.7	3.6	3.4	3.6	3.6	3.4

PRIMARY SECTOR OUTLOOK

SUMMARY

Some moderation in export prices is on the cards into the first half of 2018, but a lower NZD will provide some offset. While demand indicators remain robust, improved local supply conditions, increased competitive tensions and higher end-consumer prices flag moderation. Dairy farm cashflow is very healthy, but there could be downside to the milk price from higher export supply if it materialises.

In-market prices for New Zealand's main exports are expected to remain robust in the short term before some moderation occurs into the first half of 2018. When and how much moderation occurs will depend on local supply conditions and end-demand.

Key themes to watch include:

- **Local supply conditions, which have been tight but are generally expected to improve in 2018.** While inventory levels are low, providing flexibility for exporters, local production of dairy, sheepmeat, venison, kiwifruit, pipfruit, and viticulture are all expected to lift in 2018.
- **Trade developments - the renegotiation of NAFTA** and knock-on impacts to North American soft commodity markets remain important for all.
- **Currency movements have seen a higher euro and lower USD.** A lower USD has supported emerging market purchasing power, aiding soft commodities through 2017. A change in dynamics would pressure in-market prices, but some offset would occur from a lower NZD/USD.
- **Competition is set to intensify from key direct competitors and substitute products.** Bellwether markets such as corn, wheat, beef, pork, poultry, sugar and vegetable oils have all seen pricing pressure in recent months largely due to growing supply and ample stocks.
- **Higher wholesale prices have started to flow more strongly through to end-consumer prices**, moderating demand for some products.
- **China and broader Asia demand remains robust.** With limited local supply, this has provided inter-market competition, especially with a lifting performance from Europe and solid activity in the US. Similar dynamics are expected to persist in 2018, but the other forces above provide some price moderation.

In the dairy sector, there are some mixed signals. Milk supply is beginning to lift more aggressively across the major export regions, which is usually a precursor to prices softening. However, this is being delayed by low Oceania inventory levels, the need for sustained milk growth, seasonal dynamics, solid demand and currency movements.

New Zealand milk supply is expected to lift by 3-5% in 2017/18, but currently is being held back by very wet soil conditions in most regions. This could easily reverse as more summery conditions emerge, which would pressure WMP prices. Elsewhere **skim milk powder prices remain capped** by record-high intervention stocks and Europe/US continuing to focus on a SMP/milkfat mix. **Milkfat prices are expected to moderate** as buying pressure from the holiday consumption period subsides and Europe's milk supply increases.

At this stage we retain a $6.75/kg MS forecast, but if milk supply growth is strong then this could moderate toward the mid-$6/kg MS range. Farmer cashflow is expected to be in the high-$6/kg MS range in 2017/18 (nearly $1/kg MS y/y better).

Farm-gate lamb prices are expected to remain historically high, but moderate once new season supply arrives. Support is driven by still-tight local supply (2017 lamb crop expected to only lift 1.1%), low frozen inventory carry-over, a lower NZD and solid demand from the Middle East, China and US. The only soft spots are higher UK and Australian supplies and affordability challenges for some cuts. **Venison prices are pushing to new highs with NZ supply hitting a 20-year low** and hot demand, especially from diversification into the US. **Beef prices have moderated, with further downside to come.** While demand is robust in major markets, an increase in domestic supply will moderate procurement pressure, alongside increased supply from the US and Australia. Wool prices are set to continue to struggle with a large overhang of unsold wool domestically and in China.

Zespri is flagging $5.84/tray for Green and $9.28/tray for Gold. Average orchard revenue for Green growers is expected to be $52,100/ha (-3% y/y). The higher per-tray returns help to offset lower yields. In contrast, average orchard revenue for Gold is expected to lift to $105,000/ ha (+6% y/y). A higher per-tray return provides the boost, given steady yields. In the viticulture sector, a strong export performance across all major markets means only a small 3m litre surplus is carried into the new season. If a similar performance were maintained as seen with the smaller 2017 crop, a deficit of 26 million litres (8% of sales) would be created.

Domestic and export log/lumber prices continue to be supported by Chinese and local construction demand. 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 should continue to provide support.

FINANCIAL MARKETS OUTLOOK

SUMMARY

With the RBNZ firmly on hold, short-end yields should remain anchored around current levels until at least early 2018. We have a gradual tightening cycle pencilled in from late 2018, but it is hardly a conviction view. Globally, yields should rise slowly as QE is wound back, and while that will also lift local long-end yields, some spread compression will offset. The NZD is likely to remain elevated into 2018 before we favour a modest retracement as the global liquidity cycle turns, some cyclical forces favour the USD, and as the RBNZ is a slow adopter in removing stimulus. But currency cycles are set to be modest by historical standards.

GOING NOWHERE

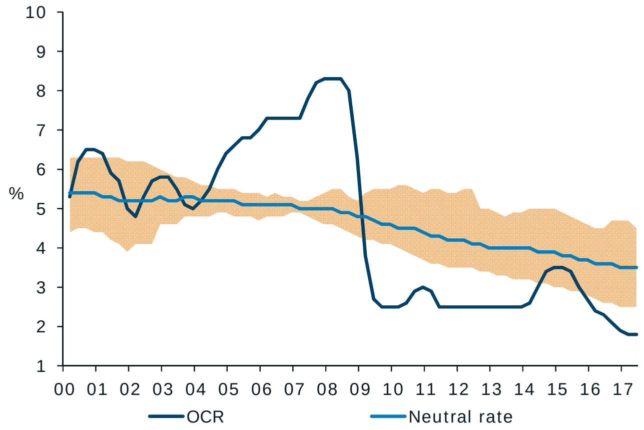
New Zealand short-end interest rates are expected to remain anchored around current levels until early 2018, with the RBNZ firmly on hold. The bellwether 2-year swap is forecast to roughly hold in a 2.10% to 2.25% range between now and the middle of 2018.

We have a lot of sympathy for the idea of the OCR not moving for a number of years, which is closer to the RBNZ's central scenario. Activity growth is barely at trend, and pro-cyclical parts of the economy (traditional drivers of inflation upturns) are being contained by macro-prudential policy under the guise of financial stability risks. The global inflation pulse is sombre, with technology changing price-setting behaviour (and power).

However, our forecasts do have a modest tightening cycle embedded, beginning in late 2018. This is premised on an expectation that the NZD heads lower as the global liquidity cycle turns, wage inflation lifts as the labour market tightens, and fiscal policy moves to a stimulatory stance.

But prospects are for a muted and gradual tightening cycle. We put the neutral OCR around 3% (the RBNZ is a little higher at 3.5% – although there is a band around that). It's hard to see the OCR moving up beyond that. Lower trend growth, subdued inflation, higher debt levels, a change in households' time preference (of money), the credit channel of monetary policy doing the work of the RBNZ, and the impact of prudential policy are all powerful forces. Together they mean that the neutral rate is far lower than in the past.

Figure 1: OCR vs the RBNZ's suite of estimates of the neutral OCR



Source: ANZ, RBNZ

FOLLOW THE LEADER

Shifting to the global rates backdrop, as markets move into the final quarter of the year, the landscape has once again disappointed the more bearish of pundits, as it has done repeatedly over the last few years. The evaporation of the 'Trump premium' in rates markets has come as inflation data has disappointed, even though other economic measures are strong and the FOMC has hiked rates. Markets have removed much of the forward pricing for hikes, leaving them in a vulnerable position should data accelerate. The issue of the stewardship of the Fed is also a topic for debate towards the end of the year.

Moreover, the gradual unwind of the Fed's balance sheet – albeit a slow, predictable and transparent process – is liable to unnerve carry markets. This comes at a time when the US Treasury considers increased issuance of debt to fund its deficits as well as the prospect of longer-dated supply.

We expect a modest rise in global front-end yields from current levels; though we note that recent weather events are likely to bring about a degree of volatility in US data. The Bank of England is set to hike before year end. Around the world, rates markets will look to the ECB next, to see if a successful withdrawal of liquidity from the Fed can translate into further talk of the slowing of asset purchases in the euro area. While central banks are struggling to hit their inflation targets, financial stability risks and the side-effects of continued extraordinary stimulus are demanding liquidity be withdrawn. This would bring about a lift in the term structure of rates markets, but also a widening in credit spreads as asset valuations become more

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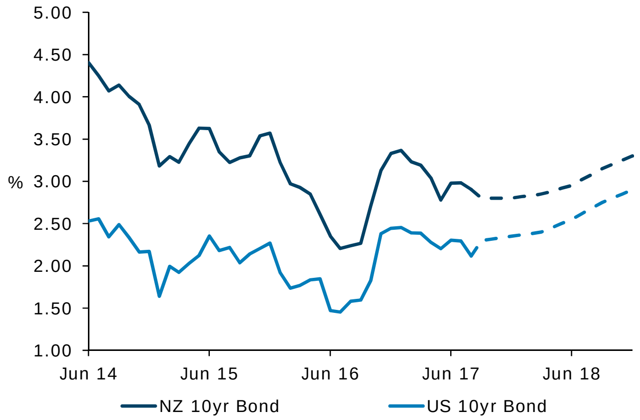
realistic and market attention turns from liquidity to economic fundamentals.

For the longer end of the global rates curve, the picture is cloudier. A faster pace of Fed hikes may drive the curve flatter if investors believe that the US economy will slow as a result of a 'policy mistake.' Equally, a slower pace or a cessation of hikes may bring investors to believe that the Fed has finished its cycle. This would reinvigorate the 'carry trade.'

Offsetting this is the gradual reduction of the USD2trn annual central bank bond buying program. The US Treasury is issuing more debt (and planning for longer tenors) at a time when the Fed is withdrawing its purchases. Valuations are also stretched, and the NY Fed's term premium remains sharply negative. That's a powerful combination calling for higher US yields.

A gradual rise in US interest rates is expected to put upward pressure on New Zealand 10-year bond yields, albeit to a lesser extent. Our forecasts assume that US rates inch gradually higher over coming quarters, but some of this will be absorbed locally via spread compression in the first instance, leaving NZ 10-year bond yields just below 3% between now and mid-2018. However, as US rates move higher at a slightly faster pace over the back half of 2018, and the market looks towards the RBNZ hiking broadly in step with the Fed, we expect spread compression to cease, with New Zealand long-end yields to move up in step with US rates.

Figure 2: ANZ NZ and US 10-year bond yield forecasts



Source: ANZ, Bloomberg

A MODEST TURN

The NZD has wobbled but generally remains elevated. There are some key reasons for this:

- New Zealand's **terms of trade** are at their highest level since the 1970s, and while more modest than it was, **GDP growth is respectable** relative to many peers. **Volatility is contained.**
- A number of **structural indicators are signalling challenges for the USD.** Typically, big USD cycles are determined by the relative structure of growth in the US (compared with the rest of the world) and by volatility. Neither of these factors are USD-supportive at the moment and we do not expect this to change.
- **Markets continue to question the prospects of the Fed (and others) lifting interest rates** given the fact that central bank expectations have failed to meet reality repeatedly since the financial crisis.
- **There is good carry** in association with low volatility.
- **Valuations are supportive.** We put structural fair value for the NZD/USD around the mid-0.70s.

The questions surrounding Fed rate hike prospects and a buoyant AUD (partly on expectations the RBA will be hiking in 2018) **are expected to keep the NZD supported until mid-2018.**

However, this near-term "elevation" view is somewhat clouded at present by domestic election-related uncertainty. Our baseline view is that (irrespective of how coalition discussions play out) the policy platform will not deviate sufficiently for it to be a material influence on economic performance over the coming years. So we are inclined to look through any short-term noise.

Beyond mid-2018, we favour a modest retracement in the NZD.

We expect some cyclical strength in the USD to emerge in 2018. We believe the current soft patch in US inflation will prove transitory, and so the Fed will continue to normalise at a faster pace than the market is currently pricing (we're also mindful of the possibility of the composition of the FOMC turning more hawkish). US fiscal policy will also turn modestly expansionary, helping US growth remain solid, showing few signs of late-cycle constraints.

Another key factor is an expected turn in the global liquidity cycle. Slowly but surely, central banks are inching towards the QE exit door. It's largely a Fed story right now and insufficient to push global real yields higher. That picture is expected to change in 2018 with global growth printing sufficiently strongly for other central banks such as the ECB to begin tapering.

The RBNZ is expected to be a follower, as opposed to a leader, in lifting interest rates. While respectable, GDP growth is barely at trend. Two false-

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start tightening cycles since the GFC also urge caution. We do not expect the RBNZ to lift rates until late-2018, and then in a slow and gradual manner. New Zealand's erstwhile yield advantage will fade.

In addition, New Zealand's soft commodity basket has been elevated. But as noted on page 8, we expect some modest pullback.

However, any turn in the NZD is expected to be modest. This is not an environment where sustained currency trends are likely to extend.

New Zealand's macro and financial scorecard remains strong, but it is no longer as differentiated and "leading" as it has been. Growth is picking up around the globe, whereas New Zealand's is moving sideways.

Figures 3: Global macro and financial scorecard

CATEGORY	NZD	AUD	USD	CAD	GBP	EUR
Economic Growth	2.5%	1.8%	2.2%	4.3%	1.7%	2.3%
Annual Inflation	1.7%	1.9%	1.9%	1.4%	2.9%	1.5%
Policy Rate	1.75%	1.50%	1.25%	1.00%	0.25%	0.00%
10yr Bond Yield*	2.9%	2.8%	2.2%	2.1%	1.3%	0.4%
Unemployment	4.8%	5.6%	4.4%	6.2%	4.3%	9.1%
C/A Balance % GDP	-2.8%	-2.1%	-2.4%	-2.9%	-3.9%	3.1%
Budget Balance % GDP~	0.6%	-2.2%	-4.0%	-2.4%	-2.8%	-1.5%
Govt Net Debt % GDP~	5%	21%	82%	26%	80%	89%

Source: ANZ, Bloomberg

INDIVIDUAL CURRENCY PAIRS

NZD/USD: Fading strength. Subject to election-related uncertainty being contained, we are expecting elevated levels to hold until mid-2018. But eventually, the global liquidity cycle and higher real global yields will weigh on the NZD. We have pencilled in a modest depreciation towards 0.67 by the end of 2018 as economic and financial drivers in the US (and elsewhere) catch up to New Zealand, and as USD strength re-emerges.

NZD/AUD: New range. Looks set to settle in a low 0.90s range as opposed to a mid-0.90s one. Improving prospects for the AUD (the RBA is expected to hike before the RBNZ) and re-rated growth prospects across the Tasman are key factors.

NZD/EUR: Waiting. The near-term upwards re-rating of the euro on improving growth prospects (and hope for reform) looks complete. We expect the NZD/EUR to remain range-bound until ECB tapering becomes clearer and economic reform talk is followed by action.

NZD/GBP: Holding pattern. Near-term strength and elevation is favoured until we get more clarity on the global liquidity cycle and real yields start to rise. The BoE is set to hike before year-end but sterling needs more than that to kick-on.

NZD/JPY: Correction pending. Expected to come under pressure as global real yields rise in 2018 and New Zealand's advantage fades.

Forecasts (end of quarter)

FX Rates	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
NZD/USD	0.73	0.73	0.73	0.70	0.68	0.67	0.65
NZD/AUD	0.90	0.89	0.88	0.91	0.92	0.93	0.93
NZD/EUR	0.60	0.62	0.63	0.63	0.59	0.56	0.53
NZD/JPY	81.8	80.3	76.7	70.0	68.0	67.0	65.0
NZD/GBP	0.55	0.57	0.57	0.55	0.52	0.51	0.49
NZD/CNY	5.00	5.02	5.04	4.84	4.73	4.66	4.52
NZ$ TWI	74.3	74.6	74.5	72.6	70.5	69.0	67.0
Interest Rates	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19
NZ OCR	1.75	1.75	1.75	1.75	2.00	2.25	2.25
NZ 90 day bill	1.97	1.98	1.99	2.08	2.34	2.50	2.50
NZ 2-yr swap	2.17	2.21	2.27	2.38	2.54	2.61	2.62
NZ 10-yr bond	2.80	2.85	2.95	3.15	3.30	3.30	3.30

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	2.6	2.9	2.8
Private Consumption	3.3	3.1	2.9	4.2	4.0	2.9	2.7
Public Consumption	1.4	3.3	2.6	2.2	3.5	2.3	1.5
Residential investment	17.5	10.9	2.0	11.0	-0.2	-0.5	-0.4
Other investment	5.2	7.5	2.2	3.6	3.6	3.5	4.7
Stockbuilding[1]	-0.2	0.4	-0.3	0.0	-0.1	0.2	0.0
Gross National Expenditure	3.6	4.2	2.3	4.1	3.4	2.9	2.7
Total Exports	0.8	3.1	7.0	1.5	2.4	3.7	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	2.2	1.6	1.2
Unemployment Rate (sa; Dec qtr)	5.6	5.5	4.9	5.2	4.7	4.4	4.3
Labour Cost Index (annual %)	1.6	1.7	1.5	1.6	2.1	2.1	2.0
Terms of trade (OTI basis; annual %)	20.2	-5.0	-3.2	6.7	4.4	-1.5	0.4
Prices (annual % change)							
CPI Inflation	1.6	0.8	0.1	1.3	1.3	2.1	1.9
Non-tradable Inflation	2.9	2.4	1.8	2.4	2.3	2.7	2.9
Tradable Inflation	-0.3	-1.3	-2.1	-0.1	-0.1	1.3	0.5
REINZ House Price Index	9.8	9.5	16.0	14.2	0.0	1.8	2.8
Fiscal and External Balance							
Current Account Balance ($bn)	-7.0	-7.7	-8.0	-7.2	-7.9	-8.2	-7.9
as % of GDP	-3.1	-3.2	-3.2	-2.8	-2.8	-2.9	-2.7
Government OBEGAL ($bn)*	-4.4	-2.8	0.4	1.8	2.8	2.0	2.0
as % of GDP	-2.0	-1.2	0.2	0.7	1.1	0.7	0.7
NZ Financial Markets (end of December quarter)							
TWI	77.3	79.2	73.6	76.1	74.3	70.5	
NZD/USD	0.82	0.78	0.68	0.69	0.73	0.68	
NZD/AUD	0.92	0.95	0.94	0.96	0.90	0.92	
NZD/CNY	4.98	4.84	4.43	4.81	5.00	4.73	
NZD/EUR	0.60	0.64	0.63	0.66	0.60	0.59	
NZD/JPY	86.5	93.4	82.1	81.1	81.8	68.0	
NZD/GBP	0.50	0.50	0.46	0.56	0.55	0.52	
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	1.97	2.34	2.75
2-year swap rate	3.85	3.80	2.85	2.46	2.17	2.54	2.73
10-year government bond rate	4.72	3.67	3.57	3.33	2.80	3.30	3.30

[1] Percentage point contribution to growth

IMPORTANT NOTICE

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