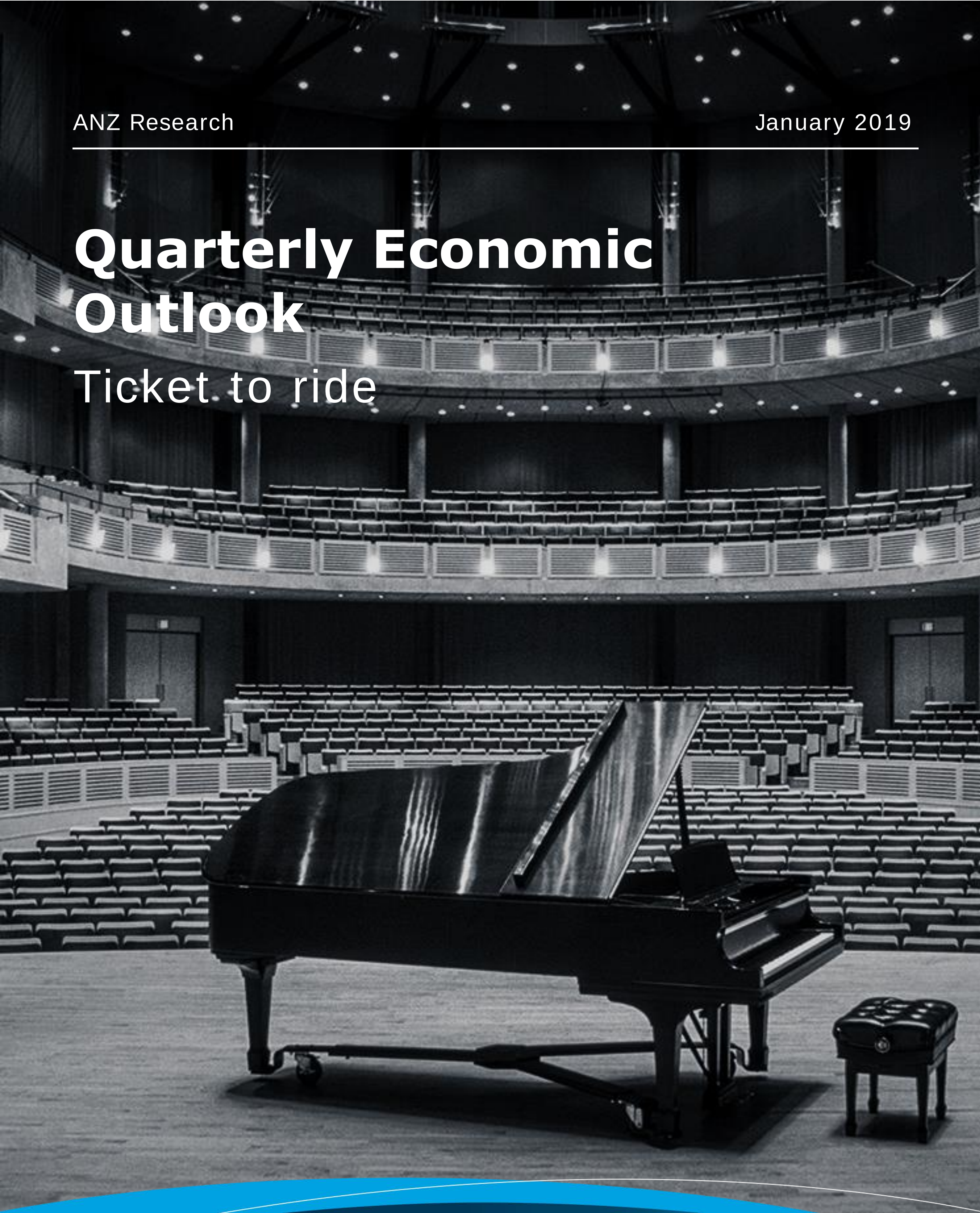
ANZ Research

January 2019

Quarterly Economic Outlook

Ticket to ride



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NZ Economics Team

Sharon Zollner
Chief Economist
Telephone: +64 9 357 4094
Sharon.Zollner@anz.com

Natalie Denne
Desktop Publisher
Telephone: +64 4 802 2217
Natalie.Denne@anz.com

Liz Kendall
Senior Economist
Telephone: +64 4 382 1995
Elizabeth.Kendall@anz.com

Susan Kilsby
Agriculture Economist
Telephone: +64 4 382 1992
Susan.Kilsby@anz.com

Sandeep Parekh
Rates/FX Strategist
Telephone: +64 9 357 4065
Sandeep.Parekh@anz.com

Kyle Uerata
Economist
Telephone: +64 4 802 2357
Kyle.Uerata@anz.com

Miles Workman
Economist
Telephone: +64 4 382 1951
Miles.Workman@anz.com

Contact
research@anz.com

Follow us on Twitter
@sharon_zollner
@ANZ_Research (global)

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New Zealand economic outlook

The New Zealand economy has had a good run, and while it's not over yet, annual growth with a 3-handle over the next couple of years looks a stretch. Momentum has slowed, and it's likely this process has further to run as the drivers of growth continue to become less synchronised. Adding to the list of headwinds, confirmed and probable changes to bank capital requirements suggest financial conditions will gradually tighten. All up, slowing growth in the context of inflation that's still shy of the RBNZ's target midpoint means the case for a little extra monetary stimulus will become evident. We expect the RBNZ's next move will be a cut.

International outlook

In recent weeks, evidence has mounted that global growth is slowing. Trade tensions and political challenges remain in focus, but the broader data-flow has softened, and risks are accumulating to the downside of ANZ's December forecasts. Growth in China is expected to be supported by increased stimulus, but headwinds are strengthening. In Australia, significant weakness in the housing market is a threat to the otherwise positive outlook. There are mixed signals out of the US, but manufacturing is coming under pressure. Euro area growth is wobbling and Brexit uncertainty continues. Tightening global liquidity and geopolitical tensions are certainly making themselves felt, and central banks will have to take note.

Primary sector outlook

Prices for New Zealand's primary sector outputs are holding up relatively well in the face of risks associated with the slowdown in economic growth in key markets. History tells us commodity returns are closely linked to global growth, but for now, demand from China still seems very strong. Dairy prices are also being supported by a decline in global supply growth, and if prices continue to trend up our $6.10 milk price forecast will prove too low. Store stock prices are high for both lambs and cattle, and horticulture and forestry are also looking in good shape.

Financial markets outlook

The RBNZ has adopted a cautious, neutral tone but continues to signal eventual rate hikes. In contrast, we now see the OCR as more likely to be cut. Market pricing will likely ebb and flow along with the data, particularly given volatility emanating from offshore at present. But ultimately, we expect that a more challenging domestic and global environment will eventually spur the RBNZ into action. A lower OCR and a more cautious Fed are expected to cap long-end yields, but nonetheless we expect recent outperformance of the long end to subside somewhat. As the market prices a lower OCR, this will weigh on the NZD (along with a challenging backdrop for risk currencies). We expect NZD/USD to reach 0.61 by year end.

Calendar Years	2015	2016	2017	2018(f)	2019(f)	2020(f)
New Zealand Economy						
Real GDP (annual average % change)	3.5	3.9	3.1	2.8	2.4	2.6
Real GDP (annual % change)	3.0	3.4	3.4	2.5	2.5	2.6
Unemployment Rate (Dec quarter)	5.0	5.3	4.5	4.1	3.9	3.8
CPI Inflation (annual %)	0.1	1.3	1.6	1.9	1.8	1.8
Terms of Trade (OTI basis; annual %)	-3.1	6.7	7.9	-1.5	-0.1	0.8
Current Account Balance (% of GDP)	-2.8	-2.2	-2.9	-3.6	-3.5	-3.9
NZ Financial Markets (end of Dec quarter)						
TWI	73.6	76.1	73.0	71.5	64.2	62.8
NZD/USD	0.68	0.69	0.71	0.67	0.61	0.63
NZD/AUD	0.94	0.96	0.91	0.95	0.87	0.84
Official Cash Rate	2.50	1.75	1.75	1.75	1.50	1.00
10-year Bond Rate	3.57	3.33	2.72	2.37	2.80	2.90

Source: Statistics NZ, REINZ, Bloomberg, ANZ Research

New Zealand economic outlook

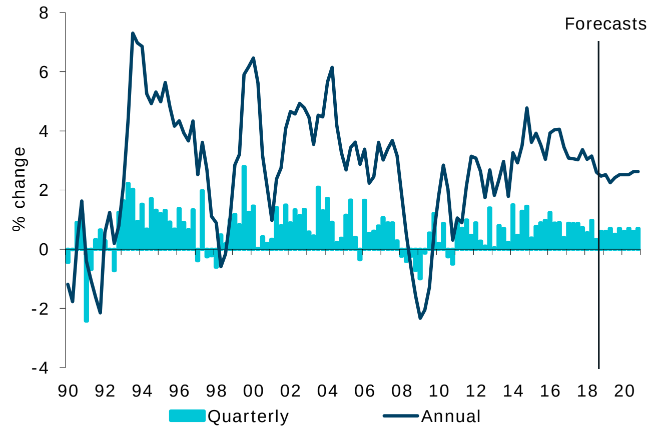
Summary

The New Zealand economy has had a good run, and while it's not over yet, annual growth with a 3-handle over the next couple of years looks a stretch. Momentum has slowed, and it's likely this process has further to run as the drivers of growth continue to become less synchronised: the impetus to growth from net migration is poised to shrink; the housing market has cooled; the terms of trade are looking past their cycle peak as storm clouds loom over China's growth outlook; and while fiscal policy is expansionary, this is neither large nor expected to last long. Adding to the list of headwinds, confirmed and probable changes to bank capital requirements suggest financial conditions will gradually tighten. All up, slowing growth in the context of inflation still shy of the RBNZ's target midpoint means the case for a little extra monetary stimulus will become evident. We expect the RBNZ's next move will be a 25bp cut in November, with two follow-up moves taking the OCR to a record low of 1.0% by early 2020. We should point out that our OCR call isn't a case of suddenly concluding that the economy is about to roll over, but rather that in the absence of a little additional monetary push, core inflation will likely decelerate alongside the economy.

Hello goodbye

As 2019 gets underway, the peak of the economic cycle continues to recede in the rear view mirror. Economic momentum has well and truly slowed, with annual GDP growth coming in at 2.6% in Q3, versus around 3½% recorded in late 2017 and a 4%+ rate two years ago. We suspect it will slow a little more yet before stabilising (figure 1).

Figure 1: Production GDP growth

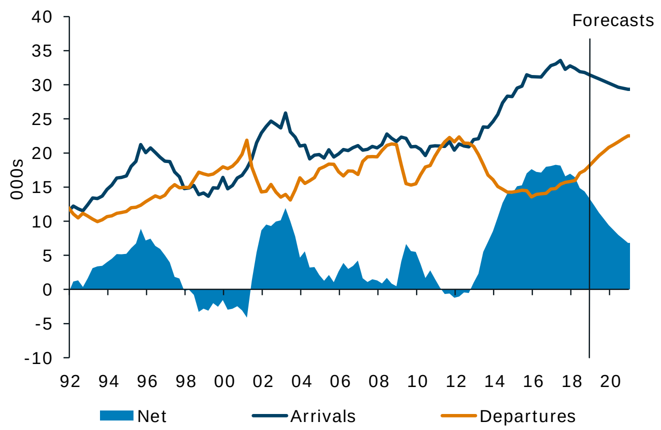


Source: Statistics NZ, ANZ Research

Slowing momentum is not a new story. We have been arguing for some time that growth will struggle to accelerate as key growth drivers continue to wane and headwinds build:

- The migration cycle peaked more than a year ago now, and as inflows continue to gradually ease, its impetus to growth will shrink. It's difficult to overstate the contribution migration-led population growth has made to headline GDP over the past few years, with productivity and per capita growth certainly nothing to write home about. This migration cycle has added more than 300,000 people to the economy over the past few years, and despite ongoing moderation we expect to see another 100,000 or so added by the end of 2020.

Figure 2: Quarterly net migration



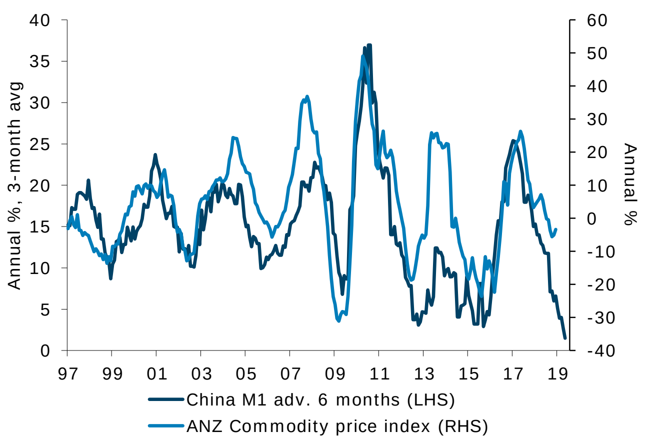
Source: Statistics NZ, ANZ Research

- In terms of the outlook, migration is a two-edged sword. Slowing net inflows are expected to be one of the catalysts behind slowing headline GDP growth, but given net migration should remain at a high level for a while yet, it also puts a floor under the deceleration. Overall, population growth is expected to moderate from around 2% y/y currently to 1.2% by the end of 2020.
- Credit conditions could get a whole lot tighter as the RBNZ moves forward with its proposal to substantially increase banks' required capital holdings. While the magnitude of the impacts are highly uncertain, it is unambiguous that they will result in a tightening in financial conditions during the transition that will weigh on economic activity even if partially offset by a lower OCR. Only the very early impacts fall within our forecast horizon, but the RBNZ will need to be pre-emptive, and thus it supports our call for a lower OCR in time. Overall, credit growth is expected to remain modest but supportive of further economic expansion.
- The housing market has cooled and isn't expected to take off again any time soon. Policy changes (known and possible) and affordability constraints are expected to keep in check the

impetus from solid housing demand, low interest rates, and gradually rising household incomes. In large part, it appears the boost to private consumption and residential investment from a hot housing market is now behind us.

- Construction activity is – and is expected to remain – at a high level. But with capacity constraints acute, costs on the rise, and cash-flow pressures building, a significant lift from here seems unlikely. KiwiBuild should put a bit of a floor under things (particularly if capacity frees up in the event of marked slowdown), but this is not a silver bullet to alleviate the headwinds the industry currently faces.
- New Zealand's infrastructure deficit is also expected to remain a limiting factor for growth going forward. While the Government is taking steps to address this, fixing almost a decade of infrastructure underspending per capita takes time. In particular, the system is creaking under the pressure of 3.8 million short-term visitor arrivals over the past year, suggesting the days of volume-driven tourism growth are over.
- The global environment is looking less favourable from a New Zealand exporter's perspective, with the fallout from the US-China tariff war weighing on China's trade data, global manufacturing activity softening, and global liquidity tightening (see page 8). So far, prices for New Zealand's key export commodities have held up relatively well, but there's no escaping the fact New Zealand export prices (and terms of trade) move closely with the global cycle – particularly developments in China (Figure 3). In this environment, exporters are likely to exercise a little more prudence than otherwise as they wait to see how the global backdrop evolves.

Figure 3: China's money supply and NZ commodity prices



Source: Bloomberg, ANZ Research

Adding flavour to the above, business surveys suggest businesses remain wary. While sentiment improved into the end of 2018, net pessimism is still the order of the day, with cost pressures, capacity constraints, margin squeeze, regulation, and difficulty finding skilled labour all weighing. The recent uptick in activity measures (such as experienced and expected activity, investment and hiring intentions) was insufficient to suggest a strong rebound in Q4 GDP growth from the modest 0.3% q/q seen in Q3. At this stage we expect a 0.6% q/q rise in Q4.

Households remain in a solid financial position, reflecting the strong labour market and earlier bump to incomes from the Families Package. The recent retreat in petrol prices (from record highs in October) should provide some relief in the near term. But beyond this, there is little to suggest households are about to up the ante. Consumer confidence is around historical levels and while the initial boost from higher minimum wages may support higher spending by lower wage earners, we don't expect to see a significant broadening in wage growth as long as businesses continue to grapple with the lengthy list of aforementioned headwinds and migration continues to add to labour supply. Labour productivity is the key ingredient when it comes to driving sustained wage growth, and the New Zealand economy has been underperforming on that front.

All up, we expect annual GDP growth to average 2.5% over the next two years, which isn't bad given we're late in the cycle and headwinds are poised to intensify. But it's fair to say that in the absence of a little additional monetary stimulus, growth momentum is likely to continue to decelerate, taking core inflation with it.

Help!

While we have not revised down our growth forecasts significantly, signs of waning momentum, in both the Q3 GDP result and forward-looking indicators, should be a significant cause for concern for the RBNZ. What's more, upward revisions to historical GDP mean the Bank may conclude that potential GDP is a little higher than previously assumed, and thus that a stronger-than-otherwise growth rate will be required to deliver inflation sustainably back at target. There have been very few (if any) developments between the 2018 November MPS and now that could warrant an upward revision to the RBNZ's growth outlook. Indeed, it's all been going modestly the other way. Accordingly, we don't think the RBNZ will just let it be – we expect the next move in the OCR will be a 25bp cut. We've pencilled it in for November, with two follow-up moves taking the OCR to a record low of

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1.0% by the end of 2020. In addition to combatting slowing economic momentum, we see OCR cuts as necessary to offset the tighter financial conditions (through higher interest rates and/or credit rationing) that will gradually evolve as banks transition to meeting tougher capital requirements. Even though there are uncertainties around the policy details (and the final word on the matter isn't due until June 2019), the lag between monetary policy and real activity mean the OCR will need to be pre-emptive in order to avoid a growth hiccup later on.

Come together

Bringing it all together, the economic outlook is a little softer than our last update, but still respectable. Annual GDP growth is forecast to continue moderating from 2.6% in Q3 2018 to 2.2% by Q2 2019 before gradually ticking up and stabilising at 2.6% by the end of 2020. On a per capita basis, growth is expected to remain subdued. Quarterly growth averages 0.6% over the forecast horizon.

Business investment is expected to step up to fill the gap left by the gradual easing in private consumption growth that results as slowing population growth more than offsets modest growth in household incomes. Residential investment is expected to remain at a high level, but will struggle to accelerate in light of acute capacity pressures.

Expansionary fiscal settings are expected to contribute to growth over the year ahead, with both capital and operational spending expected to rise. However, the Government's commitment to its net debt target means the boost to growth will be relatively small and short-lived. We have argued previously that there's scope for the Government to loosen the purse strings to address the infrastructure deficit a little faster – a move that would lean against the wind of slowing momentum and support sustainable growth over the medium term.

Net exports are expected to support growth for a little while yet, reflecting the recovery in milksolids production this season and broad-based strength across other key exports (see page 10). But beyond this, we don't see net exports making a sustained positive contribution to growth. Population-driven domestic demand has been a key feature of this economic cycle, and that's been associated with strong growth in imports. While further NZD depreciation (see page 11) should support some rebalancing towards domestic production over time, we think it would take a significant shock to household sentiment (reducing discretionary imports) and a stronger-than-expected depreciation to put an end to this dynamic any time soon. Accordingly, and despite solid exports growth, the contribution to GDP growth of net exports is expected to turn slightly negative by 2020. While the terms of trade are forecast to remain elevated (supporting national incomes), the pass-through to the rest of the economy is looking less assured. Storm clouds are looming over the global outlook, warranting a little more caution amongst exporters.

We estimate the output gap will be marginally positive over the forecast horizon, but to a lesser extent than previously. And we don't see resource pressures intensifying from here. Recent business survey data provide a tentative signal that the peak in resource pressures is behind us. GDP revisions suggest potential GDP is currently a touch higher than previously assumed, and that comes at a time when the slowdown in economic momentum appears to have further to run.

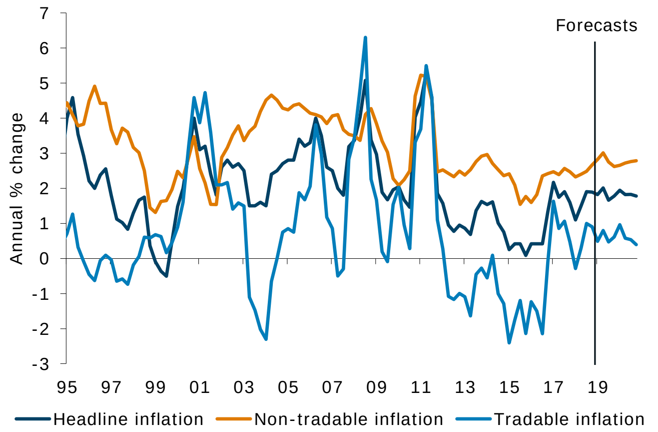
The labour market is undeniably 'tight', with the unemployment rate falling to 3.9% in Q3 – below our estimate of full employment. However, these data are backward-looking in terms of the economic "pulse" and have been quite volatile of late to boot. We expect a technical bounce-back in the unemployment rate in Q4 (to 4.1%), with the degree of "tightness" remaining broadly stable for the remainder of the forecast horizon. This will support modest wage growth.

Can't buy me love

In the absence of intensifying resource pressures, we see underlying inflation remaining broadly stable over the forecast horizon, with OCR cuts providing an eventual sustained lift to target over the medium term (beyond our two-year forecast horizon). Non-tradable inflation is expected to nudge up in the short term, on account of previous accumulation of capacity pressures that have now begun to dissipate.

Headline CPI inflation at 0.1% q/q in Q4 was softer than the RBNZ's November MPS forecast of 0.2%, but solid non-tradables and a small lift in core measures will likely provide the Bank some comfort (for now). Weaker petrol prices weighed, pulling down tradables inflation. This dynamic appears likely to continue in Q1. The RBNZ will "look through" the transitory factors impacting inflation (such as petrol price swings), but remain attentive to any implications for inflation expectations. The Bank's focus will remain on the direction of underlying inflation over the medium term. And on that front, even with OCR cuts incorporated into the outlook, we don't expect to see a marked lift. In fact, annual non-tradable inflation is expected to run around 2.8% over the next couple of years, falling short of the implicit preferred level of around 3% (with tradable inflation averaging just shy of 1% over history). Headline inflation flirts with the 2% y/y line in early 2019, but peters out to 1.8% over the medium term.

Figure 4: CPI outlook



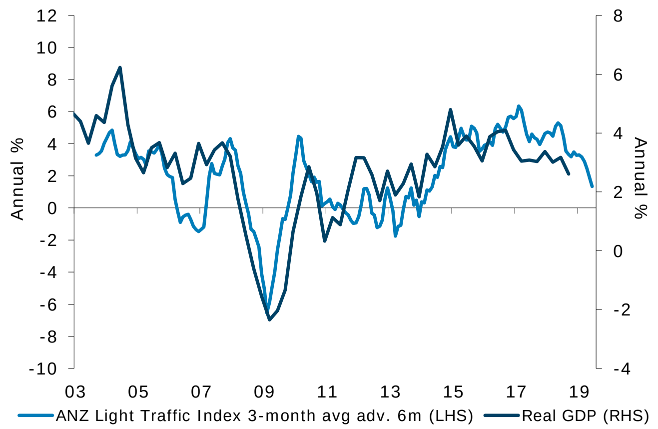
Source: Statistics NZ, ANZ Research

We see the risks to our inflation forecast as broadly balanced. Inflation has been weaker than capacity indicators would normally imply over this entire business cycle, and if resource pressures lose just a little bit of steam, inflation could decelerate significantly. However, it's also possible that inflation surprises on the upside, especially if inflation expectations increase or margin squeeze finally becomes the catalyst the for inflation pressures to intensify and broaden.

Tomorrow never knows

In terms of activity, the outlook is riddled with risks that could see the economy (and implicitly inflation and the OCR) evolve differently to our expectation. Our Light Traffic Index is providing a signal that the moderation in growth momentum may be larger than we've baked into the outlook.

Figure 5: ANZ Light Traffic Index and GDP growth



Source: Statistics NZ, ANZ Research

What might drive such a slowdown?

- Households rein in their spending more than we anticipate. Broadly speaking, households lack buffers to absorb unexpected events, such as weaker income growth or significant price rises for necessities.
- The trading partner growth slowdown and/or global market wobbles could prove more severe than anticipated, weighing on demand and prices for NZ exports, and spooking NZ households and business into reassessing their plans to spend and expand respectively.
- More generally, there's a risk that the tentative improvement in business survey data turns out to be short-lived, and hiring and investment come in on the softer side.
- Credit headwinds could intensify, leading to a growth stall (perhaps if the OCR and/or other forces fail to absorb the impact of increased capital requirements, or if global financial conditions tighten further).

However, there are upside inflation risks too:

- Our assumption that labour productivity remains muted, with its associated lack of broad-based, market-driven wage rises, may prove too pessimistic. That said, New Zealand productivity growth has a seeming unlimited capacity to disappoint.
- Business activity (including investment and hiring) could come in significantly stronger than the survey data suggest. With capacity pressures high, business investment (which has also been relatively modest this cycle) could surprise on the upside.
- The housing market could heat up again, with demand stronger than assumed (perhaps if net migration inflows surprise on the upside). But with regulatory and affordability headwinds weighing, this is looking unlikely. The RBNZ is expected to further ease loan-to-value restrictions. This should prevent the market from cooling too much, but will be intended as more of a controlled landing than a rev-up that sees house price inflation take off again. But the Auckland housing market is notorious for third or fourth winds.

By some metrics, the New Zealand economy is in better shape than is typical so late in the economic cycle in terms of weathering an adverse event. Macro-imbalances are not as severe as they have been in the past. The current account deficit is contained around its historical average and our net external liability position is sitting at a significantly smaller share of GDP (53.7% as at Q3 2018) than its peak around a decade ago (84.2% as at Q1 2009). And while the RBNZ only has 175bps to play with if downside risks do materialise, the NZD should swing into action, less-conventional monetary policy could be deployed, and fiscal policy has room to lend a hand.

The long and winding road

Regarding our OCR call, the road ahead may not be a straight one, meaning it's unlikely to be a smooth path for interest rates between now and an eventual cut. Market pricing is likely to continue to ebb and flow, and we wouldn't be surprised to see the data cause some volatility in the interim.

There are risks on both sides around the timing of the first cut, reflecting uncertainty about what the eventual catalyst will be to spur the RBNZ into action. A cut could come earlier then November should the global environment deteriorate quickly, or domestic growth or inflation indicators turn softer. On the other hand, anecdotes are pretty gung-ho about the broad state of the economy outside of the weaker pockets of Auckland housing and dairy sector confidence. A significant rebound in the data flow would lead to the Reserve Bank extending its wait-and-see stance.

Another complication is the uncertainty around the economic impacts of higher bank capital requirements. The RBNZ is yet to clarify in any detail how they see this impacting credit conditions and inflation, but if this is underestimated, it could be a while before cuts arise to provide the necessary offset. It will not be incorporated into the RBNZ's projections until the policy is finalised.

All up, despite the gradual upward trajectory for non-tradable inflation continuing, developments since the November MPS – increased uncertainty around the global outlook, weaker Q3 GDP than forecast by the RBNZ in November, and some softer leading indicators – suggest the Bank's February Statement will feature a slightly more dovish tilt.

International outlook

Summary

In recent weeks, evidence has mounted that global growth is slowing. Trade tensions and political challenges remain in focus, but the broader data-flow backdrop has softened, and risks are accumulating to the downside of ANZ's December forecasts. Growth in China is expected to be supported by increased stimulus, but headwinds are strengthening. In Australia, housing weakness is likely to dampen both construction and household spending, though households have been very resilient so far. There are mixed signals out of the US, but manufacturing is coming under pressure. Following a particularly nasty bout of equity volatility over December, the market has become sceptical of further hikes in the fed funds rate. Euro area growth is wobbling, with 2018 seeing the weakest growth in Germany in six years, led by manufacturing. Brexit uncertainty continues to hang over the UK economy. Tightening global liquidity and geopolitical tensions are certainly making themselves felt, and central banks will have to take note. Demand for New Zealand's commodities is holding up very well so far, but risks are looking one-sided.

Don't let me down

The global economy is facing challenges. Growth so far remains at robust levels in most major economies, but manufacturing data in particular has of late been undershooting expectations. Our most recent published forecasts (December's ANZ Research Quarterly) are for world GDP to expand 3.7% in both 2019 and 2020. Such a growth profile implies a supportive environment for New Zealand exports. However, the risk profile around these projections is looking skewed to the downside, particularly for the euro area.

China is New Zealand's most important trade partner, particularly for commodities. Chinese reported GDP growth is expected to be 6.3% y/y in 2019, the slowest pace in decades. Some of this slowing is entirely deliberate, in that authorities have long desired a reduction in the pace of debt accumulation for financial stability reasons. However, there are clear growth impacts emerging from both the previous deleveraging efforts and now, the tariff war with the US. The Producer Price Index, a proxy for manufacturing activity, has fallen sharply, and PMI and trade data has weakened. A sharp fall in China's new export orders in the most recent PMI survey raised eyebrows. GDP growth for 2018 at 6.4% y/y featured an ongoing decline in the growth rate of industrial production.

China's policymakers are redoubling their efforts to support growth. Tax cuts and looser constraints on lending (easing the reserve requirement ratio) are two initiatives. However, we expect the authorities will be reluctant to once more aggressively stimulate investment and credit-led growth. It is more likely that we will see efforts to support services and high-tech manufacturing, loosening of tariffs (outside of the US trade spat), subsidies and tax cuts.

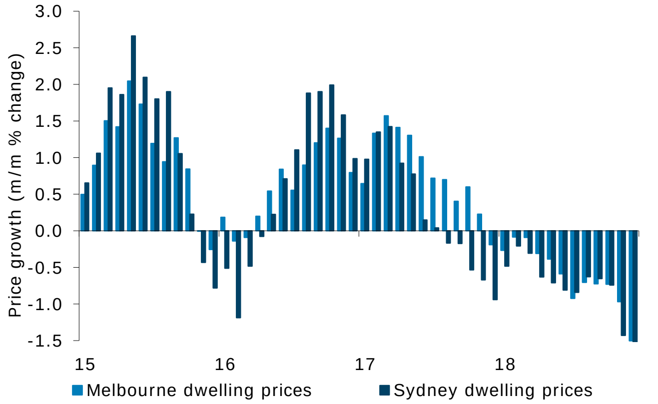
Both China and the US face strong incentives to bring the tariff war to an end, with the economic costs to both countries becoming difficult to deny. There are mixed signals regarding progress on this front.

The medium-term growth picture for China remains positive, if not smooth, and in selling food, New Zealand is less exposed to discretionary spending than are luxury goods makers and car manufacturers, whose weaker sales are in the spotlight. Nonetheless, we have deliberately targeted our exports at the premium end of the consumer market and so cannot expect to be immune from any consumer pull-back.

Australia, New Zealand's second-largest trading partner, is still experiencing strong growth but is coming under pressure. The economy is forecast to expand 3.0% over 2019, bolstered by public spending and private investment. While these drivers will continue, there are two key downside risks to watch.

First, US-China trade tensions present a key risk to export demand and prices of hard commodities, via the impact on China industrial production. Second, ongoing weakness in the housing market in several Australia cities is set to challenge both construction – dwelling consents plummeted in November – and household consumption, via the wealth effect. So far, consumers have proven remarkably resilient in terms of both their confidence and spending in the face of falling house prices and weak wage growth. But ANZ expects house prices to continue falling over this year so it's too soon to say the bullet's been dodged.

Figure 1. Melbourne, Sydney dwelling prices



* Seasonally adjusted by ANZ Research

Source: CoreLogic, ANZ Research

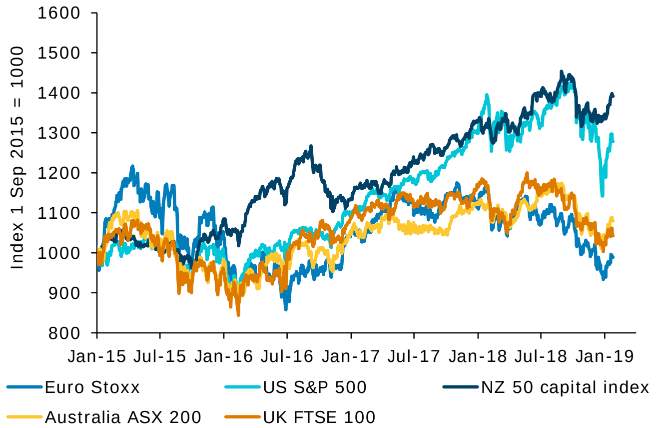
International outlook

The RBA is still expecting to raise interest rates later this year, on the back of expected ongoing above-trend growth and hence gradual increases in inflation. However, we suspect a monetary policy tightening remains a long way off. We are forecasting no increase in the cash rate this year.

The **US** Federal Reserve hiked the fed funds rate by 25bp on 20 December in response to strong US data. However, it's been a dramatic few weeks since then. Global markets experienced a spectacular bout of volatility around Christmas, and while January has been remarkably positive, equities remain well off their highs (figure 2) and sentiment remains somewhat fragile. While US labour market data has been strong, leading data out of the manufacturing sector has taken a weaker turn, with the ISM manufacturing PMI dropping sharply from 59.3 in November to 54.1 in December. Overall GDP growth is expected to slow to 1.8% y/y in 2020 on the back of the tightening in monetary policy that has taken place, which has substantially tightened financial conditions.

From here, only modest further tightening in monetary policy is expected. ANZ is forecasting just one more hike, taking the fed funds rate to a peak of 2.75% in the middle of the year.

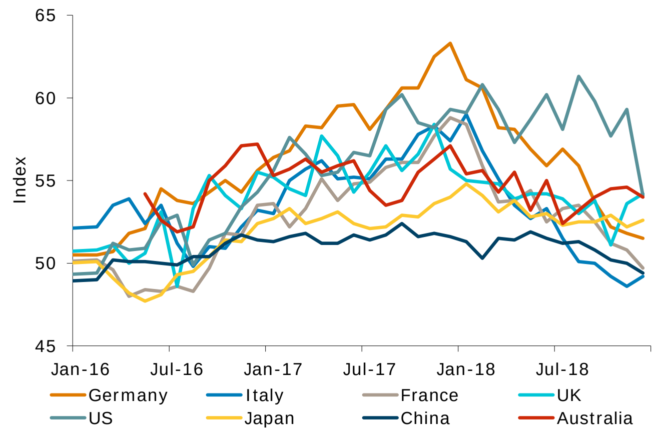
Figure 2. Selected global equity markets



Source: Bloomberg, ANZ Research

The ECB is planning to end quantitative easing later this year, with their forecasts anticipating a solid recovery in **the euro area** continuing. However, manufacturing sector data has taken a decided turn for the worse in Europe too (figure 3), with German GDP growth in 2018 estimated to be the weakest since 2012, and fears Italy may even be in recession already as a result of very weak industrial production. Our forecast of 1.8% euro area growth in 2019 is starting to look optimistic. Meanwhile the Brexit sword still hangs over the UK economy, with PM May's EU Agreement soundly rejected by the UK Parliament.

Figure 3. Selected global PMIs



Source: Bloomberg, ANZ Research

All up, although it is too soon to change our global growth projections, the risks are starting to look rather one-sided, particularly for the euro area. And the overlay of geopolitical risks – China/US relations, Brexit, US internal political shenanigans – makes the outlook particularly uncertain. The global environment affects New Zealand not only via commodity prices, but also demand for tourism and other services exports, bank funding costs, and of course the impact on the NZD. It's been relatively smooth sailing in the last couple of years for the little cork in the global ocean that is the New Zealand economy. But the wind is coming up.

Table 1: GDP Growth

Calendar Years (annual average % change)	1998-2007 average	2008-2016 average	2017	2018(f)	2019(f)	2020(f)
United States	3.1	1.4	2.2	3.0	2.3	1.8
Australia	3.6	2.6	2.4	3.0	3.0	2.8
Japan	1.0	0.4	1.7	0.9	1.2	1.0
Euro area	2.4	0.4	2.4	1.9	1.8	1.7
China	10.0	8.4	6.9	6.6	6.3	6.1
World	4.3	3.3	4.0	3.9	3.7	3.7

Source: Bloomberg, ANZ Research

Primary sector outlook

Summary

Prices for New Zealand's primary sector outputs are holding up relatively well in the face of risks associated with the slowdown in economic growth in key markets and the current global political uncertainty. However, history tells us commodity returns are closely linked to global economic growth, and at present this does not paint a particularly rosy picture. But for now, demand from China still seems very strong. Dairy prices are also being supported by a decline in global supply growth, and if prices continue to trend up our $6.10 milk price forecast will prove too low. Store stock prices are high for lambs and cattle, and the horticulture and forestry sectors are also in good shape. Another positive is the CPTPP, which is kicking in now.

Carry that weight

Commodity prices are largely being maintained by good demand from China – our largest market for virtually all of our major export commodities. However, the anecdotes and data from China look grim, with the US-China trade war adding further drag to an economy that was already facing headwinds. This would indicate that at some point we could see a correction in demand for our commodity products. But not just yet it seems!

For now, exporters from all major sectors are reporting continued strong demand from China. While its economy may not be growing as quickly as it once was, the underlying trends of urbanisation, westernisation and rising incomes continue to drive demand for imported foods. This demand has helped underpin the recent lift in dairy prices, with strong participation from Chinese buyers at recent Global Dairy Trade events.

However, the recovery in dairy prices is also a supply-side story. Slower growth in global milk supply has allowed the stocks of skim milk powder (SMP) held in the European Commission intervention programme to be virtually cleared. These stocks have overshadowed the market for the past couple of years, causing the prices of SMP to be particularly depressed but also pulling down whole milk powder (WMP) prices.

Milk supply growth is expected to remain at moderate levels in both Europe and the United States in 2019 as lower farmgate prices suppress output. Some of this slowdown in Northern Hemisphere supply has been offset by strong growth from New Zealand. New Zealand's milk supply is up 5% for the season to date but this rate of growth is expected to ease back to nearer 3.5% across the full 2018-19 season as growth rates slow in the latter part of the season.

If dairy commodity prices continue to trend up as they have in recent months, this will put upward pressure on our milk price forecast of $6.10/kg milksolid for the 2018-19 season. For now, we're cautious.

From me to you

Grazing farm returns are positive, with output expected to lift this season on the back of exceptionally favourable climatic conditions while pricing remains buoyant. Store stock prices are higher than normal for both lambs and cattle, reflecting additional demand as farmers look to increase stocking rates to utilise pasture production. Processing numbers have been down a bit for the season so far as farmers hold onto stock to utilise the extra pasture. Lambs that have been processed thus far have been heavier than normal and this trend is expected to continue through the peak slaughter period.

China is importing more and more red meat as its domestic demand expands much more quickly than its own production. Consumption of these meats is still relatively low compared to pork, indicating the potential demand for red meat is huge. China's swine fever outbreak may provide a short-term boost, but as beef and lamb command a higher price point than pork or poultry, ongoing demand growth will be dependent on average income levels continuing to rise.

Horticulture sectors are generally performing well. However, labour is a major concern for both the pipfruit and kiwifruit industries. The apple crop is expected to be larger than last season, while the number of kiwifruit to be packed is also expected to increase. The kiwifruit industry continues to trend towards gold varieties, largely at the expense of green, although some planting of gold varieties is also occurring on new sites.

The forestry sector is looking in good shape for 2019, with export log prices holding up at high levels amidst higher felling rates. Market prices are being sustained despite the lift in volumes being shipped, primarily due to good demand from China. While China's property sector is facing some headwinds, demand for logs used by the construction sector is still very strong – possibly due to additional government spending on infrastructure projects. However, a slowing of China's economy presents a high risk to this sector.

Getting better

The CPTPP took effect from the beginning of this year for the countries that have ratified it. The agreement provides New Zealand with greater access into key export markets, including Japan and Canada. A gradual reduction of the hefty tariffs that Japan applies to imports is especially welcomed by beef and horticulture exporters. For beef and apples this now puts us on a level playing field with Australia, who previously gained preferential access through a bilateral trade agreement. Japan is also a key market for several other vegetables and fruit, including cherries, which will gain tariff-free access within six years.

Financial markets outlook

Summary

The RBNZ adopted a cautious, neutral tone in November but continues to signal rate hikes in the future. In contrast, we now see the OCR as more likely to be cut, with the first move pencilled in for November this year. Market pricing will likely ebb and flow along with the data, particularly given volatility emanating from offshore at present. But ultimately, we expect that a more challenging domestic and global environment will eventually spur the RBNZ into action. A lower OCR and a more cautious Fed are expected to cap long-end yields, but nonetheless we expect recent outperformance of the long end to subside somewhat. As the market gradually prices a lower OCR, this will weigh on the NZD. Adding to this, commodity prices have been lower recently; market volatility has increased and is unlikely to fully subside; global liquidity continues to tighten; and the global economic cycle is moderating – all up, a challenging backdrop for risk currencies generally. We expect NZD/USD to reach 0.61 year end.

Revolution

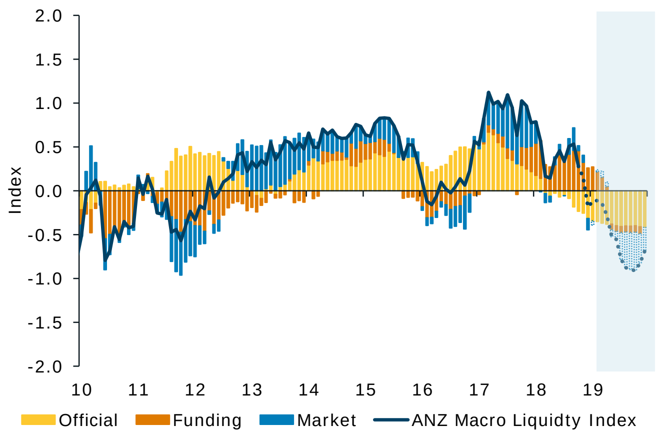
A shift has been seen in global markets over the past few months. Volatility has increased markedly, in large part due to heightened uncertainty about the economic outlook and the path of US monetary policy.

The peak in the global economic and trade cycle is behind us, and the Federal Reserve has shifted to a more cautious stance. Recently, the Fed has signalled that it is watching economic data and market developments closely, as it assesses the degree of economic momentum and aims to engineer a soft landing for the US economy. We continue to expect one further rate hike from the Fed, but it is possible that the tightening cycle has now reached an end.

Markets have started to digest this possibility, with a small chance of cuts now priced in. US bond yields have fallen from 3.2% in November to 2.75% currently. Going forward, we see US 10-year yields recovering a little from where they are today, but ultimately we expect that yields will be capped, with the end of US tightening in sight, if not already past. We are currently forecasting 10-year yields to flatten off at 3.1% over 2019.

At the same time as the US policy outlook has shifted, the global liquidity cycle continues to turn – and has shifted firmly into contractionary territory. Tightening liquidity reflects continuing shrinkage of central bank balance sheets and inertia from previous tightening that has yet to work its way through the system. We estimate that global liquidity will be an increasing headwind for markets over the coming year.

Figure 1: ANZ Global Liquidity Index



Source: Bloomberg, Thomson Reuters Datastream, ANZ Research

The global credit cycle also looks mature and credit spreads have started to widen as liquidity has been withdrawn, particularly for high-yield debt. As the tightening continues, there is scope for spreads to increase further.

Emerging markets have benefited from abundant and cheap USD liquidity, and challenges could increase as liquidity continues to be withdrawn. A slowing Chinese economy, global trade tensions and geopolitical concerns could add to challenges in these markets.

The PBOC has turned to both monetary and fiscal easing to support the Chinese economy as momentum continues to wane. So far, New Zealand's commodity prices have been resilient, but a more marked slowing in Chinese growth would not be received well in financial markets, and could weigh on the perceived outlook for Australia and New Zealand in particular.

All up, the global markets backdrop is expected to remain challenging, exacerbated by tightening liquidity. We expect to see further volatility from here, with markets expected to remain sensitive to poor news. And plenty of event risk remains. Trade tensions, the US government partial shutdown and Brexit developments are particular near-term pressure points.

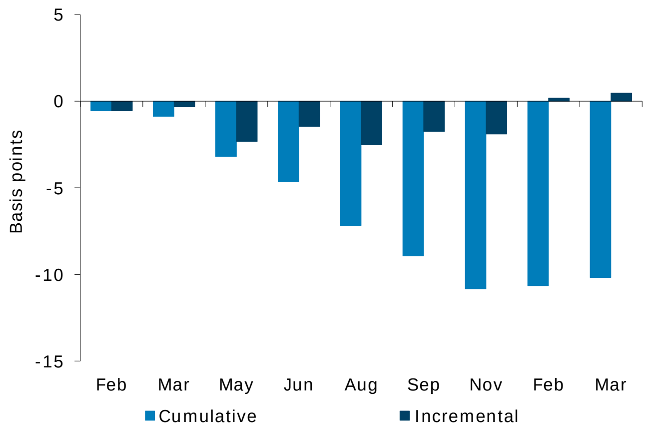
NZ rates – come and get it

Tighter financial conditions and waning global growth continue to weigh on the outlook for monetary policy in New Zealand, while the domestic backdrop also looks more challenging. We now see the next move in the OCR as being downward, with a cut pencilled in for November and another 50bps of cuts to follow in 2020.

Given the softer tone of domestic data, global developments, and the RBNZ's proposals to increase banks' capital requirements, market pricing has moved over the past month to price in around 10bps of OCR cuts by the end of the year.

Although we think it may take some time for developments to spur a cut from the RBNZ, we do expect that a more cautious tone will become evident considerably sooner. The RBNZ adopted a cautious, neutral tone in November, but we think that recent developments warrant a slightly more dovish tilt, especially on the international front. Nonetheless, market pricing may ebb and flow, particularly given volatility emanating from offshore at present. And it may take some time for it to become evident that more monetary stimulus is necessary, particularly if the domestic data flow holds up in the short term. Wage and CPI inflation lag the broader economic cycle, but this may be overlooked to some degree.

Figure 2: Market pricing for OCR



Source: Bloomberg, ANZ Research

Our expectation is that we will see some bull steeping pressure if monetary policy evolves as we expect. Short-end yields will move lower. But while a lower OCR and a more cautious Fed are also expected to cap yields, fixed income still looks expensive at the long end. We expect recent outperformance to subside somewhat, with some convergence to US yields. Spreads are expected to narrow from -40bps currently to -10bps by the end of 2020.

NZD – Get back

As we had anticipated, gravity once again came calling for the NZD over December, as financial market volatility increased. We have seen some partial retracement in January, but amid the ebb and flow of developments, kiwi weakness is a theme we see persisting. Moderating global growth, tightening global liquidity and commodity price headwinds are expected to provide a challenging backdrop for risk currencies generally. Adding to this, Chinese growth concerns are likely to weigh on the NZD and AUD in particular.

Domestically, we expect that economic fundamentals will support this view. Our view that the OCR will need to move lower is consistent with our medium-term downward bias for kiwi. Prices for New Zealand's commodity exports (long a bastion of support for the NZD) are also past their peak, pointing to a weaker outlook for the terms of trade.

But while we see the NZD lower in time, we would emphasise that further choppiness is likely, with heightened volatility expected to be an ongoing theme in FX markets this year. There are also a couple of risks that could see the NZD move differently to how we expect. First, it is possible that the NZD may not be affected to the extent that its "risk currency" status would usually imply. A more cautious Fed outlook could see USD weakness emerge as the more dominant theme, while the AUD could weaken relatively more on Chinese developments. Second, global growth could be more resilient than we expect, event risk could pass and volatility subside. That would dampen the impact of tighter global liquidity conditions on cyclical currencies and risk assets.

Individual currency pairs

NZD/USD: Push and pull. Conditions for the USD are no longer looking so favourable, on the back of the more cautious outlook for Fed policy. But we expect a more challenging environment for the NZD will be the dominant force for this cross. We are picking that the NZD/USD will reach 0.61 by the end of this year. However, with volatility expected to continue, and US monetary policy garnering particular attention, expect price action to remain choppy.

NZD/AUD: Tipping the balance. Economic outlooks in New Zealand and Australia are both looking less assured, and a slowing Chinese growth outlook is tending to buffet both legs of this cross. Eventually we expect the RBNZ's willingness to cut the OCR will tip the balance and see this cross drift south.

NZD/EUR: Set to move lower. The European growth picture has been softer, but policy normalisation from the ECB is still expected at this stage. Add to that a challenging environment for the NZD, and this cross looks set to move lower, though political risks and market volatility could see some ups and downs.

NZD/GBP: Deal or no deal. This cross is all about Brexit at present. Depending on how developments play out, the outcome for this cross is likely to be binary.

NZD/JPY: All about risk. The yen tends to be driven by risk appetite. And given our expectation that 'risk' is set to continue to face challenges, we see this cross continuing to push lower amidst choppiness.

Financial markets outlook

Table 1: Forecasts (end of quarter)

FX Rates	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
NZD/USD	0.64	0.62	0.61	0.61	0.61	0.62	0.63
NZD/AUD	0.94	0.93	0.87	0.87	0.87	0.89	0.87
NZD/EUR	0.58	0.57	0.55	0.53	0.51	0.50	0.50
NZD/JPY	70.4	67.0	62.2	61.0	58.6	58.9	59.4
NZD/GBP	0.52	0.52	0.50	0.49	0.47	0.47	0.47
NZD/CNY	4.38	4.25	4.15	4.12	4.09	4.12	4.13
NZ$ TWI	69.7	67.9	65.2	64.2	62.9	63.1	63.2
Interest Rates	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20	Sep-20
NZ OCR	1.75	1.75	1.75	1.50	1.00	1.00	1.00
NZ 90 day bill	1.98	1.98	1.90	1.65	1.23	1.23	1.23
NZ 2-yr swap	2.12	2.18	2.18	2.11	2.02	2.05	2.07
NZ 10-yr bond	2.70	2.80	2.80	2.80	2.90	2.95	2.95

Source: Bloomberg, ANZ Research

Key economic forecasts

Calendar Years	2014	2015	2016	2017	2018(f)	2019(f)	2020(f)
NZ Economy (annual average % change)							
Real GDP (production)	3.6	3.5	3.9	3.1	2.8	2.4	2.6
Private Consumption	3.1	3.6	5.3	4.8	3.1	2.9	2.4
Public Consumption	3.4	2.5	2.0	2.9	2.1	2.4	3.2
Residential investment	9.8	5.6	10.8	0.9	2.2	0.6	2.2
Other investment	9.0	3.2	2.1	4.4	4.5	2.3	3.6
Stockbuilding[1]	0.4	-0.3	0.2	-0.2	0.3	-0.5	0.0
Gross National Expenditure	4.4	3.0	4.6	3.9	3.8	2.5	2.8
Total Exports	3.3	7.4	2.1	1.8	3.6	3.6	2.2
Total Imports	7.9	4.0	3.3	6.9	6.4	2.6	3.1
Employment (annual %)	3.6	1.4	5.8	3.7	2.5	1.6	1.4
Unemployment Rate (sa; Dec qtr)	5.5	5.0	5.3	4.5	4.1	3.9	3.8
Labour Cost Index (annual %)	1.8	1.6	1.6	1.9	2.0	2.1	2.5
Terms of trade (OTI basis; annual %)	-5.0	-3.1	6.7	7.9	-1.5	-0.1	0.8
Current Account Balance ($bn)	-7.5	-7.1	-5.7	-8.1	-10.5	-10.7	-12.3
as % of GDP	-3.1	-2.8	-2.2	-2.9	-3.6	-3.5	-3.9
Prices (annual % change)							
CPI Inflation	0.8	0.1	1.3	1.6	1.9	1.8	1.8
Non-tradable Inflation	2.4	1.8	2.4	2.5	2.7	2.6	2.8
Tradable Inflation	-1.3	-2.1	-0.1	0.5	0.9	0.6	0.4
REINZ House Price Index	7.6	14.8	14.5	3.5	3.2	2.6	2.0
NZ Financial Markets (end of December quarter)							
TWI	79.2	73.6	76.1	73.0	71.5	64.2	62.8
NZD/USD	0.78	0.68	0.69	0.71	0.67	0.61	0.63
NZD/AUD	0.95	0.94	0.96	0.91	0.95	0.87	0.84
NZD/CNY	4.84	4.43	4.81	4.62	4.62	4.12	4.13
NZD/EUR	0.64	0.63	0.66	0.59	0.59	0.53	0.50
NZD/JPY	93.4	82.1	81.1	80.0	73.7	61.0	59.9
NZD/GBP	0.50	0.46	0.56	0.53	0.53	0.49	0.47
Official Cash Rate	3.50	2.50	1.75	1.75	1.75	1.50	1.00
90-day bank bill rate	3.68	2.75	2.00	1.88	1.97	1.65	1.23
2-year swap rate	3.80	2.85	2.46	2.21	1.97	2.11	2.06
10-year government bond rate	3.67	3.57	3.33	2.72	2.37	2.80	2.90

[1] Percentage point contribution to growth

Forecasts finalised 24 January 2019

Source: Statistics NZ, REINZ, Bloomberg, Treasury, ANZ Research

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Ph 64 9 357 4094, e-mail nzeconomics@anz.com, http://www.anz.co.nz