NEW ZEALAND ECONOMIC OUTLOOK

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INSIDE

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SAILING ON

NEW ZEALAND ECONOMIC OUTLOOK

Momentum is picking up from a lull over late-2016 to early-2017. This pick-up will be modest, with the economy facing capacity constraints and late cycle challenges. Our forecasts depict an economy growing at a pace strong enough to continue to gradually absorb spare capacity. But it's a solid, rather than stellar, story. Core inflation will slowly rise, and interest rates too.

INTERNATIONAL OUTLOOK

We forecast a steady picture for global growth heading into 2018. Attention is now turning to the inevitable winding down of QE excesses. That presents challenges, although we view it in a positive light. But a likely pick-up in volatility as the liquidity cycle turns, together with political polarisation, limited policy manoeuvrability, elevated leverage and poor productivity growth is a potent mix. A lot will need to go right for things not to go wrong.

PRIMARY SECTOR OUTLOOK

The cyclical upturn in New Zealand's soft commodity export prices has matured. But we are not expecting a sharp turn lower. Dairy cash flow prospects look much better into mid-2018. Meat returns are exceeding expectations, but volumes are lower. There were smaller kiwifruit and grape crops, but a larger pipfruit harvest. Price prospects are strong for kiwifruit and steady for wine and pipfruit. Forestry prices continue to be robust, driven by China and local demands.

FINANCIAL MARKETS OUTLOOK

With the RBNZ on hold for the next year or so, local short end yields should remain anchored. A notable shift in the tone from a number of major central banks has seen bond yields snap higher, resuming what is expected to be a slow upward move. As this occurs, the New Zealand yield curve should steepen. We expect the NZD to weaken from current elevated levels, but compared to past cycles, the NZD's decline should be modest.

Calendar Years	2014	2015	2016	2017(f)	2018(f)	2019(f)
New Zealand Economy						
Real GDP (annual average % change)	3.4	2.5	3.1	2.8	3.0	2.4
Real GDP (annual % change)	4.5	2.2	2.7	3.2	2.6	2.4
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	1.8	2.2	2.0
Terms of Trade (OTI basis; annual %)	-5.0	-3.2	6.7	5.6	-1.4	0.4
Current Account Balance (% of GDP)	-3.2	-3.2	-2.8	-3.0	-2.6	-2.6
Government OBEGAL (% of GDP)	-1.2	0.2	0.7	0.8	1.2	1.4
Global Growth (annual average %)						
US	2.4	2.6	1.6	2.2	2.3	2.0
Australia	2.8	2.4	2.5	1.8	2.7	2.7
China	7.4	6.9	6.7	6.7	6.5	6.3
Trading Partners	3.7	3.5	3.4	3.4	3.5	3.3
NZ Financial Markets (end of Dec quarter)						
TWI	79.4	73.7	76.1	74.7	71.2	
NZD/USD	0.78	0.69	0.69	0.70	0.67	
NZD/AUD	0.96	0.94	0.96	0.96	0.94	
Official Cash Rate	3.50	2.50	1.75	1.75	2.25	2.75
10-year Bond Rate	3.7	3.6	3.3	2.8	3.3	3.3

* Forecasts and text finalised 10 July 2017

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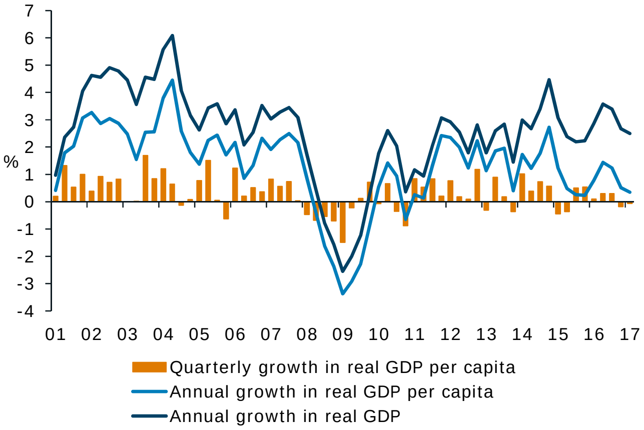
SUMMARY

Momentum is picking up from a lull over late-2016 to early-2017. This pickup will be modest, with the economy facing capacity constraints and late-cycle economic challenges, two of which are finding skilled labour and keeping excesses in check. However, business and consumer confidence are elevated, the terms of trade buoyant, fiscal policy is set to turn more expansionary, financial conditions supportive, tourism booming and migration strong. Our forecasts depict an economy growing at a pace strong enough to continue to gradually absorb spare capacity. But it's a solid, rather than stellar story. Core inflation will slowly rise, and interest rates too.

STILL WIND IN THE SAILS

The economy experienced a disappointing mark rounding as 2017 got underway. March quarter GDP growth of just 0.5% q/q, followed growth of 0.4% q/q in Q4. Mother Nature may have played a part, but it is still undeniably sub-par. In fact, the economy actually contracted modestly in per capita terms, with annual per capita growth now sitting at just 0.3% y/y. After what was a reasonably decent performance over the majority of 2016, in America's Cup parlance, the economy "came off the foils". This was despite many leading indicators (like business and consumer confidence) continuing to provide positive signals. A perplexing divergence has opened up between 'hard' and 'soft' data of late, with the former flagging 4% annual growth and only 2.5% being achieved.

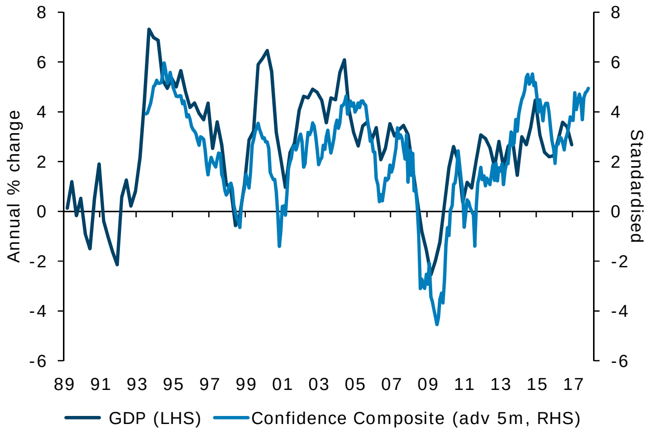
FIGURE 1. REAL PER CAPITA GDP GROWTH



Source: ANZ, Statistics NZ

This hard-soft data divergence is certainly not unique to New Zealand. Many economies are struggling to achieve the rates of growth typically seen historically. Weak productivity, elevated debt levels, unfavourable demographics, poor policy manoeuvrability and political risks are big headwinds to surmount. Reality is often failing to meet (perhaps historically skewed) expectations.

FIGURE 2. GDP VS CONFIDENCE COMPOSITE



Source: ANZ, Statistics NZ

But we are remaining 'loyal' to the economic story. We expect growth to accelerate in Q2 and Q3 (to an average pace of 0.9% q/q), which in part reflects some technical factors (particularly a recovery in net exports after dragging by an average of 1.0%pt per quarter over the past three quarters, and a reduced drag from the initial introduction of LVR restrictions), as well as a belief that the positive directional signals from a number of our forward indicators (confidence composite, Truckometer etc) still has some validity.

There are numerous helpful tailwinds:

- **Financial conditions are supportive.** The elevated NZD is being offset by a strong terms of trade. Auckland house prices have hit the reverse button (falling 2.6% since January) but the rest of New Zealand is still seeing decent growth (up 3% over the same period). Credit growth is slowing, but it's a tempered moderation.
- **The terms of trade is set to hit all-time highs.** Unlike previous terms of trade surges, this one has a more fundamental feel about it. Manufacturing and technology-based goods are the new commodities; we import those. We are seeing evidence of a moving up the export value added chain (pipfruit, dairy, kiwifruit for example). While, as highlighted on page 7, we see some near-term risks to dairy prices on the back of seasonality and stronger local supply, and the recent rout in oil prices presents some risks of contagion, we remain upbeat on the price outlook for New Zealand's broader export commodity basket.

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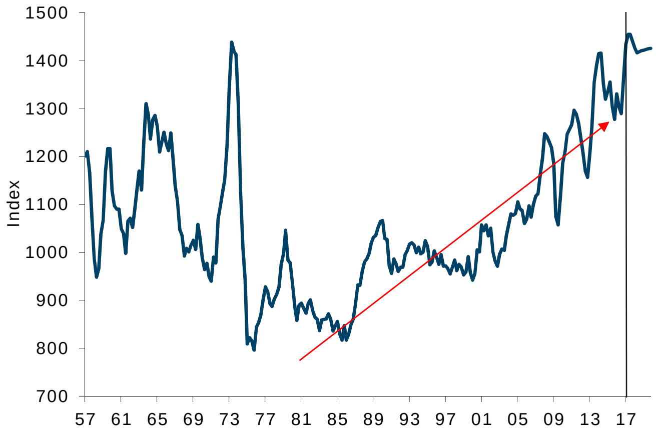
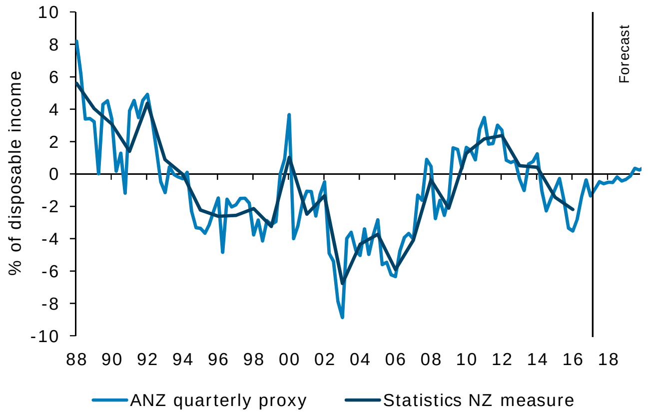
FIGURE 3. TERMS OF TRADE (OTI)



Source: ANZ, Statistics NZ

- **The policy platform remains robust.** The microeconomic policy agenda has been slowly ticking away, and there are clear signs that it is now being reflected in some macroeconomic data (terms of trade – we are exporting more value-add products; labour market – record high participation rate).
- **Migration; New Zealand is still the place to be.** Net migrant inflows are equivalent to 1½% of the population. That's a massive tailwind, although it is creating infrastructure and housing challenges. While immigration criteria are being tightened domestically, Australia and the UK are making it harder for New Zealanders to go offshore. We assume migration holds at an annual pace of around 70k well into 2018, before easing towards around 55k by the end of 2019.
- **Fiscal policy will turn expansionary in FY18 and FY19.** Infrastructure spending is a priority. The $2bn Family Income Package will put additional money in the pockets of households most likely to spend it. With the Government books in order (OBEGAL surpluses projected towards 1½% of GDP), a war-chest has been built up and it will be redeployed.
- **Some large sectors** (i.e. tourism) **and formally boutique sectors** (pipfruit, kiwifruit) **are doing extremely well.** The former supported by more and more airlines flying direct to New Zealand, and bringing 'higher value' tourists, while the latter is supported by a number of industry initiatives to derive higher margins/profits.
- **Solid household income growth should support spending.** We estimate that household disposable incomes grew in excess of 5% over 2016 and we see growth broadly holding around that level over the next few years. While wage growth has been subdued, the reality is that overall labour income has lifted solidly given the strength in employment and also hours worked per person. And on wage growth specifically, we believe we are on the cusp of a turning point, with higher CPI, skill shortages, and government policy changes (age-care gender settlement) portending to a lift off low levels. Even with our assumption that the household saving rate trends modestly higher, real household consumption is forecast to grow 3.9% and 2.8% in 2017 and 2018 respectively.

FIGURE 4. HOUSEHOLD SAVING RATE



Source: ANZ, Statistics NZ

- **The construction pipeline is considerable.** The construction sector dragged on growth for the first time in close to two years in Q1. That was driven by across-the-board weakness, with perhaps poor weather impacting on work done. While we are cautious regarding the near-term residential growth outlook given capacity and capital constraints (discussed more below), the pipeline of non-residential and infrastructure work remains large and is only growing larger as the population expands (and we host world sporting events!).
- **Broader business investment growth should remain solid.** Admittedly, Q1's 13% quarterly growth in plant and machinery investment won't be sustained, but the underlying pace of investment (beyond just construction) should remain strong. Although firms' profit margins are perhaps beginning to tighten, we estimate that they remain elevated overall. And with firms struggling to find staff, business investment will lift to help contend with capacity pressures. We forecast other fixed asset investment of 5.1% and 4.3% in 2017 and 2018 respectively.

The "worry" variables are also less worrying. Historically, New Zealand's business cycle has come to an abrupt end as the combination of valuation excesses, leverage build-up, inflation, and current account profligacy result in a correction. While we have

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some excesses in the Auckland property market, and households have been leveraging again (debt has lifted from 159% to 167% of income), this is being offset by LVR restrictions and tighter credit conditions. Inflation is low so the OCR will remain the same for a while yet, and the current account is contained at 3% of GDP (which is where we see it broadly holding).

BUT IT WON'T BE ALL PLAIN SAILING; THE FORECAST IS STILL FOR SOME UNSETTLED CONDITIONS

Skill shortages are crimping the economy's ability to grow. Finding skilled labour is firms' biggest problem according to our Small Business Microscope. Migration and rising labour force participation are helping to alleviate pressure. However, the former now faces political kick-back. There is still an intensifying mismatch between the skills firms require and the skills labour currently possesses. That is certainly not unique to New Zealand in a world of dramatic technological change, but it does present challenges for policymakers, the education system and firms themselves.

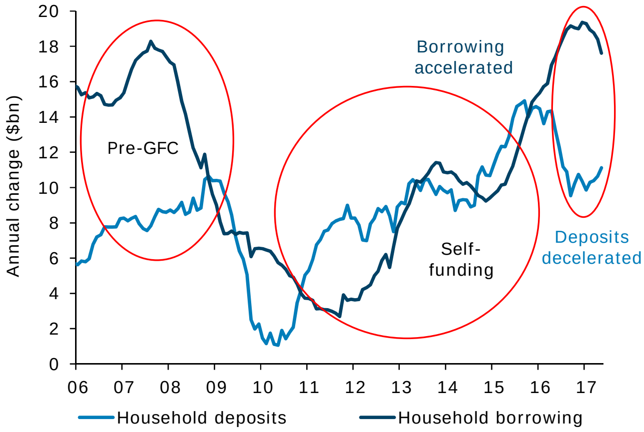
Finding skilled labour and associated fall-out for wage demands will become a more relevant issue over the coming years. A strong focus on productivity will be critical if we are to avoid real wage movements undermining competitive positions.

Policymakers are being more proactive with prudential policy to cool the housing market. The latest round of LVR restrictions has slowed the property market (in Auckland especially) and more prudential options are being put on the table. Debt-to-income limits are being proposed and the RBNZ is looking at bank capital requirements. There is always the risk that interventions carry more cons than pros. However, removing excesses (if policy is well targeted) dilutes the potential for an adverse correction and takes pressure off the RBNZ to use its primary weapon, namely the OCR. That helps exporters.

More broadly, the credit cycle has turned. Annual growth in private sector credit has slowed from 8% to 6%; which is only now on par with national income growth and further slowing is likely. We view that as a positive. Credit booms tend to be followed by busts. New Zealand had started to show some behaviours of old, with investment needs increasingly being financed by offshore borrowing (reflected in a bank funding gap), and this is now starting to place pressure on the current account deficit, which widened in the March quarter.

We are seeing credit being rationed and there is pressure for deposit rates to rise. Both are necessary if the bank funding gap is to close and the current account to remain in check. The former takes away the punchbowl and makes investment projects more difficult to get off the ground. The latter ends up with borrowing rates rising too as the playing field turns more in favour of savers.

FIGURE 5. BANK HOUSEHOLD FUNDING AND CLAIMS GROWTH



Source: ANZ, RBNZ

Ultimately, saving performance will need to lift to fund investment demands. New Zealand's historical modus operandi of funding a domestic saving shortfall through increased overseas borrowing is now facing more challenges and scrutiny from the regulator and credit rating agencies. At a time when the economy's investment pipeline remains large, more onus will have to fall on domestic saving to ensure investment is not crimped aggressively (unless the current account is set for a blowout). While the current account deficit is certainly not alarming and could conceivably widen a little further without too much trouble, it would not be in the economy's best interests to see it widen back to levels where it has often got to in the past.

But there is a trade-off with this; more saving means less spending and growth up front. Admittedly, this is not something that is driving our cyclical year-on-year views. However, it is a theme that will become increasingly relevant for the long-haul. While some obvious levers with regards to lifting saving are being pulled (growing incomes), attention will need to turn to housing, and its tax treatment relative to other asset classes, to get a lasting improvement.

Beyond this, there is also no shortage of candidates globally to throw up some stormy conditions. Growth is respectable, but not reflationary. Market volatility is remarkably low (but rising) despite considerable policy uncertainty. When policy uncertainty is high, firms typically choose to delay putting cash to work, which creates a growth void. On top of this, persistent structural questions remain regarding poor productivity, excessive leverage, misallocated investment, less favourable demographics, political polarisation and a lack of policy manoeuvrability. While one could view the recent hawkish shift in tone from some key central banks as a positive thing (we do in many ways – the world needs to be weaned off the abundant liquidity conditions seen over recent years), it speaks of more uncertainty, volatility and headwinds for 'risk' assets. It will be a delicate balancing act, and plenty will have to go right to ensure things don't go wrong.

A STEADY BEAT

We are expecting the economy to sail on a relatively steady beat. GDP growth is forecast to run at an annual pace of around 3% over the next 18 months (in fact quarterly annualised growth is expected to be stronger in the near-term). After growth of 3.1% over 2016 as a whole, 2017 growth is forecast to average 2.8% in 2017 and 3.0% over 2018. It is a pace of activity momentum that should:

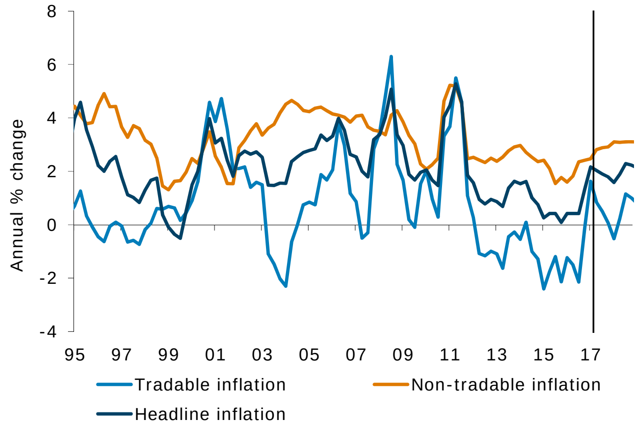
1) continue to see the unemployment rate gradually trend lower (which we see falling to 4.4% by the end of 2018 even though labour supply growth should also remain strong); and

2) result in spare capacity continuing to gradually be absorbed (we place trend growth at around 2¾%).

We see inflation pressures slowly broadening. Some measures of core inflation are already at the target mid-point of 2%. However, it is not a broad-based story, and still largely contained to housing. But we do see that gradually changing. The Phillips Curve (the relationship between inflation and spare capacity) has flattened a lot, but it is not flat. With wage growth forecast to lift off lows, non-tradable inflation should rise too. After averaging 2.0% over 2016, non-tradable inflation is forecast to average 2.8% and 3.1% over 2017 and 2018 respectively.

But there will be plenty of factors that throw headline inflation around. Although non-tradable inflation is forecast to lift, headline inflation looks set to fall back into the lower half of the RBNZ's 1-3% target band over the coming 12 months. This is largely due to the recent plunge in oil prices. While recent lifts in food prices are consistent with the broader soft commodity picture, they also reflect disruptive summer/autumn weather conditions, and some of that should at least partially unwind. There also remain plenty of questions over the global inflationary impulse. That said, headline inflation is forecast to average 2.0% in both 2017 and 2018.

FIGURE 6. CPI INFLATION FORECASTS



Source: ANZ, Statistics NZ

The OCR will head gradually higher. Time remains on the RBNZ's side given little sign of broad-based inflation pressure. The RBNZ will want to see the whites of inflation's eyes before tightening, given two false starts. Yet, we expect the RBNZ to hike in mid-2018 and the OCR to end up at 2.75% by the end of 2019, which is still incredibly low by historical standards.

INTERNATIONAL OUTLOOK

SUMMARY

The acceleration in growth seen in many economies over the past year is looking more self-sustaining, and our forecasts depict a steady picture for global growth heading into 2018. Attention is now turning to the inevitable winding down of QE excesses. That presents challenges, although we view it in a positive light. But a likely pick-up in volatility as the liquidity cycle turns, together with political polarisation, limited policy manoeuvrability, elevated leverage and poor productivity growth is a potent mix. A lot will need to go right for things not to go wrong.

STEADY GROWTH, BUT PLENTY OF QUESTIONS

The global economy is in a broad-based expansionary phase. Growth has accelerated in Europe and momentum in the US is lifting after a soft start to 2017. Global PMIs and various leading indicators are all pointing towards solid growth. China continues to perform well and momentum across the broader Asian region is respectable. Unemployment rates are generally trending lower.

But it's recovery rather than reflation. Growth across developed economies is barely sufficient to generate stronger inflation. The impact of technology, and more recently a turn south in some commodities, is also weighing on the inflation pulse. Commodity price weakness doesn't provide a strong growth signal, even if it does in part reflect supply issues. With developed economies now past the demographic hump (peak in the working population as a share of the total population), the credit accelerator model now defunct, and productivity growth poor, what growth there is, is of the 'hard graft' variety.

That said, central bank attention is slowly swivelling to the removal of policy stimulus. There is not enough growth to generate stronger inflationary pressure, but continued excess stimulus is creating financial stability risks and those risks are increasingly being noted by central banks, as well as the BIS. The US Federal Reserve was first out of the blocs (lifting rates and likely paring back its balance sheet in H2 2017), but the ECB is also inching closer to the exit door and China is deleveraging.

The global liquidity cycle – a huge source of stimulus to real assets – is set to turn, and with that we'll see an associated pick-up in volatility.

We view this shift in a positive light. Ultra-stimulatory monetary conditions have led to excessive leverage, a mispricing of risk and a misallocation of capital. A return to more normal conditions should be encouraged.

But a turn in the liquidity cycle will present challenges. Asset valuations are rich. When the liquidity cycle turns, market attention will shift towards economic fundamentals and growth. Growth is respectable but not strong, which will make the transition delicate. It will also be a tricky balancing act for policymakers wanting to avoid market unease while not being held hostage to markets either. Policy removal will be sporadic and uneven.

And the global economy is still vulnerable on many levels. 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.

Additionally, policy uncertainty is high, and this risks stalling investment. When uncertainty is high, the time value option for firms is to defer. There is a strong undercurrent of resentment within the electorate and this is manifesting in political outcomes. A number of factors are at play: angst towards globalisation and capitalism, income inequality, technology replacing real jobs and a fall in labour share of income (the economic pie). That will shape economic policy direction as a new form of capitalism takes shape within economic agendas.

Across key geographies, we are positive on the US etching out respectable growth with signs the economy is reaching full employment. Europe's recovery looks more self-sustaining, but constrained by structural rigidities. China is expected to hit its growth target of 6.5% and continue to transition away from investment-centric growth towards service and consumer based activity. Australia continues to muddle through, although concerns linger over housing-related excesses.

So while our forecasts present a steady global growth picture, risks are downwardly skewed.

Calendar Years (annual average % change)	2013	2014	2015	2016	2017(f)	2018(f)	2019(f)
United States	1.7	2.4	2.6	1.6	2.2	2.3	2.0
Australia	2.1	2.8	2.4	2.5	1.8	2.7	2.7
Japan	2.0	0.2	1.1	1.0	1.4	0.8	1.0
Euro Zone	-0.2	1.3	1.9	1.7	1.8	1.7	1.5
China	7.7	7.4	6.9	6.7	6.7	6.5	6.3
Trading Partner Growth	3.1	3.7	3.5	3.4	3.4	3.5	3.3

PRIMARY SECTOR OUTLOOK

SUMMARY

The cyclical upturn in New Zealand's soft commodity export prices has matured. But we are not expecting a sharp turn lower. Dairy cash flow prospects look much better into mid-2018. Meat returns are exceeding expectations, but volumes are lower. There were smaller kiwifruit and grape crops, but a larger pipfruit harvest. Price prospects are strong for kiwifruit and steady for wine and pipfruit. Forestry prices continue to be robust, driven by China and local demands.

Many forces that drove the strong cyclical upswing in global and New Zealand export prices have now matured, or are fading. In some cases prices are becoming too stretched, risking substitution occurring. Global economic momentum has matured with political uncertainty high. Oil (a commodity bellwether) has retraced to below ~US$50/bbl and other parts of the commodity complex have seen prices recede. This raises the question of whether New Zealand's basket is set for a correction.

For New Zealand's main exports it feels like an upper range is nearing for many, but a substantial pullback doesn't seem imminent either. For many sectors, while supply is anticipated to improve modestly, it is expected that markets will be able to absorb increases with generally low inventory levels and solid end-demand in many cases. Depending on the extent of supply improvements and seasonal conditions this could weigh on in-market prices at certain times, but an offset for farm-gate prices in many cases is expected to be a capped NZD with expectations the liquidity cycle has turned and so too prospects for the carry trade (a major support factor).

Cash flow prospects for the dairy sector are set to shift from the high-$5/kg MS to mid-to-high $6/kg MS in 2017/18. The improvement is being spent on increased cyclical expenditure (supplementary feed, grazing etc), debt repayment, catch-up in deferred maintenance and capital spending especially to meet new compliance requirements.

In terms of in-market prices we broadly expect a continuation of the 2016/17 trends. We expect skim milk powder prices to remain capped by record-high intervention stocks, high in-market inventory levels and Europe/US continuing to focus on a SMP/milkfat mix. Milkfat prices are expected to stay at record highs until late in 2017 before moderating as buying pressure from the holiday consumption period subsides. Whole milk powder has been trading in a broad US$2,800/t to US$3,400/t range since September last year. Broadly speaking, our view is that Chinese and Middle East demand will absorb the anticipated increase (2% to 3.5%) in New Zealand supply, especially with buyers reportedly currently buying hand to mouth.

With the NZD/USD trading a broad range of 0.68 to 0.73 **this indicates a high-$5/kg MS to high-$6/kg MS range for 2017/18. We are currently at the top of this range at $6.75/kg MS.** If supply increases more than expected due to conducive weather conditions this could push estimates back toward the bottom of this band.

Farm-gate lamb prices are pushing toward the high $6/kg. They are expected to hold through to early summer before moderating back to the low-to-mid $5/kg mark. An improvement in Australasian lamb supplies is expected later in 2017. That said, an overall steady demand backdrop, low frozen inventory levels, and the fact the increase is off near all-time lows in NZ is expected to see the market absorb the increase. **Venison is pushing toward new highs** with very low New Zealand supply and hot demand, especially from diversification into the US. **Beef prices are buoyant, but we are cautious with supply from both the US and Brazil set to increase** more aggressively into 2018. While demand indicators look robust across a range of markets, the size of the increase and Australasian supply biased higher points to lower prices in 2018. Wool prices continue to struggle.

Green kiwifruit prices are expected to bounce back toward $6/tray and SunGold to move above $9/tray this season. For Green, improvement is driven by a better marketing mix oriented toward Asian markets with substantially lower New Zealand supply. Lower Italian production is also expected to support returns from Europe and American countries. **For wine, a strong export performance, especially to North America in 2016/17, combined with a smaller crop in 2017 will allow wine exporters to be choosier in 2017/18.** This, combined with lower bulk wine exports through the secondary market, should support average earnings per bottle for wineries. **In the pipfruit sector a large crop was picked (+7%). The price outlook is a little more mixed** depending on the supply-demand balance for each variety and timing of harvest.

Log prices continue to be supported by Chinese demand with port-level inventory and offtake continuing to track favourably. The Chinese government has also announced lower tariffs on logs in a bid to curb the use of logs from their own native forests. Local demand has experienced the usual seasonal slowdown, but unpruned demand for structural timber and posts/polls remains strong for construction activity and horticulture expansion. Supply is set to lift toward 32.5 to 35 million m^3 over next 10 years (5-year average ~ 29 million m^3).

FINANCIAL MARKETS OUTLOOK

SUMMARY

With the RBNZ on hold for the next year or so, local short end yields should remain anchored. A notable shift in the tone from a number of major central banks has seen long-end bond yields snap higher, resuming what is expected to be a slow upward move. As this occurs, the New Zealand yield curve should steepen and the NZ/US spread will compress further. In currency markets, we expect the NZD to weaken modestly from current elevated levels as economic and financial relativities between New Zealand and the remainder of the G10 start to level out, the liquidity cycle turns, and as G4 policy normalisation weighs on risk appetites and carry trades. Compared to past cycles, the NZD's decline should be modest.

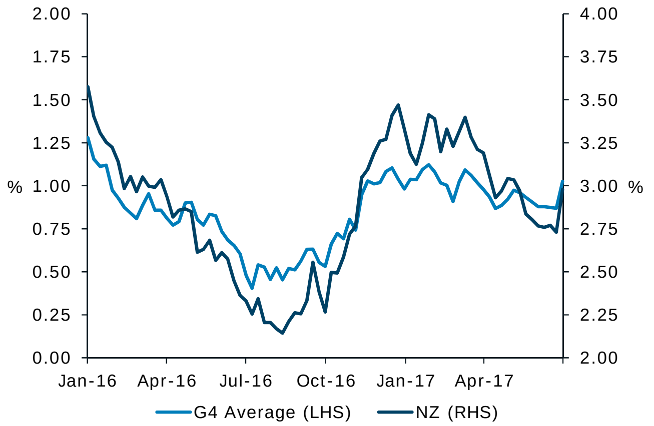
SHORT END STILL ANCHORED

Short-end interest rates are expected to remain anchored around current levels until early 2018 as the RBNZ remains on hold. Core inflation is low and the economy is barely growing at trend. Housing-related excess are moderating as prudential policy and tighter lending criteria bite. Both deposit and lending rates have risen, in effect doing some of the RBNZ's work for it. We expect to see short-end rates range trade, with 2 year bond yields holding between 2% and 2.2% between now and the end of the year.

We expect the RBNZ to lift the OCR in mid-2018. While modest recently, we see the momentum accelerating and the economy growly strongly enough to put upwards pressure on core inflation. A key area we expect inflationary pressure to manifest is via the labour market (wages) in early 2018.

But prospects are for a muted and gradual tightening cycle. We expect the OCR to slowly grind to 2.75% by the end of 2019, in broadly two x 25bps OCR hikes per year.

FIGURE 1: "G4" 10 YEAR BOND YIELDS



Source: ANZ, Bloomberg

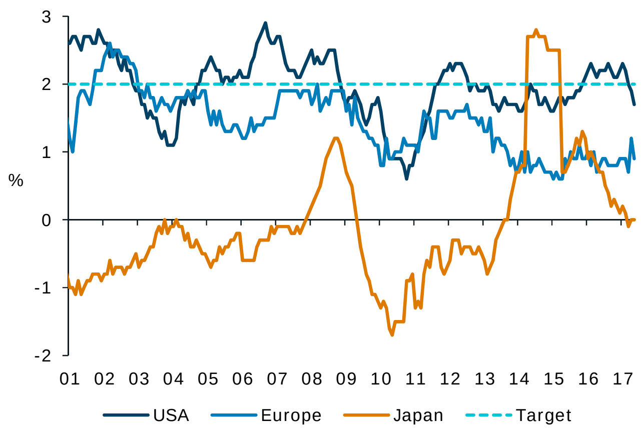
LONG END DONE WITH DOWN, NOW UP

After trending down over most of 2017, bond market price action has turned bearish of late, and is more aligned with the fundamental backdrop (of accelerating momentum across the developed economies, firming policy rates and tightening liquidity conditions). Inflation remains absent from the mix, but like most central banks, our forecasts assume it will rebound after a transitory deviation from target.

While 'economic' factors have played a role, the lift has partly been in response to a chorus of central banks signalling an end to easy monetary policy and abundant liquidity. The ECB is inching closer to the exit door, divisions are apparent at the BoE (with a 5-3 vote to hold) and China is deleveraging.

But it is the US Federal Reserve that has been at the forefront of the change in tone, having detailed how it intends to progress with reducing its balance sheet, and confirming that this process will begin before the end of 2017. Near term balance sheet reduction is likely to supplant the need for the Fed Funds rate to rise. As such, our forecasts assume that the Fed kicks off the balance sheet reduction process in September while leaving rates on hold, resuming rate hikes in December. All else equal, we expect this to be slightly less negative for bonds than pressing ahead with rate hikes would have been, especially with core inflation still well below target and falling in the US and Japan (and well below target despite encouraging signs of a lift in Europe – Figure 2).

FIGURE 2: US, EUROPE AND JAPAN CORE INFLATION



Source: ANZ, Bloomberg

WINNERS AND LOSERS

As the Fed inches closer to trimming its balance sheet and the global liquidity cycle turns, an obvious question to ask is; **which asset classes will be the most affected?**

FINANCIAL MARKETS OUTLOOK

We assume the impact will be more heavily felt by riskier assets. The impact on bonds will likely be cushioned by allocations out of equities and property and into bonds or other less risky assets. As we discuss below, the New Zealand dollar itself also falls into the category of 'risky' given the role played by carry, and the recent strong performance of domestic equities and property. While our forecast for a weaker NZD does leave us somewhat cautious about local long term interest rates given the role played by offshore investors (the bulk of which is unhedged), on balance we think this is offset by the RBNZ's neutral policy outlook.

In terms of forecasts specifically, we expect the US 10 year rate to rise to 2.3% by the end of 2017 and to 2.9% by the end of 2018. The 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 the end of 2017. However, as US rates move higher at a slightly faster pace over 2018, and the market looks towards the RBNZ hiking broadly in step with the Fed, we expect spread compression to cease and for New Zealand long-end yields to move up in step with US rates.

We expect NZ 10 year yields to gravitate to 3.3% by the end of the forecast period.

JUSTIFIABLE STRENGTH FADING

The NZD has performed strongly of late, driven by commodity prices, low volatility and investors looking for sound policy direction and stability, having been frustrated with economies besieged by the anger/resentment vote. The USD is the clearest case in point, having rallied hard into the end of 2016, only to have faltered over 2017.

Looking ahead, we expect the NZD to be supported by still strong credentials. New Zealand's terms of trade are at their highest level since the 1970s. Growth is respectable and volatility is contained (for now). Carry remains positive thanks to the highest interest rates (across the curve) in the G10.

However, our forecasts also acknowledge that New Zealand's erstwhile "clear #1" positon across a number of key "relativities" is being challenged. For example, after many years of being the fastest growing economy in the G10, New Zealand has relinquished that crown to Canada (Figure 3).

Interest rate differentials remain an absolute advantage, but the comparative advantage is slipping, with just 0.5%pts separating NZ and US policy rates. This spread was as high as 3.25%pts just two years ago.

FIGURE 3: GLOBAL MACRO AND FINACIAL SCORECARD

CATEGORY	NZD	AUD	USD	CAD	GBP	EUR
Economic Growth	2.5%	1.7%	2.1%	3.3%	2.0%	1.9%
Annual Inflation	2.2%	2.1%	2.1%	1.3%	2.9%	1.3%
Policy Rate	1.75%	1.50%	1.25%	0.50%	0.25%	0.00%
10yr Bond Yield*	3.0%	2.6%	2.3%	1.8%	1.2%	0.5%
Unemployment	4.9%	5.5%	4.3%	6.6%	4.6%	9.3%
C/A Balance % GDP	-3.1%	-0.7%	-2.4%	-3.1%	-3.9%	3.4%
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

Policy tides are also shifting, and the unwind of the US Federal Reserve's balance sheet, together with a cautious beginning to normalisation in Europe, will represent a key turning point for the liquidity cycle. This will likely dominate markets in the latter part of 2017 and into 2018. The case for further interest rate normalisation is weakening given core inflation measures continue to undershoot and a major driver of headline inflation (oil) has fallen 20%, creating a deflationary pulse. However, central bank attention is increasingly focused on stability risks and this means reducing balance sheets / winding down QE largesse. That means a turn in the credit pulse.

As liquidity is wound back, we expect volatility to increase, and for broad USD strength to re-emerge. A key reason for this is because broad USD weakness was the major identifiable trend that coincided with increased liquidity. Volatility will also play a role. **As we look towards the back end of 2017 and into 2018, market volatility is almost certain to rise; and the USD will once again find its footing** – but for a different reason. Not because of strong growth and exceptional policy divergence but rather because of a rise in risk aversion. This will drive a different sort of USD rally.

In Europe, the ECB upgraded its forward guidance at its June meeting, removing the reference to the possible need for lower interest rates in the future. Effectively, that was a formal acknowledgment that deflationary risks have receded materially. The need for ongoing depreciation in the exchange rate, as part and parcel of policies to fight deflation, is also therefore reduced. That said, our forecasts show recent EUR strength not being maintained, consistent with our belief that even though the ECB has shifted more hawkish, it is still a long way away from actually tightening policy (unlike

FINANCIAL MARKETS OUTLOOK

in the US). Political risks linger in the region too. It is not really until 2019 where we suspect EUR strength will re-emerge. In the UK, GBP continues to show signs of stabilising against the backdrop of an improving current account deficit, rising inflation, and more hawkish BoE rhetoric.

INDIVIDUAL CURRENCY PAIRS

NZD / USD: On borrowed time. 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 on New Zealand, and as USD strength re-emerges.

NZD / AUD: Elevated. Assumed to hold steady around 0.95 over the next year or so, with both central banks on hold, and the data/policy pulse changing more materially in the US, UK, Canada and Europe. We wouldn't rule out a test of parity though.

NZD / EUR: Opposing policy bias. Recent EUR/USD strength is not expected to be maintained, and with NZD/USD also forecast to ease modestly, this cross is projected to be broadly stable over the coming 12 months or so. It is not until EUR strength re-emerges, over 2019, that sees this cross push lower towards the mid-50s by mid-2019.

NZD / GBP: Sterling Silver Vaults. Our forecasts reflect the combination of a weaker NZD and a stronger GBP as markets look to an earlier start to policy normalisation in the UK.

NZD / JPY: Less vulnerable. USD/JPY is assumed to resume trending down towards 100 through a combination of valuation, and our expectation that a peak in global liquidity and rise in market volatility will drive a renewed home bias to Japan, despite persistent low rates. That takes NZD/JPY down to 67 by the end of 2018.

Forecasts (end of quarter)							
FX Rates	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
NZD/USD	0.72	0.70	0.69	0.68	0.67	0.67	0.66
NZD/AUD	0.97	0.96	0.96	0.94	0.94	0.94	0.94
NZD/EUR	0.63	0.63	0.63	0.65	0.63	0.61	0.57
NZD/JPY	82.8	78.4	75.9	71.4	67.0	67.0	66.0
NZD/GBP	0.55	0.55	0.55	0.55	0.54	0.54	0.51
NZD/CNY	4.97	4.87	4.81	4.75	4.69	4.70	4.63
NZ$ TWI	76.1	74.7	74.1	73.5	71.8	71.2	69.3
Interest Rates	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19
NZ OCR	1.75	1.75	1.75	2.00	2.25	2.25	2.25
NZ 90 day bill	1.98	1.99	2.08	2.33	2.50	2.50	2.59
NZ 2-yr swap	2.24	2.26	2.31	2.45	2.58	2.63	2.68
NZ 10-yr bond	2.80	2.80	2.85	2.95	3.15	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	3.1	2.8	3.0	2.4
Private Consumption	3.3	3.1	2.9	4.1	3.9	2.8	2.5
Public Consumption	1.4	3.3	2.6	2.4	3.0	1.3	1.2
Residential investment	17.5	10.9	2.0	11.0	0.2	-2.9	0.6
Other investment	5.2	7.5	2.2	3.7	5.1	4.3	4.7
Stockbuilding[1]	-0.2	0.4	-0.3	0.0	0.1	-0.1	0.0
Gross National Expenditure	3.6	4.2	2.3	4.0	3.7	2.4	2.6
Total Exports	0.8	3.1	6.9	1.9	0.8	5.0	3.4
Total Imports	6.2	7.9	3.8	3.3	5.2	3.1	2.9
Employment (annual %)	2.9	3.6	1.4	5.8	2.5	1.4	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	5.6	-1.4	0.4
Prices (annual % change)							
CPI Inflation	1.6	0.8	0.1	1.3	1.8	2.2	2.0
Non-tradable Inflation	2.9	2.4	1.8	2.4	2.9	3.2	3.1
Tradable Inflation	-0.3	-1.3	-2.1	-0.1	0.0	1.0	0.4
REINZ House Price Index	9.7	9.5	16.0	14.3	0.6	2.0	2.8
Fiscal and External Balance							
Current Account Balance ($bn)	-7.0	-7.7	-8.0	-7.2	-8.3	-7.6	-7.7
as % of GDP	-3.1	-3.2	-3.2	-2.8	-3.0	-2.6	-2.6
Government OBEGAL ($bn)*	-4.4	-2.8	0.4	1.8	2.1	3.3	4.0
as % of GDP	-2.0	-1.2	0.2	0.7	0.8	1.2	1.4
NZ Financial Markets (end of December quarter)							
TWI	77.3	79.4	73.7	76.1	74.7	71.2	
NZD/USD	0.82	0.78	0.69	0.69	0.70	0.67	
NZD/AUD	0.92	0.96	0.94	0.96	0.96	0.94	
NZD/CNY	4.98	4.86	4.45	4.81	4.87	4.70	
NZD/EUR	0.60	0.64	0.63	0.66	0.63	0.61	
NZD/JPY	86.3	93.6	82.5	81.1	78.4	67.0	
NZD/GBP	0.50	0.50	0.46	0.56	0.55	0.54	
Official Cash Rate	2.50	3.50	2.50	1.75	1.75	2.25	2.75
90-day bank bill rate	2.84	3.68	2.75	2.00	2.00	2.50	3.01
2-year swap rate	3.85	3.80	2.85	2.46	2.26	2.63	2.84
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

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