ANZ Research October 2018

Quarterly Economic Outlook

In the driver's seat

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New Zealand economic outlook

The economy is undergoing a transition. Previous engines of growth are not revving as they once were and the economy is facing headwinds. In our view, the economy will struggle to grow above trend and acceleration in GDP growth from here seems unlikely. Based on our expectation that GDP will grow 2½-3% y/y, we expect it will be difficult to sustain inflation near 2% y/y over the medium term. Headline inflation looks set to rise, but much of this will be transitory and the RBNZ will look through it. We currently see the OCR on hold for the foreseeable future; the RBNZ has time to see how conditions evolve. But given the risks of an eventual growth sputter, we see it as more likely that the next move is a cut than a hike.

International outlook

Global growth is gradually moderating but remains solid. Growth in China is expected to soften gradually but remain robust. In Australia, growth remains strong, but weakness in the housing market presents potential downside risk. The US economic expansion continues apace, supporting further gradual policy normalisation by the Federal Reserve. So far, the global economy has been fairly resilient in the face of tightening global liquidity and trade tensions that have become entrenched. Nonetheless, the outlook is a little softer around the edges and risks remain that could have flow on effects to New Zealand.

Primary sector outlook

Global commodity markets appear finely balanced at present. While the lower NZD is providing some support, farm-gate returns are looking a little less rosy than previously. We have revised down our milk price forecast for the 2018/19 season by $0.35 to $6.40/kg MS. But subject to demand holding up, we see market conditions tightening a touch into 2019. That said, downside risks to the outlook have intensified. For now, the global backdrop remains supportive – commodity prices remain elevated overall – but caution is warranted.

Financial markets outlook

The RBNZ continues to signal it wants to be late to the global rate hiking party, or a no-show altogether. That is keeping the short end anchored and driving a meaningful outperformance of the long end, especially with US yields grinding higher. While local long-end yields are now looking fully priced, and so the hurdle for further outperformance is higher, if the RBNZ decides to cut, we see no reason why yields could not fall to historical lows. The NZD is being impacted by similar themes as well as a softer outlook for the terms of trade. Together with tightening global liquidity, we expect the NZD/USD to reach 0.61 by early next year.

Calendar Years	2015	2016	2017	2018(f)	2019(f)	2020(f)
New Zealand Economy						
Real GDP (annual average % change)	3.6	4.0	2.8	2.7	2.6	2.4
Real GDP (annual % change)	3.1	3.4	2.9	2.5	2.6	2.3
Unemployment Rate (Dec quarter)	5.0	5.3	4.5	4.4	4.2	4.1
CPI Inflation (annual %)	0.1	1.3	1.6	2.2	1.6	1.6
Terms of Trade (OTI basis; annual %)	-3.1	6.7	7.9	-6.3	2.8	0.8
Current Account Balance (% of GDP)	-2.8	-2.2	-2.9	-3.6	-3.5	-3.8
Government OBEGAL (% of GDP)*	0.2	0.7	1.5	1.9	-0.2	0.9
NZ Financial Markets (end of Dec quarter)						
TWI	73.7	76.1	73.0	66.3	61.9	..
NZD/USD	0.69	0.69	0.71	0.62	0.61	..
NZD/AUD	0.94	0.96	0.91	0.90	0.87	..
Official Cash Rate	2.50	1.75	1.75	1.75	1.75	..
10-year Bond Rate	3.57	3.33	2.72	2.70	2.90	..

* June years
Source: Statistics NZ, REINZ, Bloomberg, ANZ Research

New Zealand economic outlook

Summary

The economy is undergoing a transition. Previous engines of growth are not revving as they once were and the economy is facing headwinds. Uncertainty and financial constraints are making firms wary about investing, despite resource pressures. And there is a risk that households follow suit and rein in their spending as the housing market continues to cool. In light of these challenges, sputtering growth is a key risk, although it is not currently our expectation. Fiscal policy is expected to provide a positive impulse, net exports are expected to contribute to growth (in part related to a lower exchange rate), and business conditions are expected to improve. At the same time, low interest rates remain supportive and the terms of trade is favourable, despite losing some shine of late. In our view, the economy will struggle to grow above trend and acceleration in GDP growth from here seems unlikely. Based on our expectation that GDP will grow 2½-3% y/y over the forecast horizon, we expect it will be difficult to sustain inflation near 2% y/y over the medium term. Headline inflation looks set to rise, but much of this will be transitory and the RBNZ will look through it. We currently see the OCR on hold for the foreseeable future; the RBNZ has time to see how conditions evolve. But given the risks of an eventual growth sputter, we see it as more likely that the next move is a cut than a hike.

Not firing on all cylinders

Economic growth has been decelerating. Annual GDP growth was 2.8% in the June quarter, down from 4½% in mid-2016. In quarterly terms, growth was strong in Q2, but this pace is not expected to be sustained, with the economy having entered a new phase. Previous growth drivers are no longer providing such an impetus to growth and the economy is facing headwinds.

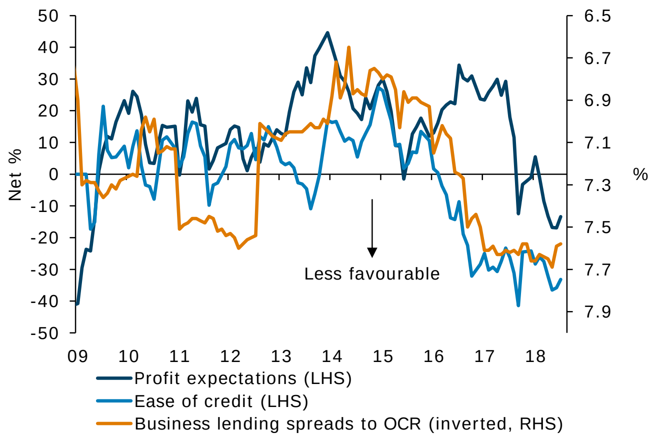
A number of factors have contributed significantly to growth this cycle, but the impetus from these is now waning:

- The migration cycle is past its peak and continues to ease gradually. Population growth is still expected to contribute to GDP growth, but much less than has been seen already this cycle. Population growth is expected to slow from around 2% y/y to 1.2% y/y by the end of 2020.
- The housing market has cooled, providing less of a boost to consumption and residential investment. Despite solid population growth and constrained supply, a number of headwinds have been at play, including policy changes, a tighter credit environment, investor wariness, and affordability constraints. With these forces continuing, the housing market is expected to remain soft, but there could be some bumps in the road ahead.
- Construction activity is elevated, but will struggle to push higher from here. The Canterbury rebuild has peaked and building in the rest of the country has filled the gap. We expect this transition to continue, with the KiwiBuild program providing support. But it will be difficult for activity to push higher given capacity constraints, delays, cost increases and cash-flow pressures facing the industry. Over the forecast horizon, we expect residential investment to be broadly stable as a share of GDP.
- Tourism exports are expected to struggle to push higher. Demand to visit New Zealand remains strong and that is expected to continue, but there is significant pressure on our tourism infrastructure that is expected to limit growth in visitor arrivals. Greater infrastructure spending or higher spend per visitor is likely to be required to achieve significant expansion.

At the same time as drivers have started to wane, a number of challenges have emerged:

- Businesses are wary about investing. Capacity constraints and cost pressures are biting and interest rates are low, which should on the face of it encourage expansion and investment in cost-saving measures. But uncertainty about activity and changes in the regulatory environment are making firms wary, while financial constraints from reduced credit availability, cost pressures, profit squeeze and higher relative costs of capital are limiting scope to invest (figure 1). In light of this, we expect to see modest rates of 'other fixed capital' investment growth through the remainder of 2018.

Figure 1: Financial conditions faced by businesses



Source: RBNZ, ANZ Research

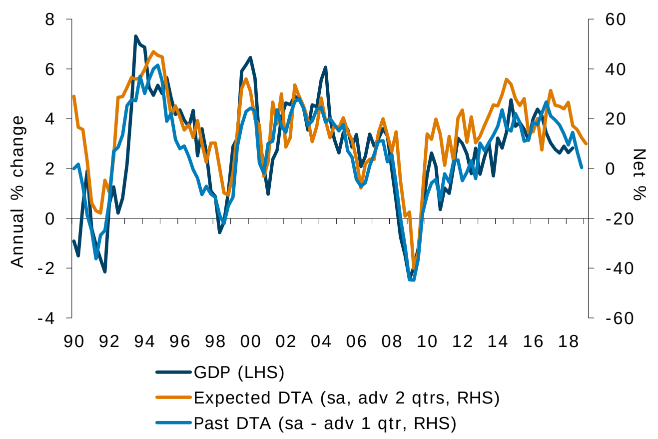
New Zealand economic outlook

- Households are feeling the pinch. Higher oil prices, a lower NZD and higher fuel taxes have conspired to see the price of petrol at the pump increase to as much as $2.50/litre in some locations. Rental inflation has also increased to 6% y/y for new bonds lodged. This has the direct effect of squeezing spending on other goods and services, especially for lower-income households.
- Lending growth is modest. While this is no longer a headwind to the same extent as it was over 2017 (when banks were looking to close their funding gaps), banks are expected to remain prudent, limiting credit availability for some households and businesses.
- After a decade of expansion, the economic cycle is looking tired. We do not have the excesses that have often plagued previous cycles (like burgeoning current account deficits, strong credit growth or high inflation). But capacity constraints and profitability challenges are making it difficult for growth to push higher without a lift in business investment or productivity growth (which has proven difficult to attain, for a range of reasons).

Growth sputter a key risk

We expect the economy will grow near recent annual rates in the near term, but a growth hiccup is a key risk – as signalled by weaker reported activity from business surveys (figure 2). We expect that investment will be subdued in coming quarters, until businesses rebuild their confidence to expand. But an important possibility is that households follow suit and rein in their spending too.

Figure 2: GDP growth and QSBO activity indicators

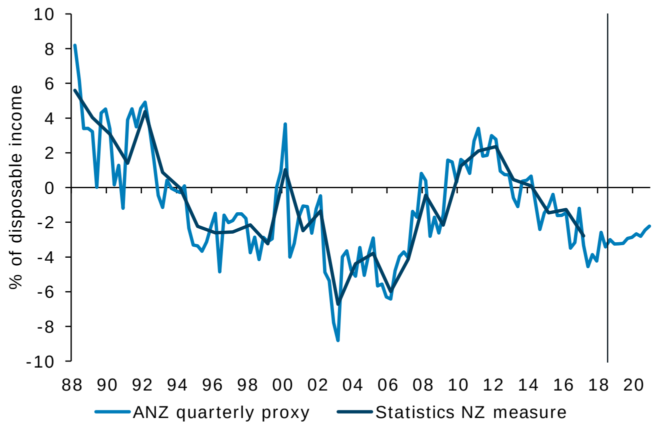


Source: NZIER, Statistics NZ

Conditions for consumers are not spectacular, but we expect consumption will continue to grow at rates of about 2-2½% y/y, supported by population growth.

Per capita consumption growth is expected to remain subdued. However, consumption has outpaced income growth in recent years and the saving rate has fallen (figure 3). This implies households lack buffers to absorb unexpected events, such as weaker income growth or cost escalation for essentials. Our central expectation is that current squeeze on discretionary spending will not persist and households will benefit from further income growth, with a modest increase in the saving rate expected over the forecast period. However, there is a risk that households rein in their spending more than we currently anticipate.

Figure 3: Household saving rate



Source: Statistics NZ, ANZ Research

In the driver's seat

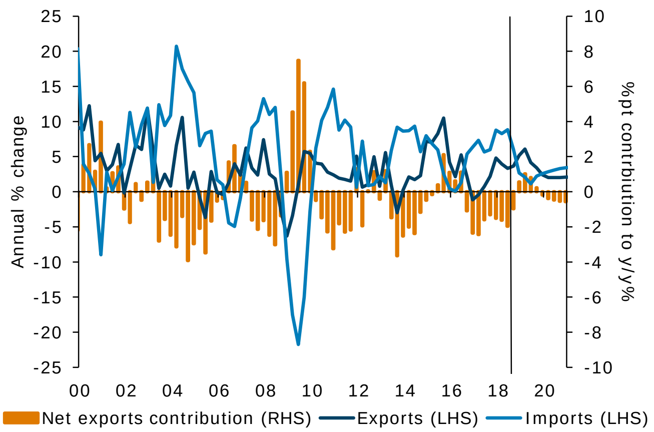
Over the medium term, a key determinant of the outlook is the extent to which economic drivers step up to support growth. We expect that a number of factors will support annual GDP growth near recent rates.

- We expect that business conditions will improve, resulting in a recovery in business investment. The RBNZ's guidance that the OCR will remain low for a long time is expected to provide reassurance. At the same time, further clarity is expected to emerge with regards to government policies (and their effects), and sentiment is expected to recover more generally. Despite this, investment is expected to remain contained, in light of lingering headwinds.
- Fiscal policy is expected to provide a positive impetus. After almost a decade of contraction, the fiscal impulse looks set to make a positive, albeit fairly small, contribution to GDP growth. The Government has an infrastructure deficit on its hands, but has sent a clear signal that it intends to keep to its fiscal targets.

New Zealand economic outlook

- Net exports are expected to support growth, in part due to a lower exchange rate. The New Zealand dollar TWI has depreciated 1% since the start of August and we expect to see further depreciation against some currency pairs (see page 11 for more details). Since 2013, net exports have been dampening annual GDP growth to the tune of 1%pts on average over recent times. This is forecast to turn slightly positive over the coming year before moderating (figure 4).

Figure 4: Net exports



Source: Statistics NZ, ANZ Research

- The global picture remains favourable generally, although there are risks to the outlook (see page 8 for more details). And while the shine has come off our commodity prices of late and the primary outlook is a little more challenging (see page 10 for more details), export prices generally remain elevated with strength broad based. The favourable terms of trade is expected to continue to support national income growth over the forecast horizon.
- In addition, low interest rates are expected to remain supportive of growth, with the OCR in stimulatory territory and expected to remain so, and financial conditions accommodative.

Slower speed, but not a stall

Adding this all up, it is fair to say that engines of growth are not revving as they once were. In our view, the economy will struggle to grow above trend from here. We expect that GDP will expand between 2½-3% y/y over the forecast period – below estimates of potential growth. A number of factors will work together to achieve continued growth, but there is a risk that this transition is not smooth. Our forecast for GDP growth is similar to that in the July ANZ Quarterly Economic Outlook, but downside risks have increased.

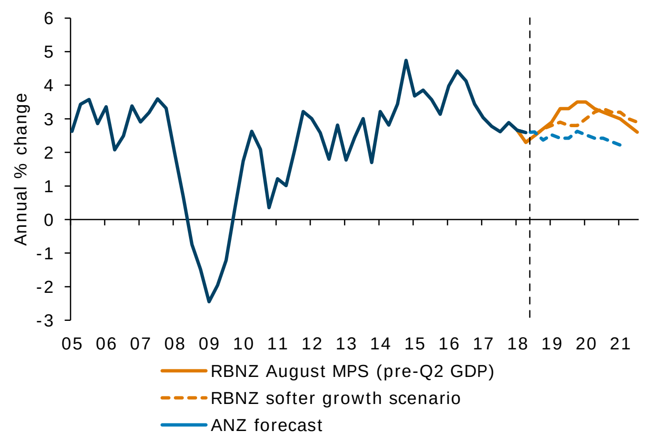
We estimate that the output gap is marginally positive, but expect that resource pressures will not intensify from here. Resource pressures that are already in place are expected to support a modest recovery in business investment through 2019, given the resource pressures that are already in place and our expectation that business conditions will improve.

We assess that the labour market is "tight", with the unemployment rate at 4.5% – close to estimates of full employment. However, with resource pressures not expected to intensify, we expect to see only modest improvement in the labour market from here.

What would it take to accelerate?

Our forecast for GDP growth is downbeat compared with those from both the RBNZ and the Treasury, in that we do not expect GDP growth to accelerate from here. By contrast, in August the RBNZ forecast GDP growth to accelerate through 2019 and peak at 3.5% y/y (figure 5) – which in their view is what is required to achieve inflation sustainably at target over the medium term (given a range of assumptions). In fact, our central projection is even weaker than the RBNZ's softer growth scenario in the August MPS.

Figure 5: RBNZ and ANZ GDP growth forecasts



Source: RBNZ, Statistics NZ, ANZ Research

In our view, acceleration in GDP growth from here would require one or more of the following:

- A significant improvement in business conditions. Business sentiment could rebound or investment could prove more resilient than surveys indicate. A reduction in the cost of capital or an alleviation of financial pressures might also encourage businesses to invest. Capacity pressures are biting, which would ordinarily lead firms to invest, and it is possible that these forces lead to a firmer outlook than we are expecting.
-

- A rebound in the housing market, perhaps associated with net migration not easing as quickly as we expect. The housing market has a history of second winds. But given recent slackening in market tightness and regulatory and affordability headwinds, this is looking increasingly unlikely. Accordingly, we expect that the RBNZ will further ease loan-to-value restrictions in November. This could reduce the need for any OCR cuts at the margin, but isn't a game changer.
- A lower OCR, which would boost growth through a number of channels. We estimate that the neutral rate is near 2½-3% currently, meaning that with the OCR at 1.75% the current degree of monetary stimulus is by no means unprecedented. Cuts in the OCR could give the economy a bit of a nudge – including via a weaker exchange rate, though this wouldn't do households any favours.

While it is possible that one or more of these possibilities leads to stronger-than-expected growth, they are not our central expectation – at least in the short term. Business sentiment is expected to improve only gradually and significant headwinds for the housing market remain, with the most immediate being the implementation of the foreign buyer ban. There is a non-trivial possibility that the RBNZ cuts the OCR, but we expect it would take some time for the data to give them conviction to do so.

Prepared to put a foot on the gas

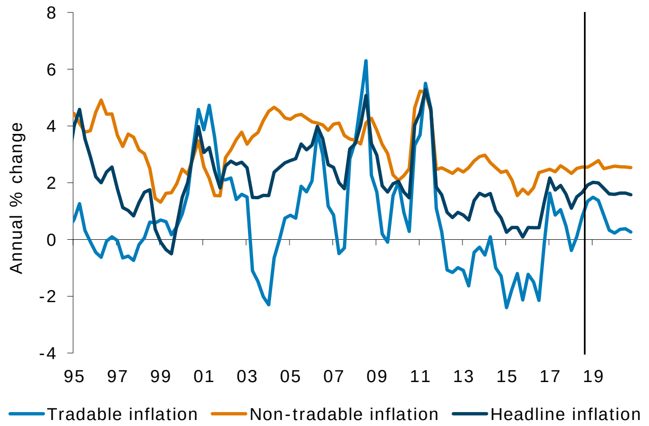
Our expectation is that activity will be weaker than the RBNZ expects and that it will be difficult to sustain inflation near the 2% target midpoint over the medium term. Based on this, we see the OCR on hold for the foreseeable future, in contrast to the RBNZ's own projections, which depict OCR increases eventually, albeit far enough in the future that much can happen between now and then.

With resource pressures not expected to intensify, underlying inflationary pressures are expected to increase only gradually – on account of previous tightening in resource capacity and expectations that inflation will be close to the target mid-point, particularly given rising, if transitory, cost pressures. Wage increases will contribute, but these impacts are not expected to be particularly persistent.

Headline inflation looks set to rise, with CPI inflation expected to be boosted by a bump in tradable inflation – due to depreciation in the NZD and higher petrol prices, which are both expected to be transitory. Tradable inflation is expected to increase to 1.5% in early 2019 before moderating back to 0.4% in early-2020.

CPI inflation is expected to tick up above the 2% midpoint, reaching 2.3% y/y in early 2019, but then easing back to 1.6% at the end of 2019, where it is expected to linger for the remainder of the forecast horizon (figure 6). Our forecast for CPI inflation is higher than at the July ANZ Quarterly Economic Outlook in the short term, primarily due to higher petrol prices.

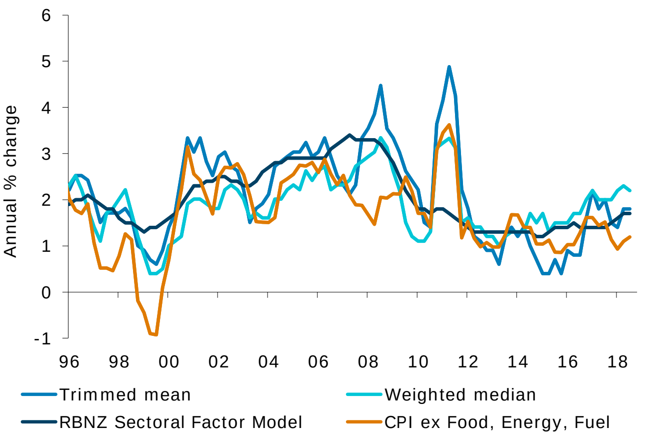
Figure 6: CPI inflation forecast



Source: Statistics NZ, ANZ Research

The RBNZ will "look through" the transitory factors affecting inflation and instead be focused on the trend that is expected to persist over the medium term. Non-tradable inflation, which tends to be more persistent than tradable inflation, is expected to remain below average, running at around 2.6% y/y on average over the forecast horizon, a bit under where the RBNZ would like it to be. Core inflation has ticked up across a range of measures, a development we expect the RBNZ will be monitoring closely (figure 7). However, with resource pressures expected to remain unchanged, further increases in core inflation are expected to occur only slowly.

Figure 7: Measures of core inflation



Source: RBNZ, Statistics NZ, ANZ Research

New Zealand economic outlook

We do not think that inflationary pressures will build to the extent that would justify an OCR increase over our forecast horizon. As we have discussed, a significant acceleration in growth seems unlikely to us, but of course remains a possibility.

Another risk is that inflation dynamics change. Inflation has been weaker than historical relationships would suggest for some time, but it is possible that inflation from here could be persistently stronger than we expect, especially if inflation expectations increase, wage pressures prove to be persistent, or margin squeeze provides a catalyst for inflation pressures to emerge. In this scenario, it would take time for the RBNZ to be assured that stronger inflation will be maintained; they will want to see core inflation sustainably near the target midpoint. Our central view is that a persistent increase in core inflation is unlikely without an acceleration in growth, but we are mindful of this risk.

With inflation having increased of late and activity so far holding up, the RBNZ has time to see how developments evolve. Our central expectation is that the RBNZ will remain cautious and bide their time so that they can be sure that the medium-term outlook is assured. Our central expectation is that the OCR will remain at its current low level for the foreseeable future. On balance, given risks to the growth outlook, we see the risks as being skewed toward the next move being a cut eventually, but there is no urgency for such a move at present given the recent data flow.

Of course, conditions can change quite quickly. Here's what we are watching that could see a cut eventuate:

- The biggest risk we see that could result in cuts in the next six months is that the softening in GDP growth signalled by business surveys comes to fruition. We already have a softer track for investment in the near term, but an increasing downside risk is that households rein in their spending too, given current pressures on cash flow. We expect that the RBNZ would prefer to pre-empt such a slowing, but they will also want get a clear signal from a broader range of data first.
- Another key risk that could see the OCR cut in the near term is the possibility that the global environment deteriorates significantly, perhaps due to ructions in financial markets. This risk has been percolating in the background for a while now and is one that could see the RBNZ move the OCR very rapidly.
- Over the medium term, a number of risks could derail the economic transition and the growth outlook. A key risk is that business investment might not recover as we expect. We are expecting that business conditions will improve and encourage greater spending, but it is possible that this does not occur without a jump-start from lower rates – especially if household spending growth starts to wane. Given the acceleration in GDP growth expected by the RBNZ, disappointment on the activity side is a non-trivial possibility.
- The migration cycle could also ease more significantly than currently assumed, leading to an even weaker (or even negative) impetus to growth. Given the large influx of arrivals we have seen in recent years, a similarly large outflow could eventuate if economic conditions in New Zealand no longer look so favourable.

International outlook

Summary

Global growth is gradually moderating but remains solid, even as trade tensions and political challenges remain at the fore. Growth in China is expected to soften gradually but remain robust, supporting demand for New Zealand's exports. The rest of Asia is facing headwinds in terms of a more challenging trade environment. In Australia, growth remains strong, supported by public spending and private investment, but weakness in the housing market presents potential downside risk. The US economic expansion continues apace, boosted by fiscal spending, supporting further gradual policy normalisation by the Federal Reserve. The ECB is expected to end QE later this year, with a solid recovery in the euro area continuing alongside increasing confidence that core inflation will increase. So far, the global economy has been fairly resilient in the face of tightening global liquidity and trade tensions that have become entrenched. Nonetheless, the outlook is a little softer around the edges and risks remain that could have flow on effects to New Zealand.

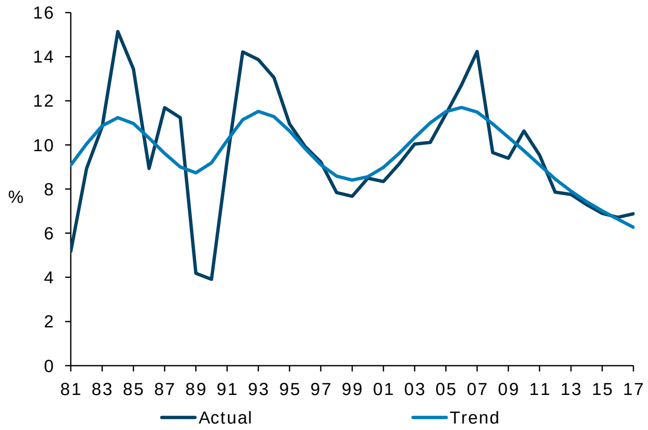
Gradual deceleration

The global backdrop remains positive for New Zealand, even as the global economy continues to navigate challenges. The data pulse has been mixed, but robust world growth is expected to continue, with only a gradual deceleration in activity expected. World GDP is expected to expand 4% y/y in 2018, before moderating to 3.9% in 2019 and 3.8% in 2020. This is expected to provide a supportive environment for New Zealand exports, although the shine has come off our export commodity prices of late.

Slowing in global growth in large part reflects an expectation that growth will slow in our largest major trading partner. Chinese GDP growth is expected to be 6.5% y/y this year – the slowest pace since 1990. Growth is expected to moderate further to 6.3% in 2019 and 6.1% in 2020. This slowing reflects deleveraging efforts on the part of Chinese authorities. So far, the effort has seen early success, with money supply growth (a good proxy for credit growth) falling to a historic low of 8% in Q2 2018. Nonetheless, recent defaults in the peer-to-peer lending sector highlighting ongoing issues.

The deleveraging effort will limit the scope for policymakers to support growth. Monetary tightening in China is clearly over, with some easing in the reserve requirement ratio of late. However, we expect the government will be reluctant to aggressively use monetary policy or fiscal spending to stimulate investment and credit-led growth. They may use efforts to support services and high-tech manufacturing, loosening of tariffs (separate from the US trade spat), subsidies and tax cuts.

Figure 1. Chinese GDP growth



Source: CEIC, ANZ Research

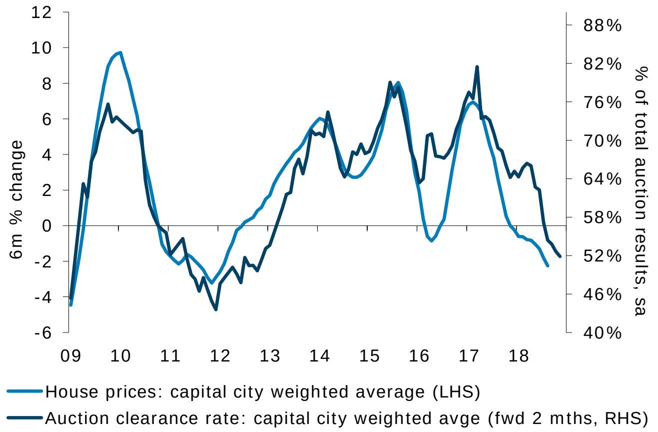
Demand from China is expected to continue to support demand for New Zealand's exports and our terms of trade. The medium-term growth picture for China is positive, even though there may be bumps along the way, supported by ongoing development and urbanisation. Continued supply-side reform is expected to boost productivity and long-term growth, although trade tensions pose risks to the growth outlook at a time when China is looking to benefit from globalisation to support its growth agenda.

A more challenging global trade environment is also presenting headwinds to economies in the rest of Asia, related to US-China trade tensions and the maturing of the global trade cycle. At the same time, some individual economies are facing domestic challenges. Growth in Asia is expected to slow at a time of solid growth in the US, which will impact capital flows and currencies in the region and in other emerging markets.

Australia, our second-largest trading partner, continues to experience strong, above-trend growth. The Australian economy is forecast to expand 3.2% over 2018 – the strongest pace since 2012 – with continued strength expected. Growth continues to be bolstered by public spending and private investment and this looks set to continue. There is a large pipeline of infrastructure projects on the agenda and capital expenditure plans suggest non-mining investment will continue to grow at a solid pace, after rising 9% over the past year.

For Australia, trade tensions present a key risk to export demand and prices of hard commodities, with China the destination for a third of Australia's exports. Weakness in the housing market is also clouding the outlook for consumer spending. So far, consumption has been resilient in the face of falling house prices and weak wage growth. But further weakness in the housing market is expected, particularly in Sydney and Melbourne. And funding cost increases, which have been passed on to retail rates, will exert a dampening influence. There is a risk that falling house prices cause households to retrench, leading to a pronounced increase in the saving rate and weaker domestic demand.

Figure 2. Australian house prices, auction clearance rates



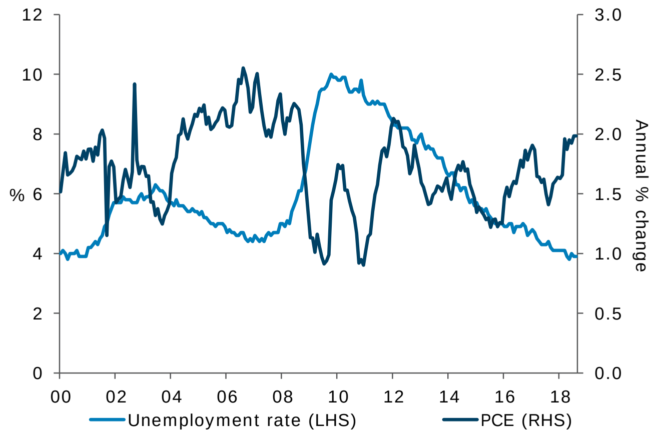
Source: CoreLogic, ANZ Research

Despite risks, the RBA currently appears on track to tighten monetary policy in August 2019. Ongoing above-trend growth should see the unemployment rate edge lower, with wage growth and inflation expected to increase gradually. That said, a weak outcome for core inflation in Q3 could see the tightening cycle pushed out.

The Federal Reserve is well advanced in their policy normalisation, with the US economy growing strongly. The US economic expansion looks set to become the longest on record, boosted by fiscal spending. Unemployment has reached very low levels and inflation has converged to the 2% target. Growth is expected to slow from 2.9% y/y in 2018 to 1.8% y/y in 2020 on the back of the tightening in monetary policy that has taken place.

From here, only modest tightening in monetary policy is expected, with the fed funds rate expected to peak at 2.75% in the middle of next year, with inflation expected to remain well anchored.

Figure 3. US unemployment and inflation



Source: Bloomberg, ANZ Research

The ECB is expected to end QE later this year, with a solid recovery in the euro area continuing alongside increasing confidence that core inflation will increase. Meanwhile, the Bank of Japan is expected to keep monetary policy easy for an extended period.

So far, the global economy has been fairly resilient in the face of tightening global liquidity, but there have been some pressures in emerging markets. Central banks remain cautious in their removal of monetary stimulus, which should limit the effects. Nonetheless, risks remain that could see financial conditions tighten, including in New Zealand.

Ongoing Brexit negotiations are casting a shadow on the outlooks for both the euro area and UK. There is still time to reach a deal, but significant hurdles remain and the possibility of a no-deal outcome remains a non-trivial possibility. While New Zealand is largely shielded from direct Brexit impacts, our markets will continue to be buffeted by changes in risk sentiment.

Table 1: GDP Growth

Calendar Years (annual average % change)	1998-2007 average	2008-2016 average	2017	2018(f)	2019(f)	2020(f)
United States	3.0	1.3	2.3	2.9	2.2	1.8
Australia	3.6	2.6	2.2	3.2	3.0	2.8
Japan	1.0	0.4	1.7	1.2	1.0	1.4
Euro area	2.4	0.4	2.4	2.2	2.0	1.8
China	10.0	8.4	6.9	6.5	6.3	6.1
World	4.3	3.3	4.0	4.0	3.9	3.8

Source: ANZ, Bloomberg

Primary sector outlook

Summary

Global commodity markets appear finely balanced at present, with weaker prices for some commodities reflecting positive supply surprises. While the lower NZD is providing some support, farm-gate returns are looking a little less rosy than previously. We have revised down our milk price forecast for the 2018/19 season by $0.35 to $6.40/kg MS. But subject to demand holding up, we see market conditions tightening a touch into 2019. That said, downside risks to the outlook have intensified, particularly around the fallout from trade war and the possibility of a sharper-than-anticipated slowdown in global growth. For now, the global backdrop remains supportive – commodity prices remain elevated overall – but caution is warranted.

While global growth is looking past its peak, and is expected to moderate, we expect demand for New Zealand exports to remain on a solid footing. However, global commodity markets have proved in recent months there is little in the way of excess demand to accommodate positive supply surprises. As always, much depends on developments in our largest trading partner – China.

On that front, developments have been mixed. The US-China trade war has escalated, and with plenty of ammo still in reserve (particularly on the US side) the end game remains unclear. On a more positive note, China recently announced it will lower average tariff rates on a range of imported goods from most of its trading partners, including on machinery, construction materials, paper and textiles. While New Zealand may not be a big exporter of these goods (construction materials and paper being the larger ones) the positive impact on Chinese households' disposable incomes should support consumption expenditure. Recent easing by the PBoC should also go some way towards stoking the engines of growth, but the associated CNY weakness is concerning from a New Zealand exporter perspective.

The US, Mexico, and Canada reaching agreement on NAFTA represents another positive global trade development. Canada has reportedly made concessions on US dairy, which at first blush do not appear too dissimilar to those under the CPTPP. Overall, it's still too early to tell how the trade war and other developments will net out. But the associated risks to global growth and/or the possibility that New Zealand exports get caught in the crossfire remain on our radar.

Over the past few months dairy prices have been slipping on the GlobalDairyTrade platform, with whole milk powder, butter, anhydrous milk fat, and cheese falling 15%, 29%, 20% and 19% respectively since May. On the back of these declines, we have revised down our forecast milk price to $6.40/kg MS for the 2018/19 season (previously $6.75/kg MS). In large part, recent price weakness reflects positive supply-side developments. New Zealand milksolids production has started the season on a solid footing, up 5.4% y/y in August season to date, and expectations for continued strength have been buoyed by favourable pasture conditions.

Global milk production has been coming in on the higher side of expectations too, affording buyers a little more patience. However, market conditions are expected to tighten. Global supply is poised for moderation on high and rising production costs; China's buying activity is expected to ramp up leading into the seasonal low-tariff window; and prices are already flirting with levels that have typically encouraged marginal buyer activity. While there might be a little more price weakness to come, we expect prices will lift into the second half of the season as softer global production is confirmed. However, if this doesn't occur, the milk price could come in lower.

Meat and fibre remains a mixed bag. Global beef prices have been under pressure on robust global supply, with weather-induced culling in the US and Australia pushing prices lower, but implying tighter supply further down the track. Lamb prices have plateaued at a high level, and are looking for direction against the backdrop of softening global growth, Brexit/GBP uncertainty, contained global supply and the lead-up to Christmas.

The shine has come off global log prices in recent months, with the weaker CNY/USD said to have eroded Chinese purchasing power. However, policy stimulus is expected to keep China construction activity buoyed. Likewise, domestic demand for lumber should remain at a high level on the back of a busy, but constrained, residential construction sector.

In the kiwifruit sector the 2018 green crop is expected to reach 80m trays (up from 65m last season), while gold volumes will push towards 65m trays as more vines reach maturity. Green returns are expected to be $5.47/tray, which is at the low end of the indicative range published in June ($5.20 - $6.20/tray), largely due to increased volumes. Gold returns are expected to push towards the upper end at $10.28/tray (indicative range $9.40 - $10.40/tray) reflecting ongoing demand from Asian markets. Gold exports to European markets have also increased markedly this year.

Latest estimates suggest the pipfruit crop for 2018 will reach a new high, surpassing last year's production by 5-6%. Strong supply growth, reduced European supply due to frosts at critical points in the season, and market access restrictions from the US into China, South Africa into Taiwan, and China into India, as well as a lower NZD will support near-record orchard-gate returns in 2018.

Financial markets outlook

Summary

The RBNZ continues to signal it wants to be late to the global rate hiking party, or a no-show altogether. That is keeping the short end anchored and driving a meaningful outperformance of the long end, especially with US yields grinding higher. While local long-end yields are now looking fully priced, and so the hurdle for further outperformance is higher, if the RBNZ decides to cut (which is a non-trivial possibility in our view), we see no reason why yields could not fall to historical lows. The NZD is being impacted by similar themes as well as a softer outlook for the terms of trade. Together with tightening global liquidity, we expect the NZD/USD to reach 0.61 by early next year.

Global scene – more choppiness

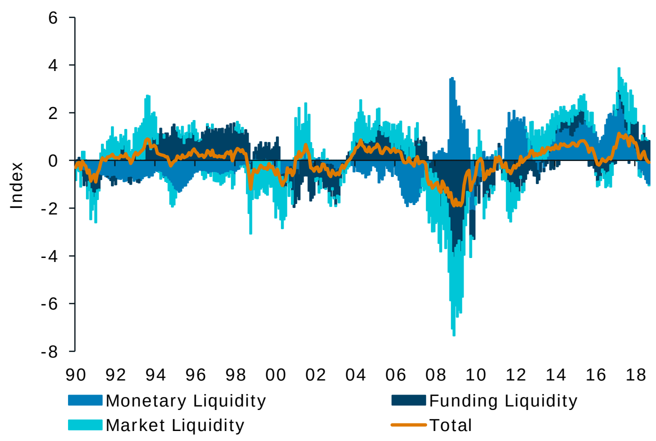
The path for US monetary policy tightening is back in the spotlight. For the majority of 2018, despite ongoing gradual tightening by the Federal Reserve and a rapidly increasing budget deficit, US long-end yields struggled to push significantly higher. A lack of broad-based inflation pressures, already-wide spreads to other economies and regulation-driven bond purchases by corporate pension plans all acted as a capping force. However, that thematic has shifted recently. The combination of ongoing strong US data and a more hawkish Fed signalling the possibility that US monetary policy could tighten beyond 'neutral' has seen US yields break to new multi-year highs.

Our forecasts have the US 10-year bond yield finishing 2019 at a lower level (3.10%) than where it sits today. That is ultimately because we feel the extent of monetary policy tightening necessary to contain US inflation pressures won't be as much as what the Federal Reserve currently project. However, the risk is now that ongoing strength in US data as the effects of previous fiscal stimulus flow through and support the economy will see policy tightening push on regardless and result in yields grinding higher in the near term.

For broader markets, this looks set to be a dominant thematic. USD strength likely has further to run yet, especially with US activity continuing to outperform other G10 economies. US equities are likely to face a few more headwinds, although with solid growth still supporting earnings, we don't see a fully blown rout just yet. But the same can't be said for emerging markets, which have benefited from previous abundant and cheap USD liquidity and are now facing challenges as that liquidity is withdrawn. A slowing Chinese economy, global trade tensions and geopolitical concerns add to these EM pressures.

Ultimately, this all fits with the thematic we have been highlighting for some time: the impact on financial markets as the global liquidity cycle tightens. We expect more volatility and for it to result in markets being less forgiving of poor news. That is already occurring, but we see this dynamic as having further to go.

Figure 1: ANZ Global Liquidity Index



Source: Bloomberg, ANZ Research

NZ rates – will they or won't they?

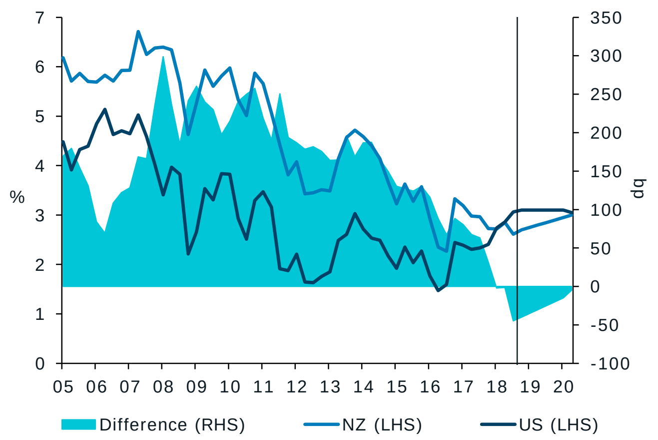
In terms of the outlook for monetary policy, the debate regarding the Fed couldn't really be in starker contrast to the domestic picture right now. Given an apparent dovish shift by the RBNZ under new leadership (and mandate) and signs that the domestic growth outlook is deteriorating, the market is seriously contemplating the possibility that the RBNZ's next move will be to ease policy.

At this stage, a rate cut is not our central forecast. Yet we also struggle to envisage the conditions necessary to justify rate hikes (hence our flat-lined OCR forecast). At the very least we expect short-end yields to remain anchored and the mid-point of the curve to flatten further as implied hikes are progressively priced out of the curve. That is, of course, unless conditions for cuts are reached, which would likely lead to a sharp curve bull steepening.

This divergent monetary policy outlook relative particularly to the US, but also others, has resulted in significant outperformance in the long end over recent times. We are now in the highly unusual situation where the entire NZGB curve is trading through its US equivalent, and by a reasonable way. It is a picture we don't see changing any time soon, although our curve won't be able to stay completely immune if global fixed income markets continue to weaken. In addition, our analysis suggests that even accounting for the RBNZ's divergent monetary policy path, NZGBs are beginning to look on the expensive side of fair. That is something that could persist for a while, but it does set a higher hurdle for further geographic outperformance from here.

This view of valuation influences our forecasts for New Zealand's 10-year bond yield. We see it gradually drifting up towards 3.0% by the middle of 2020, which sees the spread to the US gradually narrowing from around -50bps currently. However, if the RBNZ were to cut, then we'd see little reason why NZGB yields could not push to new historic lows.

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



Source: Bloomberg, ANZ Research

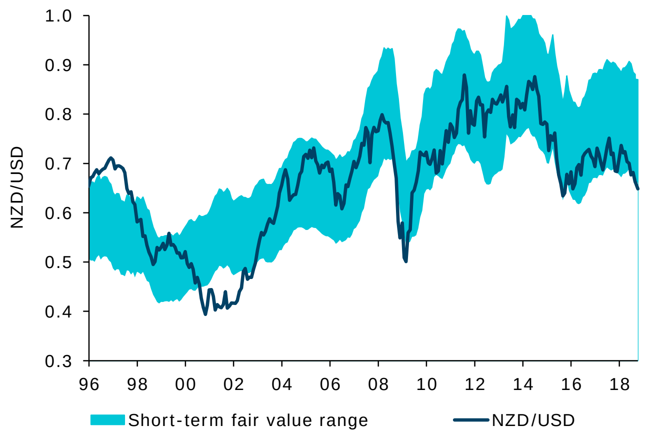
NZD – what's left to like?

The overarching themes behind our long-held bearish views on NZD direction have largely played out as expected over recent months. The main area of surprise has been the magnitude and longevity of the USD cycle (which looks like it still has legs, admittedly), but that has only added to NZD weakness. Ultimately, with the global liquidity cycle tightening, and at the same time as global growth momentum has cooled (at least outside of the US), it is a backdrop where cyclical currencies have struggled. These themes should persist, in our view.

The domestic picture has only added to the challenges the NZD faces at present. The widening in interest rate differentials between New Zealand and the US has been an obvious channel, and this would only intensify if the RBNZ is forced to cut rates. But more recently, the prices for New Zealand's commodity exports (long a bastion of support for the NZD) have started to roll over too, and together with higher oil prices, point to a weaker outlook for the terms of trade.

Admittedly, the NZD is now trading below the bottom of our cyclical fair value range, suggesting that this interest differential and commodity price story is already in the price. However, we believe that this type of model (which uses only short-term interest rate differentials) fails to account for the dramatic shift seen in New Zealand's entire yield structure over recent times. As mentioned earlier, the entire NZGB curve is trading below the US. It therefore suggests that this modelled estimate is not providing a true reflection of 'fair' at present and there is a high chance of persistent undershoot.

Figure 3: NZD short-term 'fair value' estimate



Source: Bloomberg, ANZ Research

We feel there are two factors that could cause our bearish NZD view to be wrong. The first would be if global growth were to show clear and broad-based signs of acceleration. That would dampen the impact of tighter global liquidity conditions on cyclical currencies and broader risk assets. The second would be if we are wrong on our views on the domestic economy and growth does accelerate over 2019 and RBNZ rate hikes become more likely than cuts.

Individual currency pairs

NZD/USD: More downside. We have been surprised by the magnitude and longevity of the USD cycle, but it has further to run, it appears. While positioning for the NZD looks stretched, meaning price action could be choppy as opposed to trending, we see the NZD falling to 0.62 by the end of this year, holding at 0.61 over 2019.

NZD/AUD: Within a broad range. As long as the market continues to just toy with the idea of the RBNZ cutting but cuts never eventuate, then this cross is likely to remain within a relatively wide range. However, clearer signs that the growth picture is diverging meaningfully enough to alter the current profiles for the respective central banks will see it break lower.

Financial markets outlook

NZD/EUR: Lower in time. We are reasonably constructive on the European growth picture. And with the ECB expected to begin a path of policy normalisation next year, that should be euro supportive. In the near term though, political turbulence and lacklustre data flow is likely to keep price action choppy.

NZD/GBP: Still somewhat binary. Our base case is that a Brexit deal is reached, which should allow a steady appreciation in the GBP and see NZD/GBP head towards 0.43 by mid-2020. However, there remain risks that if a deal fails to materialise, the undervaluation in GBP/USD will persist.

NZD/JPY: Watching risk appetites. Because Japan is a major capital exporter, the yen has always been driven by risk appetite. And given our expectation that 'risk' is set to face a few more challenges going forward as global liquidity tightens, we see this cross continuing to push lower.

Table 1: Forecasts (end of quarter)

FX Rates	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19	Mar-20	Jun-20
NZD/USD	0.62	0.61	0.61	0.61	0.61	0.62	0.62
NZD/AUD	0.90	0.90	0.91	0.87	0.87	0.89	0.89
NZD/EUR	0.53	0.50	0.49	0.48	0.48	0.48	0.48
NZD/JPY	70.1	67.1	65.9	62.2	61.0	59.5	58.9
NZD/GBP	0.48	0.46	0.45	0.44	0.44	0.43	0.42
NZD/CNY	4.28	4.18	4.18	4.15	4.12	4.15	4.12
NZ$ TWI	66.3	64.3	63.7	62.2	61.9	62.2	62.0
Interest Rates	**Dec-18**	**Mar-19**	**Jun-19**	**Sep-19**	**Dec-19**	**Mar-20**	**Jun-20**
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	1.75
NZ 90 day bill	1.95	1.95	1.95	1.95	1.95	1.95	1.95
NZ 2-yr swap	2.07	2.13	2.17	2.21	2.25	2.29	2.31
NZ 10-yr bond	2.70	2.75	2.80	2.85	2.90	2.95	3.00

Source: ANZ, Bloomberg

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	3.6	4.0	2.8	2.7	2.6	2.4
Private Consumption	3.2	3.7	4.8	4.4	2.6	2.1	2.0
Public Consumption	3.3	2.7	1.7	4.4	4.4	3.3	3.2
Residential investment	9.8	6.0	11.8	0.7	3.3	4.0	1.4
Other investment	9.4	3.7	4.6	4.4	4.0	2.2	3.7
Stockbuilding[1]	0.4	-0.3	0.0	-0.1	0.2	-0.4	0.0
Gross National Expenditure	4.5	3.2	4.5	4.1	3.8	2.4	2.6
Total Exports	3.3	7.4	2.1	1.8	4.0	4.0	2.0
Total Imports	7.9	3.9	3.3	6.9	6.4	2.0	3.2
Employment (annual %)	3.6	1.4	5.8	3.7	1.8	1.7	1.4
Unemployment Rate (sa; Dec qtr)	5.5	5.0	5.3	4.5	4.4	4.2	4.1
Labour Cost Index (annual %)	1.8	1.6	1.6	1.9	2.0	2.2	2.4
Terms of trade (OTI basis; annual %)	-5.0	-3.1	6.7	7.9	-6.3	2.8	0.8
Prices (annual % change)							
CPI Inflation	0.8	0.1	1.3	1.6	2.2	1.6	1.6
Non-tradable Inflation	2.4	1.8	2.4	2.5	2.5	2.6	2.5
Tradable Inflation	-1.3	-2.1	-0.1	0.5	1.4	0.4	0.4
REINZ House Price Index	7.6	14.8	14.5	3.6	3.1	2.4	2.0
Fiscal and External Balance							
Current Account Balance ($bn)	-7.5	-7.1	-5.7	-8.1	-10.5	-10.8	-12.1
as % of GDP	-3.1	-2.8	-2.2	-2.9	-3.6	-3.5	-3.8
Government OBEGAL ($bn)*	-2.8	0.4	1.8	4.1	5.5	-0.5	3.0
as % of GDP*	-1.2	0.2	0.7	1.5	1.9	-0.2	0.9
NZ Financial Markets (end of December quarter)							
TWI	79.4	73.7	76.1	73.0	66.3	61.9	..
NZD/USD	0.78	0.69	0.69	0.71	0.62	0.61	..
NZD/AUD	0.96	0.94	0.96	0.91	0.90	0.87	..
NZD/CNY	4.86	4.45	4.81	4.62	4.28	4.12	..
NZD/EUR	0.64	0.63	0.66	0.59	0.53	0.48	..
NZD/JPY	93.6	82.5	81.1	80.0	70.1	61.0	..
NZD/GBP	0.50	0.46	0.56	0.53	0.48	0.44	..
Official Cash Rate	3.50	2.50	1.75	1.75	1.75	1.75	..
90-day bank bill rate	3.68	2.75	2.00	1.88	1.95	1.95	..
2-year swap rate	3.80	2.85	2.46	2.21	2.07	2.25	..
10-year government bond rate	3.67	3.57	3.33	2.72	2.70	2.90	..

[1] Percentage point contribution to growth; * June years

Forecasts finalised 18 October 2018

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

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