NEW ZEALAND ECONOMIC OUTLOOK

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INSIDE

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LOOKING TRENDY

NEW ZEALAND ECONOMIC OUTLOOK

Our forecasts depict an economy growing broadly around trend for the next couple of years, with the unemployment rate set to remain low. It is hardly a negative story. We see wage growth gradually lifting off lows, corresponding with a modest broadening in domestic inflation pressures in time. That lift should eventually see the RBNZ join other central banks in removing monetary policy stimulus. However, we feel strongly that it will be late to that party, with the first hike not until the second half of 2019.

INTERNATIONAL OUTLOOK

Our global growth forecasts continue to depict a steady and – on balance – positive picture. But risks are skewed to the downside. Expansionary US fiscal policy should support global trade, but markets will remain attentive to further tensions as the China-US trade saga continues to unfold.

PRIMARY SECTOR OUTLOOK

Export prices are holding near cycle highs. Apart from lifting dairy and beef supply, there is little on the horizon to suggest a change in either direction. The main risk appears to be an escalation in global trade protectionism, but it's unclear exactly how this may play out for New Zealand exports.

FINANCIAL MARKETS OUTLOOK

While funding market pressures both here and abroad are creating some angst, we don't believe local pressures will escalate. We see scope for local short-end rates to fall modestly in the near term, but ultimately remain anchored by RBNZ policy inaction. Local long-end rates should rise in line with global moves, seeing the curve steepen. However, we see further scope for further local outperformance, with NZ-US 10-year spreads to push more clearly negative. We expect downward pressure on the NZD over the course of 2018, especially against G4 currencies. NZD/AUD has threatened to break higher, but we see it remaining range-bound.

Calendar Years	2015	2016	2017	2018(f)	2019(f)	2020(f)
New Zealand Economy						
Real GDP (annual average % change)	3.5	4.0	2.9	3.0	3.0	2.5
Real GDP (annual % change)	3.1	3.5	2.9	3.2	2.6	2.4
Unemployment Rate (Dec quarter)	5.0	5.3	4.5	4.2	4.2	4.1
CPI Inflation (annual %)	0.1	1.3	1.6	1.6	2.0	1.8
Terms of Trade (OTI basis; annual %)	-3.1	6.7	7.3	-2.1	0.3	0.4
Current Account Balance (% of GDP)	-3.0	-2.3	-2.7	-2.5	-2.5	-2.3
Government OBEGAL (% of GDP)	0.2	0.7	1.5	1.2	0.7	0.9
Global Growth (annual average %)						
US	2.6	2.9	1.5	2.3	2.6	2.1
Australia	2.6	2.5	2.6	2.3	2.8	3.1
China	7.3	6.9	6.7	6.9	6.5	6.3
World	3.5	3.1	3.2	3.8	3.9	3.8
NZ Financial Markets (end of Dec quarter)						
TWI	73.7	76.1	73.0	67.8	65.1	65.1
NZD/USD	0.69	0.69	0.71	0.67	0.65	0.65
NZD/AUD	0.94	0.96	0.91	0.93	0.93	0.93
Official Cash Rate	2.50	1.75	1.75	1.75	2.25	..
10-year Bond Rate	3.57	3.33	2.72	3.50	3.50	..

* Forecasts and text finalised 29 March 2018

NEW ZEALAND ECONOMIC OUTLOOK

SUMMARY

The economy has cooled from the strong rates of growth achieved over 2015 and 2016, in large part due to natural late-cycle forces. Relative to then, the backdrop has become more challenging and it is expected to remain that way. But we don't believe it is about to get overtly difficult. In other words, while there are some challenges to navigate we don't see the economy rolling over in a meaningful way, even though that has been the historical tendency at this point in the cycle. Our forecasts depict an economy growing broadly around trend for the next couple of years, with the unemployment rate set to remain low. It is hardly a negative story. We see wage growth gradually lifting off lows, corresponding with a modest broadening in domestic inflation pressures in time. That lift should eventually see the RBNZ join other central banks in removing monetary policy stimulus. However, we feel strongly that it will be late to that party, with the first hike not until the second half of 2019.

CRUISE CONTROL

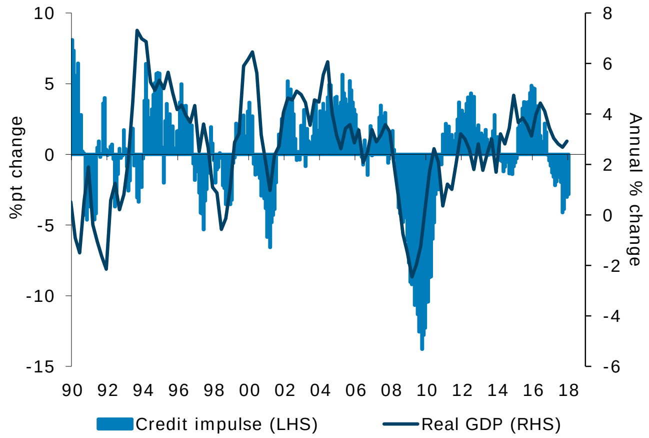
In many ways, the recent revisions to historical GDP growth have squared the circle on a number of issues. The New Zealand economy is now reported to have grown at a far stronger pace over 2015 and 2016 than previously estimated. In fact, the level of real GDP was revised close to 3% higher in Q3 2017. The revisions therefore go quite some way towards resolving the conundrum of why per capita growth was reportedly so surprisingly poor over the past few years. The data now marries up far better with anecdote, which at the time was generally of an economy that was performing exceptionally well and eating into spare capacity.

But what the figures also confirm (including the latest Q4 GDP data) is that the economy has cooled. In the December quarter, the economy expanded 0.6% q/q, with annual growth steady at 2.9% y/y. In fact, annual growth has effectively hovered around this pace for the better part of 12 months now. It is certainly still a respectable rate of growth – in fact, we see it as effectively trend – but it is well down from the 4½% annual pace of growth pace experienced in mid-2016.

This slowing has been driven by a number of factors:

- **Typical late-cycle forces:** Across many sectors of the economy, but particularly construction, capacity pressures are intense, and margins are tightening. According to the QSBO, firms are reporting that finding skilled staff is the most difficult it has been since 2005 and economy-wide capacity utilisation is near historic highs. These issues are of course of the 'nice to have' variety, and are unsurprising for an economy that has been in an expansion phase for the better part of eight years (growing above trend for some of that time). But it does represent a natural hand-brake on future expansion.
- **Credit cycle headwinds:** A large gap opened up between bank lending and deposit growth over 2016. This forced banks into credit rationing and more aggressive competition for deposits, with the credit cycle turning from friend to foe. In fact, we estimate during 2017 the credit impulse – the change in the ratio of credit growth to GDP – turned the most negative it has been since the global financial crisis. It is consistent with both firms reporting it is much more difficult to access credit within our Business Outlook survey and the observed softening in the housing market.

Figure 1: Credit impulse and GDP growth



Source: Statistics NZ, RBNZ, ANZ Research

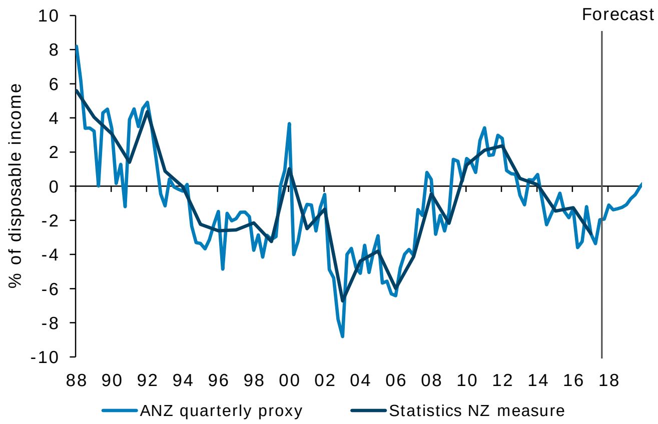
- **Softer housing market activity:** No doubt related to the credit cycle dynamics discussed above, but also affordability constraints and increased political uncertainty, national annual house price growth has cooled from over 15% to around 3½% currently. Despite recovering a little of late, turnover remains well below its 2016 average. History has taught us time and time again that where the housing market goes, the broader economic cycle is usually not too far behind. We think that will broadly be the case this time too, for all that 'this time is different' in that interest rates remain low. There are direct linkages to consider, like the impact on real estate services activity and activity in the financial sector. But a weaker housing market also has indirect effects, through things like confidence and appetite to spend.

NEW ZEALAND ECONOMIC OUTLOOK

It speaks to an economic backdrop that has gotten a little more challenging, at least relative to where it was tracking, and that is unlikely to change. We struggle to see growth accelerating back to an above-trend pace from here. Not only would that be unusual for the New Zealand economy at this point in the cycle, but there are a host of factors that we see limiting the upside.

- **Housing market activity should remain contained.** Yes, turnover has bounced and national prices have risen for seven consecutive months (after falling over the prior three), but we don't see conditions accelerating again. While interest rates remain low and demand and supply fundamentals are still extremely supportive, the tax and other measures proposed by the new Government should, at the very least, contain investor sentiment. In addition, we doubt the recent tightening in bank lending appetites will fully reverse, and affordability pressures remain as evident as ever. We assume annual house price growth slows from 4% to 2% over the next couple of years.

Figure 2: Household saving rate

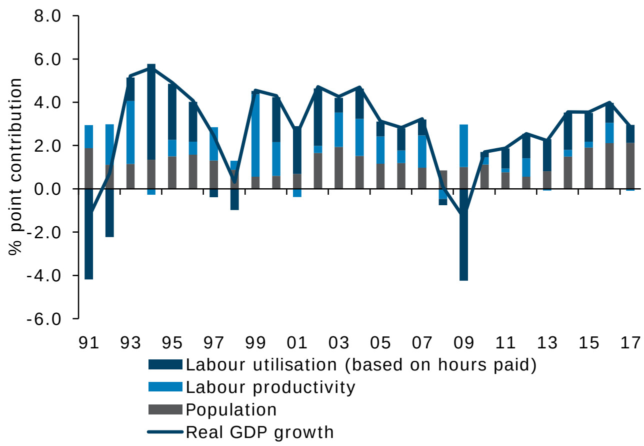


Source: Statistics NZ, ANZ Research

- **Households are likely to look to rebuild precautionary saving.** We estimate the household saving rate is currently around -2%, down from around +3% in 2011. Household income growth looks set to remain reasonable on the back of a strong labour market and an expected modest lift in wage growth. Some of the new Government's initiatives are likely to put more money into the pockets of those households most likely to spend it. But we still believe that at a time when the asset side of household balance sheets is looking less firm (and debt levels are elevated), households will look to rebuild saving buffers, which all else equal will contain consumption growth. We forecast real household consumption to slow from 4.5% y/y in 2017 to 3.5% and 2.5% in 2018 and 2019 respectively. That said, we admit that there could potentially be an element of mixing up what we believe households *should* do with what they *will* do. When consumers get the bit between their teeth they can be hard to rein in, and that's an upside risk to our forecasts.

- **Some of the 'easier' growth levers have already been pulled.** Over the past four or so years, the economy has been growing larger by working harder as opposed to smarter. In the year to December, we estimate that of the 2.9% growth that was recorded, 2.1%pts came from population growth, and 0.8%pts was from labour utilisation, with labour productivity growth flat. Population growth is expected to slow on the back of an assumed easing in net migrant inflows,[1] and labour utilisation growth is unlikely to be maintained at recent rates, given that both the participation and employment rates are already at all-time highs. Thus, the onus is going to be on labour productivity growth to accelerate. That is not out of the question, and we are hopeful, but it is hard to have a great deal of conviction about it happening, given weak productivity growth has been a global phenomenon over recent years.

Figure 3: GDP growth decomposition



Source: Statistics NZ, ANZ Research

- **Capacity challenges are not going away.** While the likes of the underutilisation rate at ~12% suggest there is still spare capacity in the labour market, there are some skill shortages. It is not unique to New Zealand, but there are some mismatches between the skills firms want and what is available. In time, businesses will likely look for alternative ways to expand capacity, and automation is a logical choice for some, but it is not something that can be ramped up quickly.

[1] We are assuming 12-month rolling net migration slows to 46k by the end of 2019.

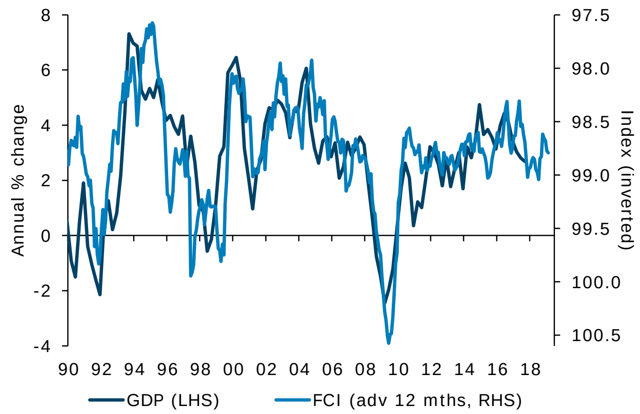
MORE CHALLENGING BUT NOT OVERTLY HARD

But while the economic backdrop is going to remain a little more challenging, that doesn't mean we think it will get overtly difficult. In our view the cycle is not about to roll over in a meaningful way just yet.

That is something in itself, as a tipping over of the cycle has actually been the historical tendency around now. Look back over history and years ending in '8' have not been kind to the New Zealand economy. Not only have they more often than not been associated with economic downturns, but these downturns have been rather sharp and painful. **That is not our view right now for a number of reasons.**

- **The economy doesn't have the same degree of imbalances it typically does at this point in the cycle.** The current account deficit is contained and net external debt has fallen to the lowest level as a share of GDP since data began (2000). There is no shadow banking sector to speak of and the RBNZ has been far more active in containing housing market risks than in previous cycles, via macroprudential policy. Credit growth is now running at a slower pace than nominal GDP growth. In addition, we still believe that, at least in Auckland, there is a shortage of housing rather than surplus. Housing surpluses have often exacerbated housing market corrections in other countries. The fact that economic imbalances are less extreme right now doesn't make the economy bullet proof. But it does provide it with more resilience to shocks than would be the case otherwise.
- **The RBNZ is happy to keep the party pumping.** Previous downturns (or at least a turn in the business cycle) have often occurred as the central bank actively looks to apply the brakes. However, that is not the RBNZ's message right now, given how remarkably contained inflation pressures have been. In fact, it is still talking about a non-trivial chance of future interest rate cuts. That is not our core view, but we certainly don't see the RBNZ beginning to withdraw stimulus for some time yet, and even when it does it will be in a tip-toe fashion.
- **Broader financial conditions are still supportive.** In part due to the above, but also due to the likes of narrow credit spreads, decent equity market performance and elevated commodity prices, our Financial Conditions Index is still consistent with solid GDP growth. To be fair, an eye needs to be kept on the recent widening in local bill-OIS spreads, as this has often been a signal of financial stress in the past. However, it currently looks to primarily reflect equivalent US moves rather than any strain in in the local banking sector, so we are assuming that pressures don't escalate from here.

Figure 4: Financial Conditions Index and GDP



Source: Statistics NZ, ANZ Research

- **Fiscal policy is turning more expansionary.** We don't believe it is as simple as the Government stating that it intends to spend *x* dollars and this will have *y* impact on growth. At a different stage in the cycle that may have been the case, but with capacity constraints evident, we are of the mind that there will be some crowding out effect on private sector activity of some of the Government's new programmes, particularly with regards to housing and infrastructure construction. That being said, the Treasury estimates the fiscal impulse will average 1.2% of GDP over the next two years, which certainly makes a change from the 0.8% of GDP drag that it averaged over the prior six.
- **Perhaps the worst of the credit headwinds are behind us.** The fact banks had to put the brakes on new lending is arguably an under-appreciated factor behind the slowing in GDP growth over recent years. But with the gap between bank lending and deposit growth having narrowed, those pressures are no longer as intense.
- **The global economy is still expected to perform well.** To be fair, it is hard to see things improving in a growth sense from here. Arguably the global economy has already been in its most synchronised upswing since the financial crisis over the past 12 months or so – but it is probably 'as good as it gets'. There are also perhaps a few more risks creeping in of late, including on the trade front and how markets handle the steady removal of US monetary policy stimulus.

NEW ZEALAND ECONOMIC OUTLOOK

Ultimately, it is an outlook where we remain relatively constructive on the domestic picture overall. Is the economy firing on all cylinders? No, it is not. But you wouldn't expect it to be after an extended period of expansion, with supply-side challenges clearly evident. Data flow and sectoral economic performance has turned more mixed and we expect that theme to persist. There will no doubt be some inter-quarter volatility as there always is for a small, open economy like New Zealand. But we still forecast the economy to maintain a GDP growth rate of around 3% over the next couple of years, which, given the cycle is getting a little long in the tooth, is hardly a negative story.

BUT ARE WE STILL TOO NEGATIVE?

So what would see us shift more positive on growth? After all, while our forecasts could certainly not be classed as negative, we are not as upbeat as the likes of the Treasury or RBNZ, who both see growth accelerating above trend over the next couple of years.

There is a possibility we are under-estimating the economy's supply side potential. If we are wrong on the fact that capacity pressures are here to stay, either because they are overstated or investment increases, then the economy would have more room to grow than we currently believe. Likewise, if productivity growth were to stage a miracle comeback and burst to life, that would of course help support the growth outlook. We would welcome such a development.

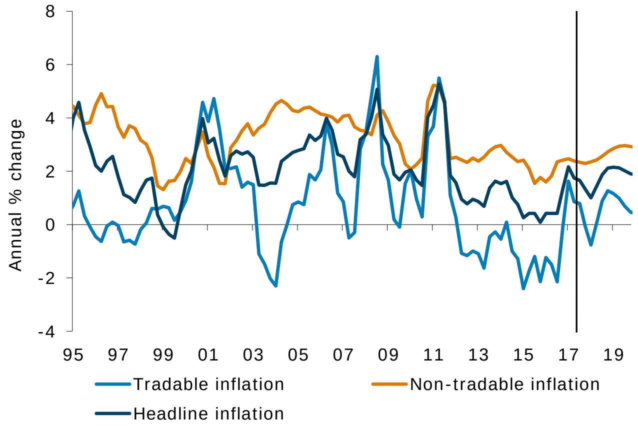
But there are other factors that could support the growth picture that we would not necessarily welcome with open arms. We already discussed the possibility of an over-exuberant consumer. A resurgence in housing market activity would exacerbate this risk significantly, and that is not out of the question given that some of the factors behind the strength to begin with – low interest rates, strong population growth, and a constrained supply-side – are still very much in play. Stronger house prices would come with that initial feel-good factor and support confidence and spending in the economy. However, given that it would no doubt correspond with strong credit growth, with household debt already at record highs relative to incomes. We fear such a development would accelerate an economic hangover, say in 2020.

HIGHER INFLATION IN TIME… WELL, MAYBE

Despite our core forecasts showing growth only around trend over the next few years, we still forecast domestic inflation pressures to rise in time. That is largely based on the view that wage growth will lift modestly from here. Anecdotally we are hearing more messages of firms having to pay up to attract staff, and we see the unemployment rate eventually falling to 4.2% by 2019, intensifying skill pressures. The new Government has also been unapologetic about its attempts to raise wage expectations, through the likes of minimum wage hikes and workplace relations reforms, and at least in spirit they lean in that direction. We forecast the private sector LCI to lift to 2.2% by 2019, which would be the strongest since 2009.

Even if we are correct that wage growth is set to rise, it is far from certain that this will feed through into consumer prices. As in many other countries, consumer inflation has been surprisingly subdued throughout the economic cycle. Various theories from technology, to industry concentration, to the ongoing impact of globalisation have been suggested for the breakdown of traditional inflation dynamics, but it is fair to say that no one has all the answers. Inflation forecasts are currently subject to greater-than-normal uncertainty. For the record, we are picking headline inflation to average 1.6 and 2.0 over 2018 and 2019 respectively. Courtesy of base effects and the impact of tertiary education subsides, headline inflation is forecast to drop to 1.1% in Q1 and not return to the 2% target mid-point until H2 2019. In our assessment, risks to the near-term forecast are skewed to the downside.

Figure 5: CPI inflation



Source: ANZ, Statistics NZ

Such a gradual pick-up in inflation will hardly put the wind up the Reserve Bank. At its latest OCR Review, it reiterated that "Monetary policy will remain accommodative for a considerable period". We concur. Although we see a little more inflation pressure over the next couple of years than was evident in the Reserve Bank's latest published forecasts, we are not forecasting any increase in the Official Cash Rate until the second half of 2019, and even then a number of ducks still need to line up.

INTERNATIONAL OUTLOOK

SUMMARY

Our global growth forecasts continue to depict a steady and – on balance – positive picture. But risks are skewed to the downside. Expansionary US fiscal policy should support global trade, but markets will remain attentive to further tensions as the China-US trade saga continues to unfold.

STABLE FROM HERE?

The global data pulse remains positive. In March, the ANZ Global Lead Index continued to point to above-trend, broad-based global growth. Consumers and businesses remain upbeat, levels of industrial activity are high, and inflationary pressures, particularly in the US, are building alongside tightening labour market conditions and modest wage growth.

Our global growth outlook is for broad-based, above-trend growth to continue. While we've revised down our expectation for world growth a tick in 2019 to 3.8%, in an absolute sense this is immaterial. The bottom line is that world growth reached 3.8% in 2017, and is likely to remain around that level through 2018 and 2019.

Fiscal stimulus in the US is expected to contribute meaningfully to global demand and trade. However, the Government is injecting additional stimulus into an economy that is already running hot: household spending is being underpinned by solid jobs growth and modestly rising wages; the drag on growth from lower investment in the energy sector (in the wake of depressed energy prices in early 2016) has now well and truly passed; and consumers and businesses remain upbeat. With the US effectively at full employment, fiscal stimulus is likely to result in some combination of higher inflation and a wider trade deficit, which could partially offset the Government's growth impulse.

A boost in global exports to the US could inflame trade tensions, presenting further headwinds for markets. President Trump wants a USD100bn reduction in China's trade surplus with the US and threatened to raise tariffs on some Chinese imports to encourage what Washington argues is 'fairer' trade. Beijing has said it could retaliate. Disputes that disrupt the free flow of global trade and capital have the potential to negatively impact growth. So far, this is not the case. But higher trade friction can't be ruled out and that could raise concern over the financing of the US budget and current account deficits. This would imply higher bond yields and greater volatility for financial markets as financial conditions tighten. That could have negative implications not just for US growth but global activity.

Here are some of the big themes we are watching:

- **The US fiscal impulse** is firmly on our radar. With the US economic cycle already in a late stage, there are questions around how much additional growth fiscal stimulus can squeeze out. Will a resulting more aggressive tightening cycle by the Fed spoil the party?
- **The ECB's very stimulatory policy settings** are facing greater scrutiny with growth becoming more secure. Signals have been sent for a possible unwinding of the ECB's bond purchasing program from September.
- **If the US broadens its trade measures**, China is likely to retaliate, which will be negative for global sentiment – and likely commodity prices.
- **Will wages and inflation lift sustainably?** While activity growth suggests an ongoing slow absorption of spare capacity, secular deflationary suppressants, especially technology, remain in play. Ultimately, we suspect the profile for inflation will be the most critical driver of financial markets and hence financial conditions and the longevity of the cycle.

While our forecasts present a picture of stability in global growth, risks are skewed to the downside. The central view is that key fundamentals underpinning growth are set to continue. However, cool heads and sensible policy are required to maintain this somewhat fragile equilibrium.

Calendar Years (annual average % change)	2013	2014	2015	2016	2017	2018(f)	2019(f)
United States	1.7	2.6	2.9	1.5	2.3	2.6	2.1
Australia	2.2	2.6	2.5	2.6	2.3	2.8	3.1
Japan	2.0	0.4	1.4	0.9	1.7	1.2	1.0
Euro area	-0.2	1.3	2.1	1.8	2.3	2.4	2.0
China	7.8	7.3	6.9	6.7	6.9	6.5	6.3
World	3.8	3.5	3.1	3.2	3.8	3.9	3.8

PRIMARY SECTOR OUTLOOK

SUMMARY

Export prices are holding near cycle highs. Apart from lifting dairy and beef supply, there is little on the horizon to suggest a change in either direction. The main risk appears to be an escalation in global trade protectionism, but it's unclear exactly how this may play out for New Zealand exports. Overall dairy earnings are set to tighten slightly in 2018/19 after a solid 2017/18. Forestry, sheep meat and venison's stellar runs are set to continue. Larger horticulture crops are expected in 2018 as the planted/growing area expands. Combined with robust orchard-gate prices this should support overall revenue.

Export prices are holding near cycle highs. It's difficult to pinpoint catalysts for a sustained move in either direction. In the short term dairy and beef prices look the most vulnerable to a move lower due to improved supply conditions, but earnings for most other sectors look fairly solid. Equally, a push higher in prices for most sectors seems unlikely given improved local supply conditions, valuation challenges (buyer resistance and substitution risks) and the upward cycle in global economic growth maturing.

The main specific risk on the horizon is trade protectionism. For soft commodity markets NAFTA re-negotiations and trade developments between China and US matter a lot. If the trade dispute between the two heavyweights – the US and China – were to escalate, negatively impacting on global trade/economic activity, this would normally depress soft commodity prices.

However, depending on how far things escalate it could also work out in New Zealand's favour if we managed to fly under the radar. Indeed, if China were to place tariff and/or non-tariff barriers on US agricultural imports this could strengthen demand for New Zealand products. The sectors that would most likely benefit in such a situation are meat and dairy. This would be through both reduced direct competition and higher feed costs (soybeans, corn, alfalfa hay etc), which would increase costs and reduce the growth of China's domestic production, making imports more attractive. Most of the growth in Chinese domestic livestock production has been driven by large-scale intensive systems that are somewhat reliant on imported feed.

More specifically, dairy sector earnings still look respectable for 2017/18 but are likely to be tighter in 2018/19, depending on seasonal pasture conditions. By all accounts it's been a tougher production year, with the variable weather conditions impacting on pasture conditions and animal performance. Generally production has come at a higher cost with the use of more supplementary feed and reduced per-cow performance during the hot and humid early-to-mid summer period. Luckily farm-gate returns (fourth highest on record) have managed to hold up, supporting net earnings.

Looking toward 2018/19 we expect a milk price of $6.00 to $6.25/kg MS with whole milk powder prices continuing to fluctuate in a USD2,800/t to USD3,300/t range.

The short-term risk is we cycle lower due to improved New Zealand and European milk flow suppressing the opening milk price in May. The offset at the farm-gate is that the NZD/USD seems vulnerable to any turn lower in our terms of trade. The opening milk price is important for setting farmer cash-flow and expenditure expectations into early 2019. Early forecasts suggest these will be tighter than 2017/18, but by how much?

Meat and fibre returns remain robust with high farm-gate returns for meat products the main driver. Beef prices could pull back as US supply continues to increase and New Zealand's cull cows are turned off. So far, robust intra-market competition between China and the US appears to be soaking up the extra supply, but a further step-up will be required to maintain current prices. Apart from some valuation concerns and normal seasonal adjustments the outlook remains positive for both sheepmeat and venison prices. Strong wool prices have found a base on bargain hunting and price competition. However, a large overhang of local inventory means a sustained recovery remains a distant prospect.

In the kiwifruit sector the 2018 green crop is expected to reach 80 million trays (up from 65 million in 2017), while gold volumes will push towards 65 million trays as more vines reach maturity. The low volumes in 2017 improved the marketing mix, lifting per tray returns to a record high of $6.54/tray for Green and pushing Gold prices back up to $10/tray. Despite lower volumes, the high per tray returns lifted orchard revenue to record highs too.

Vintage 18 appears likely to deliver a near-average crop volume on a per hectare basis in the main growing regions. Combined with new plantings reaching maturity (with a circa 10% increase in area planted in Marlborough since 2012), this is expected to see the total crop lift back into the low 400,000 tonne range in 2018.

The pipfruit crop is expected to lift to 576,000 tonnes (circa +6%) driven by a 4% increase in the planted area. The average fruit size is larger due to regular rainfall and heat during the growing season, particularly early on. Pricing indicators looks favourable, especially early on with lower carryover European stocks and reduced NZD/EUR.

NZ log production and export volumes are strong. Total log production is tracking 9% ahead of the 5-year average and log exports are 16% above their 5-year average. Domestic and export log and lumber prices remain well above last year, but upward momentum has flattened out as construction activity in China and domestically steadies at high levels.

FINANCIAL MARKETS OUTLOOK

SUMMARY

While funding market pressures both here and abroad are creating some angst, we don't believe local pressures will escalate. And with the RBNZ not set to tighten policy until the second half of 2019, we see scope for local short-end rates to fall modestly in the near term, but ultimately remain anchored by RBNZ policy inaction. Local long-end rates should rise in line with global moves, seeing the curve steepen. However, we see further scope for further local outperformance, with NZ-US 10-year spreads to push more clearly negative. The NZD has faced a little more downward pressure recently on the recent shift higher in market volatility, and together with signs that global growth momentum is peaking, is something we see continuing over the course of 2018, especially against major G4 currencies. The NZD/AUD has threatened to break higher of late, but we ultimately see it remaining range-bound.

RBNZ UNMOVED, BUT WATCH THOSE FUNDING SPREADS

All else equal, the RBNZ's cautious stance should continue to anchor short-end interest rates. In large part due to a subdued domestic inflation environment, the RBNZ is not expecting to have to begin tightening monetary policy until the second half of 2019. It is a view we share. We have not pencilled in the first OCR hike until August 2019.

However, the near-term picture has been complicated by a rise in bank funding costs. Pressures have been particularly evident in the US, where the likes of CP/OIS and FRA/OIS spreads have lifted over recent months, in some cases to the widest levels since the European periphery debt crisis of 2012.

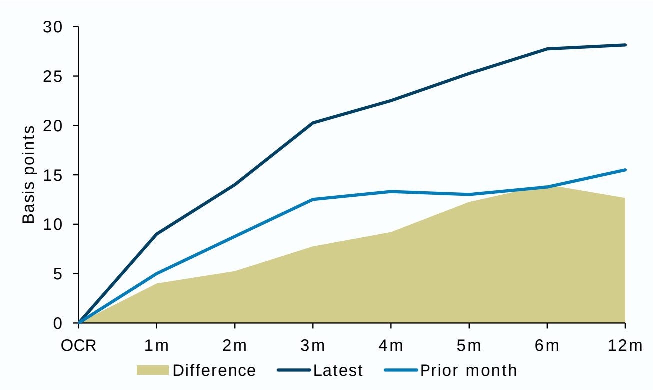
In and of itself, occasional spread widening is a normal part of the ebb and flow of markets and doesn't represent a significant concern. And in our view, this widening is more about crowding in the market (particularly given the US Treasury is also issuing more short-term debt) than it is about any crisis in funding. However, US tax-related repatriation flows have thrown up a curious by-product. The technology companies, who have transmogrified to become 'tech-fin', have become an important cog in the financing world. The 'FAANGS', as they are collectively known, have become large bond holders – providing capital to banks, corporates and sovereigns. Their withdrawal from this role, to pay for share buybacks and dividends, removes a large slice of capital from markets.

It means that US funding markets are now likely to remain in a more challenged environment for the foreseeable future. We believe this fundamental shift in the backdrop of funding markets will last over the course of the year.

New Zealand has not been immune to these pressures. Despite local banks generally being awash with cash, term bills-OIS spreads have widened. The 3-month BKBM has lifted to 1.96% – the highest level since October last year, despite the market pushing out expectations for the first RBNZ OCR hike. This has pressured short-dated swap rates to follow suit, with the bellwether 2-year swap currently at 2.24%, up from a recent low of 2.15%. All else equal, it has represented a modest tightening in financial conditions.

We are certainly mindful of the fact that the challenges facing domestic funding markets could persist. However, we don't believe they are on anywhere near the same scale as seen in the US, and more than anything think they represent a move in sympathy, rather than being justified by local fundamentals. Therefore, with the RBNZ firmly on hold, we see scope for short-end interest rates to push back towards their lows again, which will also lead to modest curve steepening.

Figure 1: NZ Bills-OIS curve



Source: Bloomberg, ANZ Research

LONG END OUTPERFORMANCE

Our views on the broader global interest rate environment are ultimately unchanged. Global front ends are likely to face further pressure as central banks continue down the path of monetary policy stimulus withdrawal and quantitative tightening. Near-term risks appear skewed towards more, rather than less, tightening, with the market yet to full embrace the idea of the Fed potentially shifting towards four hikes over the course of 2018 (which admittedly is not our view).

FINANCIAL MARKETS OUTLOOK

But global long-end yields are rising in sympathy, and it is a theme that we expect has further to run. Term premiums are lifting and inflation expectations are rising. We forecast the US 10-year bond yield to lift to 3.5% by the end of this year. However, there are limits to how high interest rates can go before they start to have a negative impact on asset values, growth and the inflation outlook itself. Of course, that's how monetary policy is supposed to work, but given current high levels of both asset values and debt, plus low productivity growth and structural deflationary forces, we suspect that ironically, the higher interest rates go now, the more likely they are to be lower in the future.

For the local long end, the main judgement centres on whether or not the significant NZ-US spread compression seen over recent years has further to run. We are of the view that the major move is behind us, and certainly on some historical benchmarks New Zealand bonds look expensive. But again, with the RBNZ anchored and still some way away from shifting stance, together with the new Government sending a clear signal that it will work within relatively prudent debt and spending confines (reducing fears of a debt-supply shock), the New Zealand 10-year bond yield looks set to comfortably trade through the US equivalent for the first time since the mid-1990s.

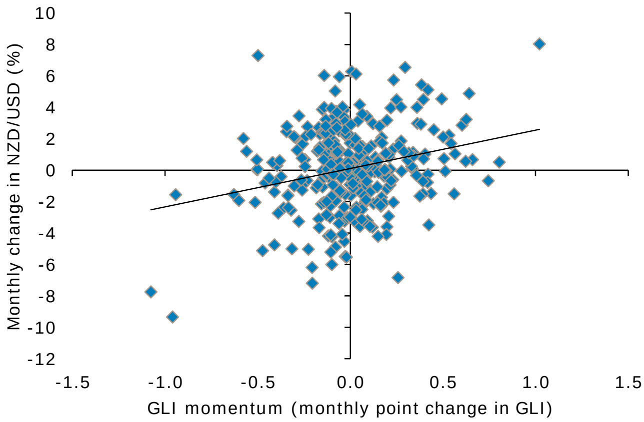
ON THE DEFENSIVE

The overarching themes driving our view on the outlook for the NZD have not changed a great deal. We are still of the belief that with the global liquidity cycle tightening as global central banks remove monetary policy stimulus, a return to more 'normal' volatility conditions will represent a less favourable environment for the likes of the NZD.

In fact, this process is already underway. It comes as little surprise to us that as market volatility has shifted higher over the past month or so, the NZD has underperformed G4 currencies. It is a theme we expect to persist.

What is also likely to keep the NZD on the defensive over the months ahead (again largely against the major G4 currencies), is our belief that the global growth cycle is at, or near, a peak. The NZD, like many cyclical currencies, benefited from the synchronised global upswing and broad commodity price strength. There are perhaps now some tentative signs that the global data pulse is turning more mixed. But more clarification of that would further pressure the NZD in our view, particularly at a time when interest rate differentials have already narrowed significantly (and look likely to continue doing so).

Figure 2: NZD versus global growth (ANZ GLI) momentum



Source: Bloomberg, ANZ Research

We believe these global considerations will continue to trump domestic ones for now. In saying that, the domestic cyclical and structural backdrop for the New Zealand economy remains respectable. The economy is growing around trend and is expected to continue to do so. The economy's external imbalances, namely the current account deficit and net external debt levels – long the economy's and the NZD's Achilles' Heel – are in far better shape than they'd typically be at this point in the cycle. That doesn't diminish the possibility of a currency cycle, but should at least provide some cushion to the downside.

INDIVIDUAL CURRENCY PAIRS

NZD/USD: On the back foot. We believe the cyclical high has now been experienced and the factors weighing recently (increased market volatility especially) will continue to do so over the coming months, driving a move to 0.67 by year end.

NZD/AUD: Range bound. While this cross is threatening to break higher, we ultimately see it in a broad range-trading environment as both central banks remain cautious with regards to tightening policy and global themes dominate. We are watching global trade developments closely, given the risk they hurts the AUD more in the first instance.

NZD/EUR: Set to head lower. Although the ECB is set to be extremely gradual in shifting stance, and political risks within the euro area remain, we see this cross heading lower in a medium-term context as the NZD underperforms as global liquidity is withdrawn – just as the opposite was the case when global central banks had their cheque books out.

FINANCIAL MARKETS OUTLOOK

NZD/GBP: Making progress. The GBP in undervalued on a number of different measures, but Brexit uncertainty justifies that. However, progress is supposedly being made and as clarity ensues, we see the NZD/GBP falling back below 0.50.

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.

	Actual	Forecasts (end of quarter)						
FX Rates	29-Mar	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
NZD/USD	0.72	0.70	0.69	0.67	0.66	0.65	0.65	0.65
NZD/AUD	0.94	0.92	0.93	0.93	0.94	0.93	0.93	0.93
NZD/EUR	0.59	0.56	0.54	0.52	0.51	0.50	0.50	0.50
NZD/JPY	76.9	74.2	71.8	69.0	66.0	64.4	63.1	62.4
NZD/GBP	0.51	0.50	0.49	0.47	0.46	0.45	0.45	0.45
NZD/CNY	4.54	4.40	4.33	4.19	4.12	4.05	4.04	4.03
NZ$ TWI	74.4	70.8	69.6	67.8	66.5	65.4	65.2	65.1
Interest Rates	29-Mar	Jun-18	Sep-18	Dec-18	Mar-19	Jun-19	Sep-19	Dec-19
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.25
NZ 90 day bill	1.96	1.98	2.08	2.34	2.50	2.50	2.59	2.75
NZ 2-yr swap	2.22	2.49	2.62	2.80	2.88	2.89	2.94	3.00
NZ 10-yr bond	2.74	3.05	3.30	3.50	3.50	3.50	3.50	3.50

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	4.0	2.9	3.0	3.0	2.5
Private Consumption	3.2	3.8	5.0	4.5	3.5	2.5	2.2
Public Consumption	3.3	2.7	1.7	4.7	5.0	3.3	2.4
Residential investment	9.8	6.0	11.8	0.6	-1.2	-1.6	-3.9
Other investment	9.4	3.7	4.5	4.2	5.0	4.4	3.9
Stockbuilding[1]	0.4	-0.3	0.0	0.0	0.1	0.0	0.0
Gross National Expenditure	4.5	3.2	4.7	4.0	3.8	3.1	2.4
Total Exports	3.1	7.0	1.5	2.6	0.7	2.4	2.9
Total Imports	7.9	3.8	3.3	6.6	1.4	2.2	2.3
Employment (annual %)	3.6	1.4	5.8	3.7	1.6	1.2	1.2
Unemployment Rate (sa; Dec qtr)	5.5	5.0	5.3	4.5	4.2	4.2	4.1
Labour Cost Index (annual %)	1.7	1.5	1.6	1.8	2.1	2.2	2.2
Terms of trade (OTI basis; annual %)	-5.0	-3.1	6.7	7.3	-2.1	0.3	0.4
Prices (annual % change)							
CPI Inflation	0.8	0.1	1.3	1.6	1.6	2.0	1.8
Non-tradable Inflation	2.4	1.8	2.4	2.5	2.0	2.9	2.6
Tradable Inflation	-1.3	-2.1	-0.1	0.5	1.2	0.9	0.8
REINZ House Price Index	6.3	11.5	13.8	4.9	0.5	2.0	2.1
Fiscal and External Balance							
Current Account Balance ($bn)	-7.7	-7.6	-6.0	-7.6	-7.4	-7.9	-7.6
as % of GDP	-3.2	-3.0	-2.3	-2.7	-2.5	-2.5	-2.3
Government OBEGAL ($bn)*	-4.4	-2.8	0.4	1.8	4.1	3.6	2.0
as % of GDP	-1.2	0.2	0.7	1.5	1.2	0.7	0.9
NZ Financial Markets (end of December quarter)							
TWI	79.4	73.7	76.1	73.0	67.8	65.1	65.1
NZD/USD	0.78	0.69	0.69	0.71	0.67	0.65	0.65
NZD/AUD	0.96	0.94	0.96	0.91	0.93	0.93	0.93
NZD/CNY	4.86	4.45	4.81	4.62	4.19	4.03	4.03
NZD/EUR	0.64	0.63	0.66	0.59	0.52	0.50	0.50
NZD/JPY	93.6	82.5	81.1	80.0	69.0	62.4	62.4
NZD/GBP	0.50	0.46	0.56	0.53	0.47	0.45	0.45
Official Cash Rate	3.50	2.50	1.75	1.75	1.75	2.25	..
90-day bank bill rate	3.68	2.75	2.00	1.88	2.34	2.75	..
2-year swap rate	3.80	2.85	2.46	2.21	2.80	3.00	..
10-year government bond rate	3.67	3.57	3.33	2.72	3.50	3.50	..

[1] Percentage point contribution to growth

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