

Inflation pressures largely contained to housing sector

- Inflation was flat over Q2, weaker than market participants had expected. Annual inflation dipped back to 1.7% yoy.
- Domestically-generated inflation was largely absent, save price pressures in the housing sector (notably in Auckland).
- As a result, the Government's Auckland infrastructure announcement is a step in the right direction.

Last week's [CPI release](#) showed that, on balance, NZ did not generate any inflation in Q2. This was in stark contrast to Q1, when the CPI rocketed up 1% qoq. Although most economic commentators had expected inflation pressures to soften, **the flat result was weaker than anyone had expected.** And while a degree of the softness came through the recent falls in fuel prices as expected, **underlying inflation pressures in many sectors of the economy remain notably absent.**

A key source of weakness in Q2's result was on the non-tradable side of the equation (or domestically generated inflation). In particular, accommodation services fell by 8.1% qoq, credit services fell for the second quarter in a row and price pressures in miscellaneous services were also more muted than anticipated. Transport prices were also subdued with passenger transport services being driven lower by a 14.5% fall in domestic airfares. Interestingly, **impacts from the Lion's Tour were, for the most part, largely uncaptured in the Q2 survey.** For example, accommodation prices were surveyed before the tour began. **As a result, Q2 CPI provides a relatively accurate picture of underlying inflation, as it wasn't impacted by this one-off event.**

However, inflation is continuing to lift in some parts of the economy which offset the falls mentioned above. Notably, the housing sector. In Q2, **construction costs** (i.e. prices for building a new house, excluding land costs) rose 1.8% over the quarter, driven by a 3.0% rise in construction costs in Auckland. **As well as the cost of building houses continuing to rise, so is the cost of renting them.** Rental prices lifted 0.4% in Q2, with Auckland once again leading the pack with a 0.7% qoq increase in rents. Despite the recent softness in the Auckland housing market, **it remains the case that the rapid population increase (see the Chart of the Week below for more information) is continuing to place pressure on Auckland's housing stock.**

And over the weekend, **the Government took another step in acknowledging these pressures in Auckland by announcing that it had set up a new Crown company, Crown Infrastructure Partners, to help boost the construction of new homes in Auckland.** The company will invest \$600m in housing-related infrastructure and will be **funded by a combination of development contributions and targeted rates within the new developments.** One reason housing construction had been slow to respond to the increase in demand has been the difficulty for Auckland Council to fund the required infrastructure (see our paper on infrastructure challenges [here](#)). Under the Crown Infrastructure Partners model, infrastructure debt will remain off the Council's books, helping the Council remain below its debt ceiling. If the Council were to breach its debt ceiling it would risk being downgraded and face higher costs of funds. However, infrastructure is only one part of the picture and while capacity constraints remain rife in the construction sector, it will take some time before we know how successful this model is in bringing forward housing construction in Auckland.

Foreign Exchange

- NZD lifted strongly over the second half of the week.

Interest Rates

- NZ interest rates movements over the past week were mixed.

Week Ahead

- Trade balance and building consents for June, ANZ business outlook for July.

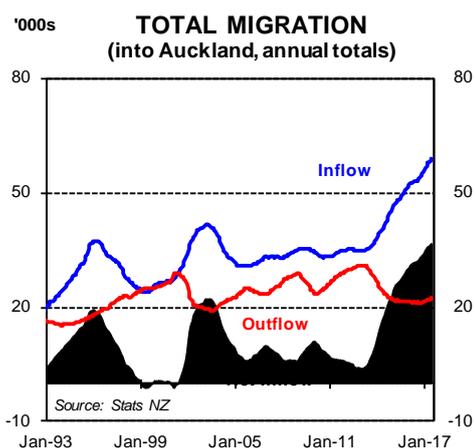
Week in Review

- Q2 CPI was flat, dairy prices were unchanged last week while net migration hit a new record high.

Global Calendars

- The US Fed's interest rate announcement is awaited this week, along with Australian CPI.

Chart of the Week: Population growth keeping the pressure on Auckland



Net migration into New Zealand has largely been trending higher since 2013, with the latest figures released by Statistics NZ showing that annual net migration climbed above 72,000 in the year to June 2017 (yet another new record high). And, with roughly half of these new immigrants settling in Auckland (an additional 36,650 people in the year to June), it's not surprising that we have seen, and are still seeing, pressure building on Auckland's current housing stock.

Although we are expecting the inflow to fall back and the outflow to pick up on a nationwide basis, it could be some time before we see net migration back at more historically normal levels. Further, as net migration into Auckland in particular is more often than not positive compared to NZ as a whole, demand for Auckland housing is likely to remain at reasonable levels. This dynamic is one of the key reasons why we expect the current softness in the Auckland housing market to be only temporary.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7445	0.7328	0.7266	0.7204	0.6999	FLAT	0.7350	0.7550
NZD/AUD	0.9415	0.9378	0.9616	0.9511	0.9354	FLAT	0.9300	0.9500
NZD/JPY	82.75	82.52	80.85	81.84	74.04	FLAT	81.60	84.10
NZD/EUR	0.6381	0.6394	0.6508	0.6703	0.6345	FLAT	0.6300	0.6490
NZD/GBP	0.5729	0.5596	0.5721	0.5797	0.5291	FLAT	0.5650	0.5820
TWI	78.9	78.0	78.4	78.7	75.0	FLAT	77.00	80.00

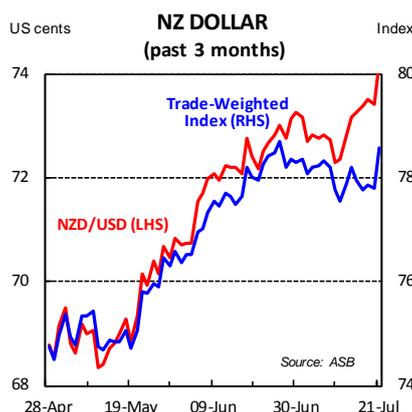
^Weekly support and resistance levels * Current is as at 9.30 am Monday; week ago as at Monday 5pm.

NZD lifted strongly over the second half of the week, shrugging off the weaker than expected Q2 CPI result on Tuesday 18th July. **Comments by the NZ Finance Minister** that the higher NZD “reflects strong New Zealand economy” and “New Zealand firms are coping well with Kiwi at current levels” also **further propelled the NZD**.

The USD was weighed down by the collapse of the Republican’s second attempt to bring a health care reform bill to the Senate. The apparent lack of Republican Party consensus adds to financial markets growing doubts that an aggressive US fiscal stimulus package can be implemented by the end of the year. **We expect the USD to consolidate this week**, and see the risk is the USD adjusts higher in the coming weeks supported by improving US economic activity.

AUD lifted strongly against the USD and NZD on Tuesday following the release of the RBA meeting minutes, which were upbeat in light of recent labour market improvements and included discussions around the neutral cash rate. The AUD eased later in the week when RBA Deputy Governor commented that neutral cash rate discussions were not a signal that rate hikes were imminent. **The AUD will be sensitive to core CPI outcomes** (Wed 26th), with expectations centred on a 0.5% qoq (1.7% yoy) lift.

Short-term outlook:



Key data

	Date	Time (NZT)	Market
NZ June Trade Balance, \$m	26/07	10.45 am	+100
AU Q2 CPI, core measures %qoq	26/07	1.30 pm	+0.5
FOMC policy Announcement	27/07	6.00 am	No change
US Q2 GDP, % saar	29/07	12.30 am	2.5

Key events: NZD: Jun trade balance (Wed). USD: FOMC meeting (Thu), Jun trade balance, Jun durable goods (Thu); Q2 GDP (Fri). AUD: Q2 CPI (Wed); Q2 terms of trade (Thu). JPY: Jun CPI, retail sales & unemployment (Fri). EUR: Jul PMIs (Mon); Jul German IFO (Tue); Jul business climate (Fri). GBP: Q2 GDP (Wed).

Speakers: RBA: Governor Lowe (Wed). BoE: Brazier (Tue); Haldane (Wed). ECB: Smets (Tue).

Medium-term outlook:

Last Quarterly Economic Forecasts

Our FX forecasts were fine-tuned last week following a period of low volatility in currency markets. Despite the fine-tuning, we have left our USD forecasts unchanged. Uncertainties around the timing of US fiscal stimulus remain, especially given the ongoing difficulties in getting other reforms through Congress, and will continue to weigh on the USD. **As a result, we continue to expect the NZD/USD to average 0.7200 over the second half of 2017. Over 2018, we expect the NZD to outperform the USD.** NZ’s persistently high Terms of Trade (ToT) will continue to provide the NZD with significant support. The high ToT will lift real GDP and will keep the RBNZ on track to raise interest rates by the end of 2018. **We expect the USD to stabilise once the fiscal policies are signed into effect, however, this may now not occur until 2019.**

On top of the persistently high ToT, the NZD remains supported by relatively high interest rates, increased offshore investor demand and a structural improvement in the current account deficit. As a result, we expect the NZD/AUD to remain firm. Further, the **risk that the RBNZ raises interest rates before the Reserve Bank of Australia will further support the NZD/AUD.** Over 2017, we expect the NZD/AUD to average 0.9500 then lifting above 0.9600 towards the end of 2018.

We have revised our GBP forecast higher again, following our upward revision in May. High UK CPI is likely to see the BoE raise interest rates in November. Further, the fact that the European Court of Justice will now have a role in UK law making post-Brexit means the UK economy is likely to hold up better than expected over the forecast horizon. We expect the NZD/GBP to largely remain with a range of 0.54-0.57 until the end of 2019.

In the near term we expect to see NZD/JPY hold above 80. The recent narrowing of the Japanese current account surplus has removed some of the JPY strength. Further out, the prospect for more BOJ easing and RBNZ tightening should further strengthen the NZD against the JPY, holding the NZD/JPY above 84 over 2018.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	1.75	1.75	1.75	1.75	2.25	FLAT
90-day bank bill	1.94	1.95	1.95	1.98	2.31	FLAT
2-year swap	2.26	2.29	2.25	2.46	2.09	FLAT
5-year swap	2.80	2.86	2.72	3.04	2.18	FLAT
5-year benchmark gov't stock	2.57	2.63	2.46	2.64	1.89	FLAT
NZSX 50	7671	7700	7554	7067	7246	FLAT

^Weekly support and resistance levels * Current is as at 9.30am Monday; week ago as at Monday 5pm.

NZ interest rates movements over the past week were driven by a mix of influences from the US and Australia. The weaker-than-expected NZ Q2 CPI result on Tuesday had a fleeting impact, initially weighing on shorter-term interest rates as market participants pared back expectations for rate hikes in NZ. However, by Tuesday afternoon focus had turned to Australia. The RBA meeting minutes were more upbeat than expected, which generated a large reaction in Australian rates and cash rate expectations. Much of this was subsequently unwound following a speech by RBA Deputy Governor. The speech clarified that discussion of the neutral cash rate was not a signal that rate hikes were imminent, prompting the market to correct its earlier over-reaction. NZ short-term rates moved in sympathy with Australian interest rates, lifting over Wednesday but then unwinding these moves on Friday.

NZ longer-term rates were influenced by the downward movements in US government bond yields. The combination of weak inflation reducing Fed hike expectations and the Republican Party's failure to unite over health care reform both weighed on US interest rate expectations. The Republican Party's difficulties cast doubts that aggressive US fiscal policy reform can take place this year, lowering US growth and inflation expectations.

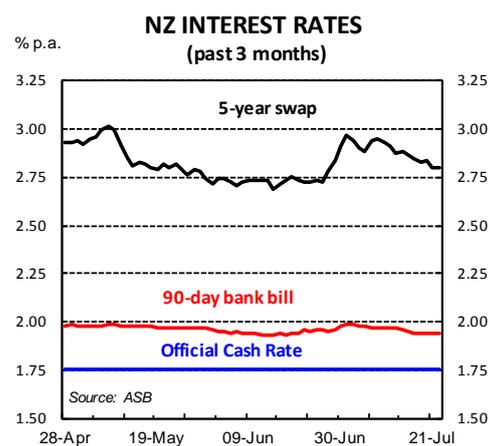
Short-term outlook:

Key data

Date

Time (NZT)

Market



AU Q2 CPI, core measures %qoq

26/07

1.30 pm

+0.5

FOMC policy Announcement

27/07

6.00 am

No change

US Q2 GDP, % saar

29/07

12.30 am

2.5

Comment: The key focus this week will be Australian CPI and the FOMC rate announcement. In light of the past week's volatility in Australian rate expectations, we expect the market would be sensitive to the Q2 CPI outcome. RBA Governor Philip Lowe's speech (titled: The Labour Market and Monetary Policy) on Wednesday will also be of interest.

Meanwhile, the **Federal Open Market Committee (FOMC) policy announcement and US Q2 GDP growth will be the other major event for financial markets this week.** The Federal Reserve is widely expected to make no monetary policy or guidance changes at Thursday's meeting.

Medium-term outlook:

Last Quarterly Economic Forecasts

The RBNZ continued to hold the OCR at its record-low of 1.75% at its June OCR Review. In May, the RBNZ surprised markets by retaining its neutral policy stance, despite the stronger than expected Q1 CPI result and Q2 RBNZ inflation expectations data.

At the June OCR review, the RBNZ acknowledged the major developments since the May Monetary Policy Statement. **GDP growth proved weaker than expected, the TWI has appreciated and energy prices have declined.** However, providing some offset, the **higher Terms of Trade and Budget 2017** are all positive for medium-term growth prospects. While the **RBNZ's assessment of events was broadly in line with our expectations, some market participants were surprised that the RBNZ did not use firmer language on the NZD.** The RBNZ 'merely' noted the higher NZD was partly due to export prices.

At the May MPS, a key point of difference between our view and the **RBNZ's was our medium-term milk price assumption.** We see scope for the RBNZ to revise this up in light of **Fonterra's confident opening season milk price forecast.** However, we will have to wait for the August MPS to confirm if this is the case.

The **RBNZ's view of the inflation outlook remained unchanged from the May MPS and OCR Review.** The RBNZ reiterated that the Q1 strength was largely due to temporary rises in petrol and food prices and that inflation was likely to be volatile over the next few quarters. **Indeed, Q2 inflation moderated more than the RBNZ expected,** with annual inflation falling back to 1.7% compared to the RBNZ's May expectation of 2.1%. Looking forward, we expect tightening domestic capacity pressures and improving global growth to lift inflation back towards the 2% mid-point of the target band by late 2019.

We continue to expect the RBNZ to leave the OCR on hold at 1.75% until late 2018.

Key international data for the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Eurozone Markit Composite PMI, July, Index	24/07	8:00 pm	56.3	56.2	56
Australia CPI, Headline, Q2, %qoq	26/07	1:30 pm	0.5	0.4	0.5
RBA Gov. Lowe speech on Labour Mkts & Monetary Policy	26/07	-	-	-	-
UK GDP, Q2, %qoq	26/07	8:30 pm	0.2	0.3	0.3
US Fed Interest Rate Announcement, %	27/07	6:00 am	1.00-1.25	1.00-1.25	1.00-1.25
Australia Import Price Index, Q2, %qoq	27/07	1:30 pm	1.2	0.7	-2.0
Japan CPI, June, %yoy	28/07	11:30 pm	0.4	0.4	0.2
US GDP, Q2, seasonally adjusted annual rate	29/07	12:30 am	1.4	2.5	2.5

Both headline and core **inflation in Australia** are forecast to rise by 0.5% over the second quarter of the year. The annual headline rate is expected to step up to 2.3% while underlying inflation should come in at 1.7%.

The **Reserve Bank of Australia Governor Philip Lowe** is slated to give a speech on "The Labour Market and Monetary Policy" at the Anika Foundation Luncheon in Sydney.

Australian import and export prices are expected to post declines over Q2. Export prices, however, should record a more significant decline because commodity prices fell over the quarter. This implies that the Q2 Terms of Trade will also likely register a fall.

Japan's inflation pressures remain very weak despite more than four years of the BoJ's extreme policy easing. We see little chance of Japanese inflation rising while wage growth is weak and inflation expectations are low.

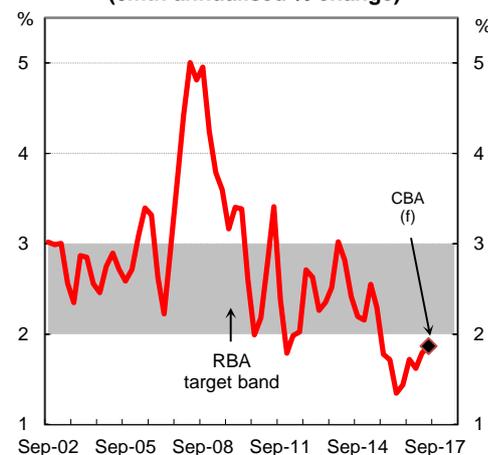
Robust regional Performance Measurement Indices (PMI's) suggest the July **Eurozone composite PMI** will print at levels around 56.

We anticipate **Q2 UK GDP** will print at 0.3% qoq. Recently-released survey and activity data are consistent with a lift over the second quarter, from poor Q1 data.

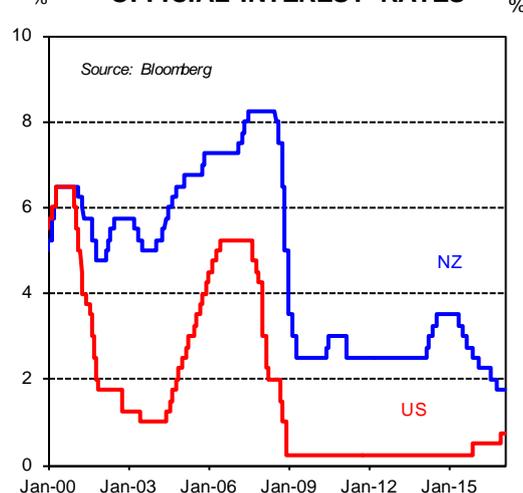
We expect the **Federal Open Market Committee meeting** to be a non-event with no change in policy and no change in forecasts. We expect the FOMC's statement to highlight the current strength in the US labour market but to be cautious about the slowdown in US inflation.

We expect **Q2 US GDP** to rebound from Q1's (unusual) weakness. Real personal consumption spending and industrial production have accelerated. But construction spending has softened. The FOMC's forecast for Q2 GDP growth is 2.8%saar while the Atlanta Fed's tracker is softer at 2.5%saar.

UNDERLYING CPI
(6mth annualised % change)



OFFICIAL INTEREST RATES



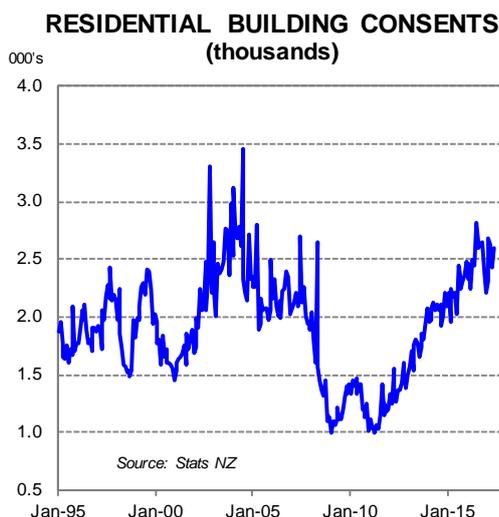
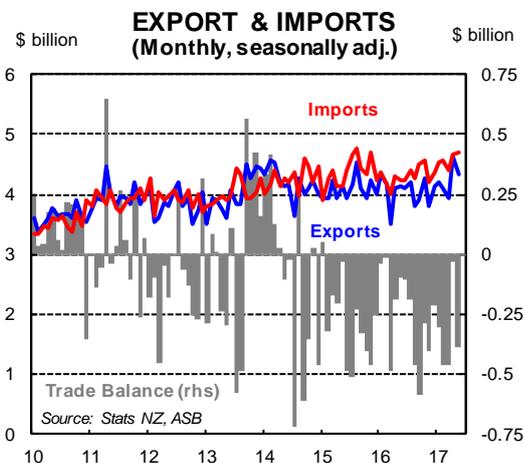
NZ Data Preview: a look at the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Trade balance, June, \$m	26/07	10:45 am	+103	+300	+400
Building Consents, residential, June, %mom	31/07	10:45 am	+7	-	-
ANZ Business Outlook, headline confidence, July	31/07	1.00 pm	24.8	-	-

We expect a **trade surplus of \$400m in June**. Looking over the month, we expect dairy export values to maintain their new higher level and for rising meat export prices to translate into a fourth successive monthly surplus. At the same time, import values remain firm, in line with healthy domestic demand. Looking at the annual balance, **we expect the annual trade deficit to narrow to \$3.46 billion**.

Residential building consents lifted 7% in May, bouncing back from April's Easter-induced decline. The lift in consents was particularly strong in the large cities (Auckland, Wellington and Christchurch). Strong population growth over the past few years has lifted housing demand in many parts of the country, and **we expect strong housing construction to continue at least for another year**.

Business confidence jumped higher in June, back towards levels seen in H2 2016. Own-activity expectations remain particularly robust, especially in the agricultural sector. Current **dairy prices**, combined with Fonterra's bullish opening season forecast, are likely **underpinning confidence**. We expect economic growth will accelerate over the coming year, with business confidence (in particular own-activity measures) remaining robust. However, confidence could dip ahead of the General Election due to be held in September this year.



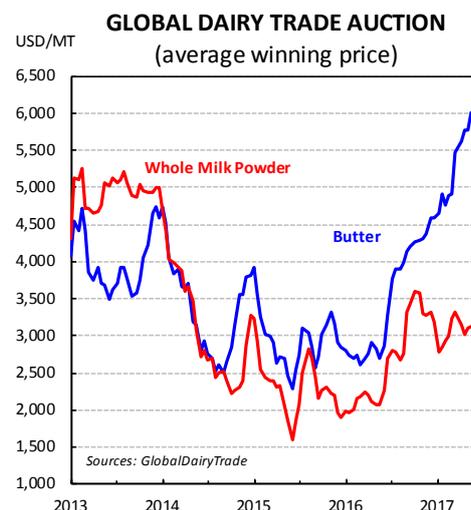
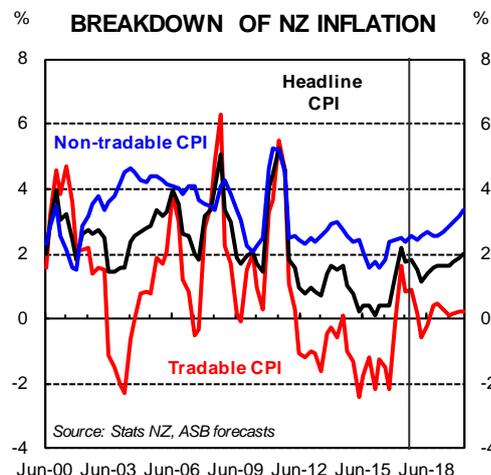
Data Recap: weekly recap

Data	Date	Actual	Market forecast	ASB Forecast
CPI, Q2, %qoq	18/07	0.0	0.2	0.1
GlobalDairyTrade auction, whole milk powder, % change	18/07	0.2	-	1 to 3
International Travel & Migration, May, Net Migration, 000s	21/07	6,350	-	6,000

Q2 CPI was flat over the quarter and, on an annual basis, inflation pulled back to 1.7% yoy. As expected, falls in fuel prices weighed on inflation over the quarter. However, non-tradable inflation was also a key source of weakness. We, as well as the RBNZ, view domestic capacity pressures as a key source of inflationary pressures over the coming years. If that view is correct, non-tradable inflation should soon start showing signs of broad-based price rises (outside of just construction and rents). **We continue to expect the RBNZ will not lift the OCR until late 2018** – certainly there is no hurry for the RBNZ to act any earlier based on the Q2 CPI. Heading into the August Monetary Policy Statement, the RBNZ will remain very comfortable with its recent stance of holding the OCR down for a considerable period.

Dairy prices were largely unchanged at last week's auction with overall prices rising 0.2%. Similarly, whole milk powder prices rose 0.3%. The WMP rise was marginally less than that indicated by futures prices prior to the auction; futures prices had pointed to a 1% to 3% WMP lift. **Meanwhile, butter prices set a fresh record high, surpassing US\$6,000/MT for the first time.** While butter prices will eventually fall, generally higher butter or milk fat prices are here to stay. Demand has fundamentally shifted higher as consumers now accept that butter is no longer that bad for you. Notably, this is the 10th time that butter has set a new record high this year. **All up, prices continue to be in a holding pattern.** From here, we expect prices to hold in the low US\$3,000s/MT range over coming months. In particular, meaningful NZ production data will be thin on the ground over July and August as production is very low over winter.

Net migration recorded a new record high, on both a (seasonally-adjusted) monthly basis (6,350) and annual basis (72,305). In June, departures ticked slightly lower (down 0.8% over the month), while arrivals continued to climb (up 3.3%). **NZ's comparatively strong economy and labour market remain a draw card**, seeing fewer New Zealanders leaving and a growing number of arrivals (particularly on work visas, now 34% of all arrivals compared to 31% a year ago). Record high levels of migration and population growth will **continue to put a strain on NZ's tight housing market**, as construction has been struggling to keep pace in Auckland and Wellington. **There are no implications for our OCR view; we expect the RBNZ keep the OCR on hold at 1.75% until late 2018.** Net migration flows will continue to support overall economic growth.



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 24 Jul	~	AU	HIA House Affordability Index	Q2	Index	81.4	~	~
	12:30	JN	Nikkei Japan PMI manufacturing	Jul P	Index	52.4	~	~
	17:00	JN	Leading index CI	May F	Index	104.7	~	~
Tue 25 Jul	01:00	CH	Conference Board China June Leading Economic Index					
	11:30	AU	ANZ Roy Morgan Weekly Consumer	Jul	Index	112.5	~	~
	11:50	JN	BOJ Minutes of June 15-16 Meeting					
Wed 26 Jul	10:45	NZ	Trade balance	Jun	NZD mn	103.0	300.0	400.0
	11:50	JN	PPI services	Jun	y%ch	0.7	~	~
	13:00	AU	Skilled vacancies	Jun	m%ch	1.2	~	~
	13:30	AU	CPI	Q2	q%ch	0.5	0.5	0.5
	13:30	JN	BOJ Nakaso speaks in Hiroshima					
	13:05	AU	RBA's Lowe speech in Sydney					
	17:00	JN	Small business confidence	Jul	~	49.2	~	~
Thu 27 Jul	13:30	AU	Import price index	Q2	q%ch	1.2	1.0	-2.0
	13:30	AU	Export price index	Q2	q%ch	9.4	-5.0	-7.0
	13:30	CH	Industrial profits	Jun	y%ch	16.7	~	~
Fri 28 Jul	11:30	JN	Jobless rate	Jun	%	3.1	~	~
	11:30	JN	National CPI	Jun	y%ch	0.4	~	~
	11:50	JN	BOJ Summary of Opinions at July 19-20 Meeting					
	11:50	JN	Retail sales	Jun	m%ch	-1.5	~	~
	13:30	AU	PPI	Q2	q%ch	0.5	~	~

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 24 Jul	09:00	EC	Markit Eurozone manufacturing PMI	Jul P	Index	57.4	~	~
	09:00	EC	Markit Eurozone services PMI	Jul P	Index	55.4	~	~
	14:45	US	Markit US manufacturing PMI	Jul P	Index	52.0	~	~
	14:45	US	Markit US services PMI	Jul P	Index	54.2	~	~
	14:45	US	Markit US composite PMI	Jul P	Index	53.0	~	~
	15:00	US	Existing home sales	Jun	\$mn	5.6	5.5	~
	17:00	EC	ECB's Frank Smets speaks in Munich					
Tue 25 Jul	11:00	UK	CBI business optimism	Jul	~	1.0	~	~
	14:00	US	FHFA house price index	May	m%ch	0.7	~	~
	14:00	US	S&P CoreLogic CS 20-City	May	m%ch	0.3	~	~
	15:00	US	Conf. Board Consumer Confidence	Jul	Index	118.9	116	~
	15:00	US	Richmond Fed Manufacturing Index	Jul	Index	7.0	7.0	~
Wed 26 Jul	09:30	UK	BBA loans for house purchase	Jun	~	40,347	~	~
	09:30	UK	GDP	Q2 A	q%ch	0.2	0.3	~
	09:30	UK	Index of services	May	m%ch	0.2	~	~
	12:00	US	MBA mortgage applications	Jul	%	6.3	~	~
	15:00	US	New home sales	Jun	000	610.0	616.0	~
	19:00	US	FOMC rate decision (upper bound)	Jul	%	1.25	1.25	~
	19:00	US	FOMC rate decision (lower bound)	Jul	%	1.0	1.0	~
Thu 27 Jul	09:00	EC	M3 money supply	Jun	y%ch	5.0	~	~
	11:00	UK	CBI retailing reported sales	Jul	~	12.0	~	~

	13:30	US	Durable goods orders	Jun P	%	-0.8	2.7	~
	13:30	US	Initial jobless and continuing claims	Jul	~	~	~	~
	13:30	US	Cap goods orders nondef ex air	Jun P	%	0.2	0.4	~
	13:30	US	Advance goods trade balance	Jun	\$bn	-66.3	-65.0	~
	13:30	US	Wholesale inventories	Jun P	m%ch	0.4	~	~
	13:30	US	Retail inventories	Jun	m%ch	0.6	~	~
	13:30	US	Chicago Fed National Activity Index	Jun	Index	-0.3	~	~
	15:00	US	Fed nominee Quarles confirmation hearing at Senate Banking					
	16:00	US	Kansas City Fed manufacturing activity	Jul	~	11.0	~	~
Fri 28 Jul	00:01	UK	GfK consumer confidence	Jul	~	-10.0	~	~
	10:00	EC	Economic confidence	Jul	~	111.1	~	~
	13:30	US	Employment cost index	Q2	Index	0.8	0.6	~
	13:30	US	Revisions: GDP revised from 2014-16; reference year remains 2009					
	13:30	US	GDP annualized	Q2 A	q%ch	1.4	2.6	~
	13:30	US	Core PCE	Q2 A	q%ch	2.0	~	~
	15:00	US	Uni. of Michigan sentiment	Jul F	~	93.1	93.2	~
	18:20	US	Fed's Kashkari speaks at Townhall Event					

Economics & Research

				Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz		(649) 301 5659	(649) 302 0992
Senior Economist	Jane Turner	jane.turner@asb.co.nz		(649) 301 5853	
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz		(649) 448 8778	
Senior Economist, Wealth Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz		(649) 301 5915	
Publication and Data Manager	Kim Mundy	kim.mundy@asb.co.nz		(649) 301 5661	
	Judith Pinto	judith.pinto@asb.co.nz		(649) 301 5660	

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ASB North Wharf, 12 Jellicoe Street, Auckland

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