

Economic Weekly

15 October 2018

Keeping a wary eye

Last week was punctuated by plunging sharemarkets. Markets are increasingly wary of rising US interest rates and US-China trade tensions. Closer to home the news was on the whole better, with the Government posting a larger-than-expected 2017/18 surplus and hitting its net debt target a full four years early. Offsetting some of that good local news was Fonterra, who trimmed its 2018/19 milk price forecast. This week's data highlight is Q3 CPI and we discuss inflation in more detail on Page 2. While that release will be a driver for the direction of NZ interest rates in the short term, we will keep one eye firmly on global sharemarkets through the week.

Key events and views

Key Insights	Inflation dragon slain or slumbering?
Foreign exchange	NZD/USD strengthened over the week, unaffected by the sharemarket declines.
Interest rates	NZD yields fractionally higher than this time last week, while global yields fall.
Domestic events	Q3 CPI, GlobalDairyTrade auction, September migration.
International events	US Fed meeting minutes (Sep), Australian labour market (Sep), Chinese Q3 GDP.
Calendars	NZ and international calendar of upcoming economic events.

Chart of the Week: Global sharemarkets dive

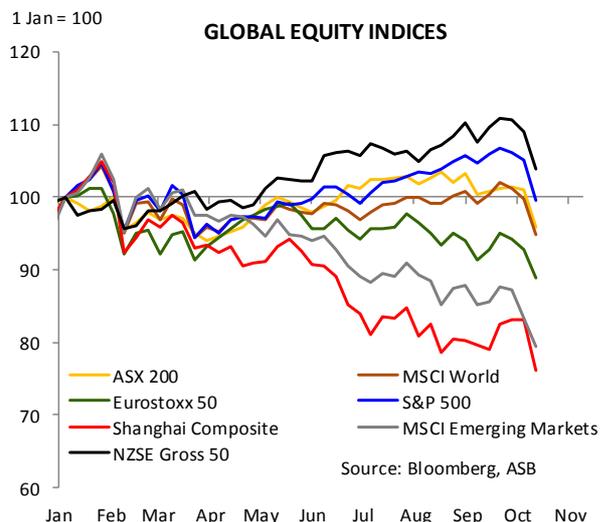
Global sharemarkets dropped last week. The S&P 500 dived over 5%, with many markets down by similar amounts. Taking one of the biggest plunges was the Shanghai Composite, down over 8% for the week. The NZ market was not immune, with the NZSE Gross 50 diving 4.7%.

The reasons for the dive are varied. On top of stretched valuations, analysts have pointed to rapidly-rising US interest rates and US-China trade tensions as catalysts for the declines.

For our part, **we are most wary of the large declines seen in emerging market indices over the year.** For example, the MSCI Emerging Market Index is down around 18% so far this year.

These falls are in line with broader economic and political concerns around emerging economies such as Turkey, Brazil, Argentina and South Africa.

The key risk is that contagion effects kick in, particularly if markets begin to question the credit worthiness of these economies. Market volatility may continue this week. Watch this space!



Key Insights this week: Inflation dragon slain or slumbering?

Key points

- The US economic example highlights that previous economic relationships remain broadly intact; when an economy grows faster than ‘potential’ for an extended period of time, inflation pressures will build.
- This suggests that in NZ, inflation is slumbering rather than slain. The main question is when NZ economic growth will pick up to a level that absorbs spare capacity in the economy, creating inflation.
- Tomorrow’s Q3 CPI is likely to highlight that inflation remains contained within the economy at this point in time, with the risk being that the RBNZ cuts the OCR in order to lift economic activity sooner.

US inflation is rising

One debate that has sprung up recently is whether the inflation dragon has been permanently slain, or is merely slumbering like Smaug until conditions prod it back to life. Venezuela’s 1,000,000+% inflation rate is a tragic reminder that inflation still lurks for opportunity, though the causes are less relevant to NZ. **US economic trends, though, are highly relevant.** For some time the US economy has been growing considerably faster than its ‘potential’ growth rate.

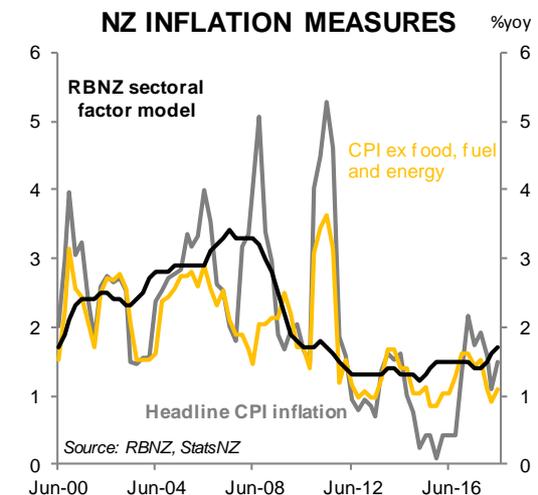
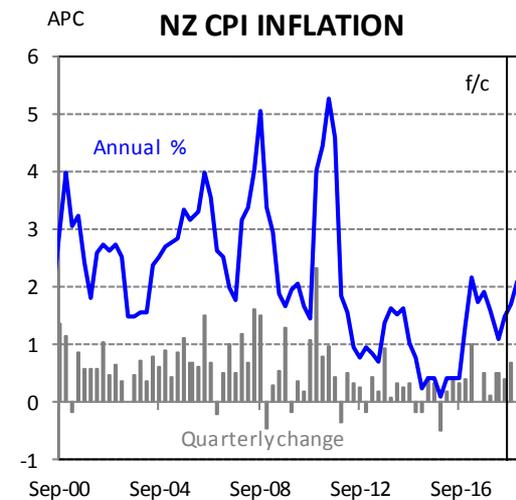
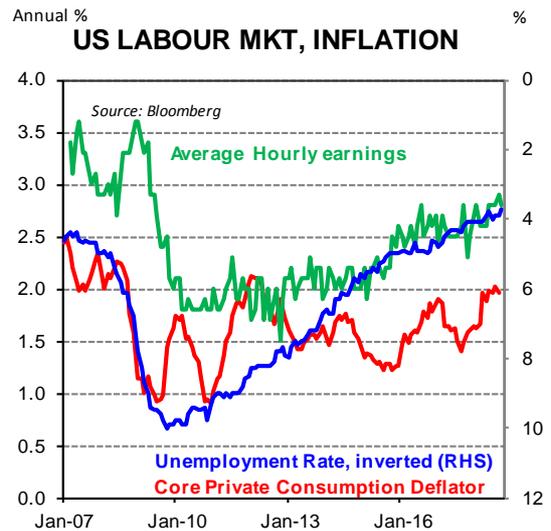
The result is a steady absorption of spare capacity, one example being the headline unemployment rate falling to the lowest rate since 1969. Wage growth has lifted over the past couple of years as the labour market has tightened. Core consumer inflation (i.e. excluding volatile food and fuel prices) has gradually trended up in fits and starts. Global factors will have helped contain past inflation, though are increasingly shifting in the other direction.

The lesson from recent US developments is that historical relationships remain broadly intact. That is, **inflation pressures will pick up if capacity pressures develop.** For NZ, it still is a matter of when – not if – that happens here, even if inflation dynamics are different now to past economic cycles.

Inflation lagging in NZ

In NZ the ‘when’ seems more distant given the mounting question marks about whether the economy will grow sufficiently fast over the next few quarters to continue absorbing spare capacity, boost inflation pressures, and maximise the level of employment. Wage growth, for one, is not yet lifting the way it is in the US.

Ongoing spare capacity in the economy should be evident in tomorrow’s Q3 CPI release. Yes, we are expecting another lift higher in inflation (+0.7% qoq and 1.7% yoy), but this is not a reflection of widespread capacity pressures. Instead, **we expect inflation to remain contained to housing-related costs** (where capacity pressures have been building for some time) **and fuel**

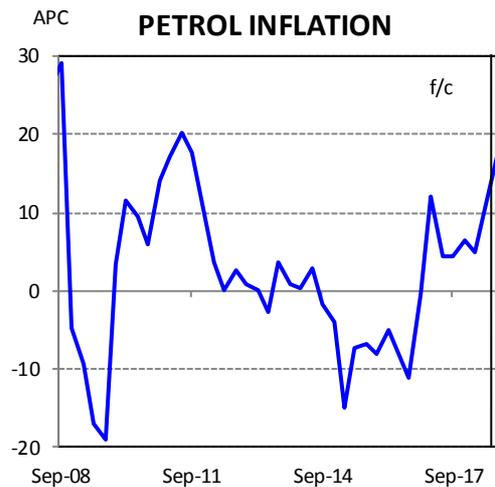
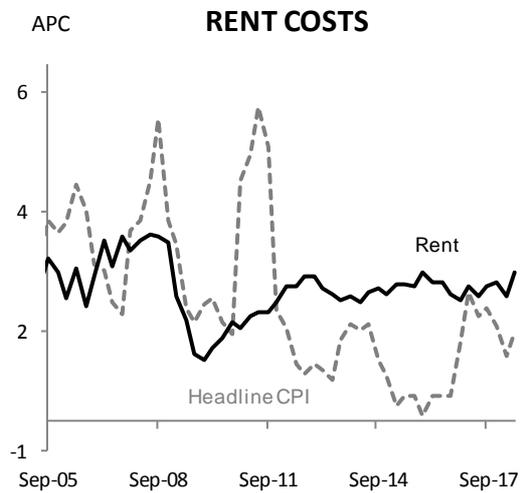
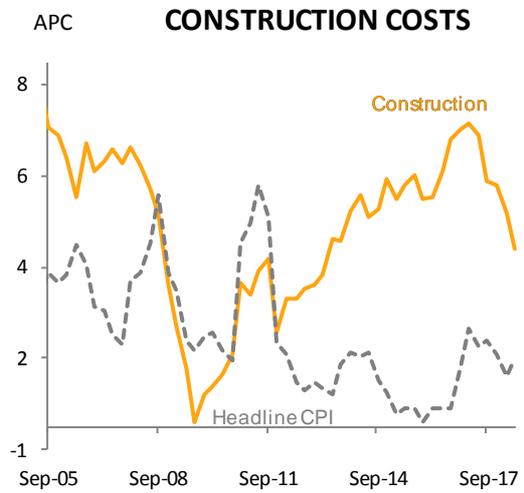


(reflecting high global oil prices, a lower NZD and Auckland’s regional fuel tax).

Measures of core inflation (such as the trimmed mean, CPI ex food & fuel and the RBNZ’s sectoral factor model) will be important given that these measures will highlight when broad capacity pressures are starting to generate widespread underlying inflation. **A key risk now is the impact higher fuel prices could have on demand in other sectors of the economy,** given that a higher proportion of consumers’ wages each week are now being spent at the pump. As a result, we expect the RBNZ to largely look through the increase in inflation over Q3.

Looming risk of an OCR cut

There is a further risk that getting the ‘when’ to occur soon enough may even mean the RBNZ cutting the Official Cash Rate further. But in the longer term, NZ will also move along the same path the US is currently on. When this happens, expect to see sustained inflation comfortably in the target band and slightly higher interest rates than have been the norm for much of the past decade.



Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	Year ago	ST Bias	Support^	Resistance^	MT Bias
NZD/USD	0.6507	0.6439	0.6585	0.7140	FLAT	0.6350	0.6620	UP
NZD/AUD	0.9148	0.9123	0.9150	0.9111	FLAT	0.9000	0.9250	FLAT
NZD/JPY	72.98	73.31	73.64	80.08	FLAT	71.9	74.1	FLAT/UP
NZD/EUR	0.5636	0.5593	0.5629	0.6026	FLAT	0.5500	0.5720	FLAT
NZD/GBP	0.4969	0.4911	0.5019	0.5379	FLAT	0.4870	0.5020	DOWN
TWI	71.4	70.6	71.4	75.03	FLAT	70.0	73.0	FLAT

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

NZD Recap

The **NZD outperformed the USD** over the past week. The NZD was surprisingly unaffected by the global equities sell-off, while **US developments weighed on the USD** – in particular **weaker-than-expected September month CPI inflation figures**. Meanwhile, President Trump criticised the Federal Reserve’s interest rate normalisation process last week, calling the Fed “out of control” and claiming that “I think I know about it better than they do”. There was little reaction from the NZD after Fonterra revised its 2018/19 milk price forecast lower. **The EUR eased over the past week due to market concerns around the disagreement between Italy and the European Commission (EC) over Italy’s 2019 budget**. The EC has already warned that Italy’s fiscal plan is a significant breach of EUR rules. Italian bond yields have lifted relative to German bond yields after the new Government indicated it would like to expand the budget deficit. The Italian Finance Minister has said that the Government is worried by the ‘unacceptable’ bond yield spread.

Near-term outlook

Key political events are likely to be the major themes driving currencies this week, including Brexit talks, the European Commission’s (EC) formal response to Italy’s budget plan and the US Treasury Department’s assessment of exchange rate policies. **In New Zealand, Q3 CPI and the RBNZ’s assessment of core inflation (sectoral factor model) will be the key focus (released Tuesday)**. The European Union summit on Brexit will be important for the GBP, as if there is no breakthrough on reaching a deal the risk of a “hard” Brexit will materially increase. Meanwhile, the EUR will likely weaken if the EC concludes that Italy’s 2019 fiscal plan is in breach of EU rules and the Italian government refuse to make any modifications. We do not expect the US Treasury will label China a currency manipulator, but if it did US-China trade tensions would rise and undermine the commodity currencies.

Medium-term outlook

We have a stronger USD outlook given the solid US growth outlook, high US Terms of Trade, and the weaker Chinese and emerging market outlook. We expect the NZD to oscillate in a 65 to 71 US cent range over the forecast period (although it has recently dipped below this range). Nevertheless, the NZD TWI should remain broadly supported by a solid growth outlook, our historically-high Terms of Trade and upwardly drifting NZ interest rates. The NZD is expected to remain in a 90-91 Australian cent zone through to the end of next year. We expect the NZD to ease slightly over the projection period relative to EUR. The European Central Bank is expected to hike rates in September 2019, although slow growth in the Eurozone will limit the extent of ECB tightening. We also expect that Brexit risks will keep the GBP low against the NZD. Low inflation is expected to keep the BOJ on hold, with the NZD/JPY modestly strengthening over the forecast period.

ASB foreign exchange forecasts (end of quarter)	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
				<< actual	forecast >>				
NZD/USD	0.71	0.72	0.67	0.66	0.65	0.66	0.68	0.70	0.66
NZD/AUD	0.91	0.94	0.92	0.92	0.90	0.90	0.91	0.90	0.90
NZD/JPY	80	77	74	75	73	74	73	75	74
NZD/EUR	0.59	0.59	0.58	0.57	0.58	0.58	0.55	0.55	0.54
NZD/GBP	0.53	0.51	0.52	0.51	0.52	0.53	0.53	0.54	0.51
NZD TWI	74.3	74.3	72.5	72.1	71.4	71.9	72.3	72.8	70.2

Interest Rate Market

<u>Wholesale interest rates</u>	Current	Week ago	Month ago	Year ago	ST Bias	MT Bias
Cash rate	1.75	1.75	1.75	1.75	FLAT	UP
90-day bank bill	1.89	1.88	1.88	1.93	FLAT	UP
2-year swap	2.02	2.03	1.98	2.20	FLAT	UP
5-year swap	2.39	2.40	2.31	2.72	FLAT	UP
10-year swap	2.93	2.94	2.82	3.24	FLAT	UP
10-year govt bond yield	2.64	2.65	2.56	2.96	FLAT	UP
Curve Slope (2s10s swaps)	0.91	0.91	0.84	1.05	FLAT	FLAT/DOWN

* Current as at 9.30am today; week ago as at Monday 5pm

Market Recap

NZD swap yields start the week fractionally higher than this time last week, with yields edging up towards the end of last week. Australian yields also rose modestly. The increase in Australasian yields was from low levels, and may be due to positioning-related flows. **Global interest rate markets generally rallied last week**. US yields were lower following the plunge in global equity markets, with the MSCI World Index, S&P500 and NZSX50 gross index down by roughly 4% last week. The IMF downgraded its assessment for the global economy, with weaker than expected US core CPI inflation data and criticism by President Trump over the Fed for raising interest rates also driving global yields lower. US 10-year Treasury yields start this week at around 3.16% (3.23% from a week ago).

Near-term NZD interest rate outlook

We have a neutral bias for domestic rates this week. While some calm returned to US equity markets at the end of last week, the global risk profile is negatively skewed and we also remain concerned over global growth prospects and various geopolitical risks. This week's Brexit talks and the formal response of the European Commission to Italy's budget plans may also impact market sentiment. **NZ yields remain low in an absolute sense and in relation to global yields, and are likely to continue to underperform global counterparts on global rallies**. The major domestic focus is tomorrow's Q3 CPI. We expect an in-line with consensus +0.7% qoq (+1.7% yoy), which is well above the RBNZ August MPS 0.4% qoq, +1.4% yoy forecasts. **The market implications will depend on what the NZ core inflation measures infer for the medium-term inflation outlook**. A slip in core inflation from the RBNZ sectoral model from the 1.7% Q2 outturn will likely see market pricing further add to the 5-6bps of OCR cuts priced in over the next 12 months. The policy relevance of this week's RBA and Fed Minutes will be limited as they predate the slump in global equity markets. The RBA assessment should reaffirm the slight upward bias for the cash rate, whereas the Fed should depict an environment necessitating gradual policy hikes. Speeches by 2018 Fed voters Brainard, Bostic, and Quarles and non-voters Bullard and Evans this week will be of particular interest given recent global market volatility.

Medium-term outlook

Given the cautious RBNZ assessment over the pace of NZ growth and due to our low CPI inflation outlook we expect the OCR to remain on hold until February 2020. If growth momentum slows and inflationary pressure fails to materialise, the OCR could be lowered to a new record low, but we still view the hurdle to OCR cuts as being reasonably high. We expect a historically-low OCR endpoint of just **2.75% this cycle** (from August 2021 onwards). **Longer-term NZD rates should also drift higher with global counterparts**. We expect US 10-year Treasury yields to settle above 3%. Modest RBNZ tightening and low global yields should limit the climb in NZD yields.

ASB interest rate forecasts (end of quarter)	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
				<< actual	forecast >>				
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50	2.75
NZ 90-day bank bill	1.88	2.0	2.0	1.9	1.9	2.0	2.3	2.7	3.0
NZ 2-year swap rate	2.21	2.2	2.1	2.0	2.1	2.2	2.5	3.0	3.2
NZ 10-year Bond	2.75	2.7	2.9	2.7	3.0	3.1	3.3	3.5	3.6

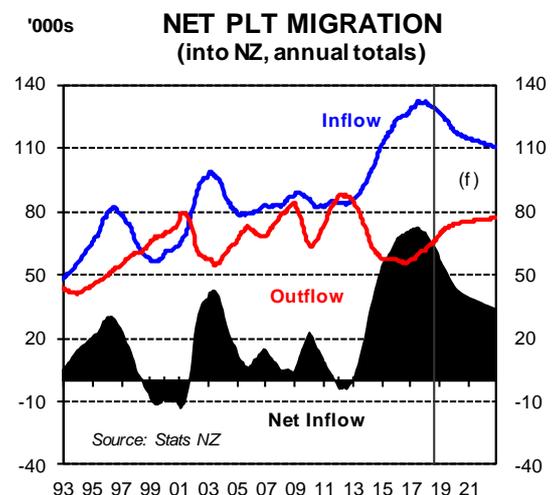
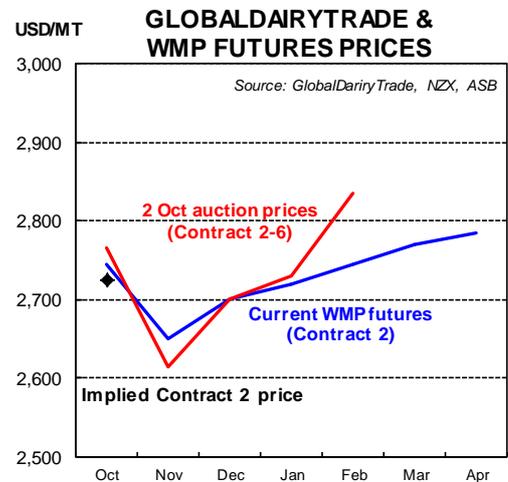
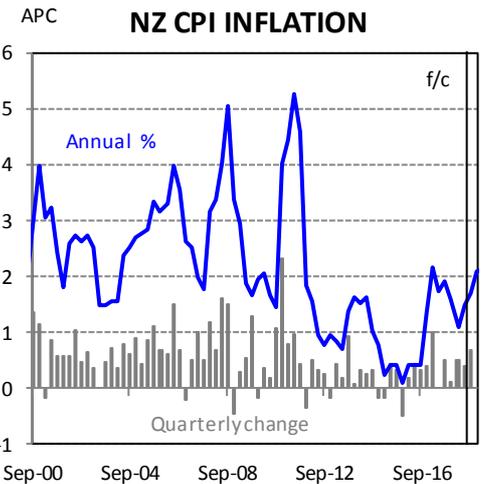
Major Domestic Events for the week ahead

Data	Date	Time (NZT)	Previous	Market	ASB
CPI, Q3 %qoq	16/10	10:45 am	0.4	0.7	0.7
Global Dairy Trade auction, whole milk powder, % chg	16/10	Overnight	-1.2	-	-1.5
Net Migration, September	19/10	10:45 am	5,010	-	4,900

We expect the CPI to lift to 1.7% yoy (+0.7% qoq) in Q3. Our forecast is stronger than that published in the RBNZ's August Monetary Policy Statement (+0.4% qoq, 1.4% yoy). However, the RBNZ's forecast is unlikely to capture the more recent lift in fuel prices. A weaker NZD, high global oil prices and the Auckland regional petrol tax have combined to push fuel prices higher again in Q3. Outside of this, we also expect housing-related costs to have increased further in Q3. However, with near-term costs pressures still largely contained and downside risks to the medium-term outlook, we expect the RBNZ to largely look through the headline figure. **We continue to expect the RBNZ to leave the OCR on hold until early 2020.**

We expect whole milk powder prices to remain soft at the GlobalDairyTrade auction overnight Tuesday. A fortnight ago whole milk powder (WMP) prices fell by 1.2%. At the current juncture, futures pricing suggests WMP prices will fall by a similar amount. With NZ production and auction volume offerings peaking over October, we anticipate that prices will remain subdued until the dual peaks pass. Low WMP futures prices for the current season (all under \$2,850) reflect milk production's strong start to the season that was also captured in Fonterra's latest forecast last week.

We expect annual net permanent and long-term (PLT) immigration inflows to continue to recede from mid-2017 peaks. There were tentative signs in August that net permanent and long-term immigration was stabilising at just under the 60,000 person per year mark, but we expect net PLT inflows to abate as PLT departures climb from low levels. Encouragingly, for labour market capacity, work visa numbers are expected to continue to test new record highs. All up, we expect net PLT immigration to slow to around 40-45,000 persons by the end of 2019. **Visitor numbers are expected to remain elevated.** The lower NZD will bolster tourism spending per visitor and should help underpin strong demand. Expanding capacity, while maintaining New Zealand's allure as a destination, remain the major challenges for the tourism industry.



Major International Events for the week ahead*

Data	Date	Time (NZT)	Market	ASB
RBA Board Meeting Minutes, October	16/10	1:30 pm	-	-
China CPI, September, %yoy	16/10	2:30 pm	2.5	2.5
US Retail Sales, September, %mom	16/10	1:30 am	0.4	0.5
UK Unemployment, August, %	16/10	9:30 pm	4.0	-
RBA Deputy Governor Debelle speech at conference	17/10	-	-	-
UK CPI, September, %yoy	17/10	9:30 pm	2.6	2.6
Australia Unemployment, September, %	18/10	1:30 pm	5.3	5.3
US Federal Reserve Meeting Minutes, September	18/10	7:00 am	-	-
Japan CPI, September, %yoy	19/10	12:30 pm	1.3	1.5
China GDP, Q3, %yoy	19/10	3:00 pm	6.6	6.5

*Originally published by CBA Global Markets Research on Friday 12th October 2018 at 14.06pm.

The statement accompanying the Reserve Bank of Australia's October meeting showed the Governor remains upbeat on the domestic and global economic backdrop. While the central bank acknowledged the risks to global growth from a ramp up in the trade war, it was not factored into their base case forecasts. There was a slight change in the wording around lending, with the RBA noting that credit conditions have tightened as many lenders have increased mortgage rates in recent months.

We expect China's consumer inflation to rise to 2.5% yoy in September because of rising food inflation and higher fuel prices. Adverse weather conditions and an outbreak of the African Swine flu weighed on supply and increased fresh food prices. Meanwhile, we expect PPI growth to ease to 3.7% on account of a high base effect.

The RBA Deputy Governor Debelle is slated to speak at a conference on Wednesday. While the topic of the speech has not been published, we understand that Debelle is due to speak to a group of offshore investors so any comments on the domestic outlook are likely to be positive.

Continued strong growth in fresh food and energy prices in Japan will likely support a further lift in Japanese headline inflation to 1.5% yoy. But core inflation will remain weak at 0.6% yoy because wage growth is very weak.

Australian leading indicators are pointing to another solid employment report. We are expecting a 30k lift in the number of jobs, while the unemployment rate will likely stay at 5.3%. Starting from this release, the monthly labour force report will include the underemployment rate measure (previously published quarterly). Elevated underemployment is a major reason why wages growth is low.

We expect China's GDP growth to ease to 6.5% yoy over Q3, dragged down by weak net exports and soft investment. In contrast, we expect consumption growth to remain resilient.

Retail sales in the US are poised to rebound by 0.5% in September from the weakness in August. Retail sales will be supported by the strength in US job creation and a pick-up in wage growth.

The UK's August unemployment rate is expected to remain at a multi-decade low of 4%. Tighter labour market conditions point to decent average weekly earnings (ex-bonus) growth of 2.9% yoy in August.

Headline UK CPI inflation is expected to ease at an annual pace of 2.6% in September from 2.7% the previous month, as the pass-through of higher import prices diminishes. The Bank of England projects CPI inflation of 2.5%yoy in Q3 2018 and 2.2%yoy in Q3 2019. Core CPI inflation will likely remain contained near 2%yoy.

We expect the US Federal Reserve minutes to continue the discussion of why wage growth is not stronger amidst low unemployment. The minutes may also discuss the pros and cons of continuing to provide forward guidance – "further gradual increases" in the Funds rate – when the Funds rate is approaching its 'neutral' rate (a range of 2.5-3.5%).

Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Previous	Forecast	
							Mkt	ASB
Mon 15 Oct	10:30	NZ	Performance services index	Sep	Index	53.2	~	~
	17:30	JN	Industrial production	Aug F	m%ch	0.7	~	~
Tue 16 Oct	10:45	NZ	CPI	Q3	q%ch	0.4	0.7	0.7
	13:30	AU	RBA October meeting Minutes					
	14:30	CH	CPI	Sep	y%ch	2.3	2.5	2.5
Wed 17 Oct	~	AU	RBA's Debelle gives speech in Sydney					
	12:30	AU	WBC leading index	Sep	m%ch	0.1	~	~
Thu 18 Oct	12:50	JN	Trade balance adjusted	Sep	¥bn	-190.4	~	~
	13:30	AU	Unemployment rate	Sep	%	5.3	5.3	5.3
	13:30	AU	NAB business confidence	Q3	~	7.0	~	~
Fri 19 Oct	10:45	NZ	Net migration	Sep	~	5,010	~	4,900
	12:30	JN	National CPI	Sep	y%ch	1.3	1.3	1.5
	15:00	CH	GDP	Q3	q%ch	1.8	1.6	~
	15:00	CH	Retail sales	Sep	y%ch	9.0	9.0	9.2
	19:35	JN	BOJ Kuroda speaks in Tokyo					

*P = Preliminary

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Previous	Forecast	
							Mkt	ASB
Mon 15 Oct	13:30	US	Empire manufacturing	Oct	~	19.0	20.0	~
	13:30	US	Retail sales advance	Sep	m%ch	0.1	0.7	0.5
	15:00	US	Business inventories	Aug	%	0.6	0.5	~
Tue 16 Oct	09:30	UK	ILO unemployment rate 3 mths	Aug	%	4.0	4.0	~
	10:00	EC	Trade balance	Aug	€bn	12.8	~	~
	14:15	US	Industrial production	Sep	m%ch	0.4	0.2	~
Wed 17 Oct	09:30	UK	CPI	Sep	m%ch	0.7	0.3	~
	10:00	EC	CPI	Sep	m%ch	0.2	0.5	~
	13:30	US	Housing starts	Sep	000	1,282	1,215	~
	13:30	US	Building permits	Sep	000	1,249	1,280	~
	19:00	US	FOMC Meeting Minutes	Sep	~	~	~	~
Thu 18 Oct	09:30	UK	Retail sales ex auto fuel	Sep	m%ch	0.3	~	~
	13:30	US	Philadelphia Fed bus. outlook	Oct	~	22.9	21	~
	14:05	US	Fed's Bullard speaks to Economic Club of Memphis					
Fri 19 Oct	09:00	EC	ECB current account	Aug	€bn	21.3	~	~
	14:00	US	Fed's Kaplan speaks in New York					
	15:00	US	Existing home sales	Sep	\$mn	5.3	5.3	~
	16:30	UK	BOE Governor Carney speaks in New York					
	17:00	US	Fed's Bostic speaks on Economic Outlook					
Sat 20 Oct	17:00	US	Fed's Bostic speaks in Atlanta					

Key Forecasts

ASB NZ economic forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
			<< actual	forecast >>					
GDP real - Q%	0.6	0.5	1.0	0.6	0.4				
GDP real - A%	2.9	2.6	2.8	2.8	2.5	2.7	3.0	2.9	2.8
GDP real - AA%	2.8	2.7	2.7	2.8	2.7	2.7	2.8	3.0	2.8
CPI - Q%	0.1	0.5	0.4	0.7	0.4				
CPI - A%	1.6	1.1	1.5	1.7	2.0	2.0	1.6	1.7	2.0
HLFS employment growth - Q%	0.4	0.6	0.5	0.4	0.3				
HLFS employment growth - A%	3.7	3.1	3.7	1.9	1.9	1.6	1.7	1.4	1.2
Unemployment rate - %sa	4.5	4.4	4.5	4.5	4.5	4.5	4.4	4.4	4.3
Annual current account balance as % of	-2.9	-3.0	-3.3	-3.3	-3.1	-2.4	-2.0	-2.3	-2.7

Q% = percentage change on previous quarter

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)			<< actual	forecast >>					
NZ OCR	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50	2.75
NZ 90-day bank bill	1.88	2.0	2.0	1.9	1.9	2.0	2.3	2.7	3.0
NZ 2-year swap rate	2.21	2.2	2.1	2.0	2.1	2.2	2.5	3.0	3.2
NZ 10-year Bond	2.75	2.7	2.9	2.7	3.0	3.1	3.3	3.5	3.6

ASB foreign exchange forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21	Mar-22
(end of quarter)			<< actual	forecast >>					
NZD/USD	0.71	0.72	0.67	0.66	0.65	0.66	0.68	0.70	0.66
NZD/AUD	0.91	0.94	0.92	0.92	0.90	0.90	0.91	0.90	0.90
NZD/JPY	80	77	74	75	73	74	73	75	74
NZD/EUR	0.59	0.59	0.58	0.57	0.58	0.58	0.55	0.55	0.54
NZD/GBP	0.53	0.51	0.52	0.51	0.52	0.53	0.53	0.54	0.51
NZD TWI	74.3	74.3	72.5	72.1	71.4	71.9	72.3	72.8	70.2

ASB Economics & Research

Chief Economist
Senior Economist
Senior Economist
Senior Rural Economist
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