ASB

Quarterly Economic Forecasts

August 2017

Big wheels keep on turning

- Economic fundamentals are the big wheels keeping the global economy turning.
- In NZ growth has much ado about the people, with exports also faring well.
- The housing market has cooled off, with a soft landing underway in Auckland.

The wheels of the global economy keep turning, despite near upsets at electoral polls over the past year and early-morning Twitter tirades. The prospects for global growth are fair, just sprinkled with the usual political uncertainty.

The main source of political uncertainty remains just as enigmatic. In our last Quarterly we flagged the risk that Donald Trump would take a surprisingly long time to get his much-vaunted tax package enacted. That risk is firmly on the path to becoming reality, which means any fiscal boost to the US looks more distant (and smaller). But, on the other hand, trade protection noises are also proving to be quieter and drowned out by free trade talk elsewhere.

We still think the prospects for NZ's economy are solid, with support coming from well-diversified sources. The dairy sector has had a shot in the arm through Fonterra now coming out with a forecast of 6.75/kg for the new dairy season, in line with our long-held view. The broader agriculture sector is doing well. Tourism has had feel-good sporting factors boosting it recently, though accommodation capacity will increasingly constrain growth. Population growth is also supporting growth and reinforcing that construction activity will remain high for some time yet. But, importantly for individuals' prospects, we expect per-capita growth to lift back to long-run average levels.

However, even with these tailwinds, the economy grew surprisingly slowly in the final quarter of 2016 and the first of 2017. Is that something to be worried about? We have looked hard at the question. And it is hard to argue with the solid foundations for growth, and we continue to expect economic growth to increasingly gain momentum over the rest of 2017 and into 2018.

But one part of NZ that is losing steam is the housing market, particularly in Auckland. Auckland house sales have fallen around 30% over the past year, with homes listed for sale now 66% higher. Prices have now softened around 1% over the past few months. Affordability challenges, the RBNZ's added loan restrictions, lifts in mortgage rates and reduction in the Fear Of Missing Out will be key drivers of the slower market conditions.

In the short term would-be sellers will adjust to the softer market by becoming more realistic about the price their home will sell for, and others who don't need to sell will pull out of the market or not list in the first place. Longer term, Auckland's shortage of homes to live in will keep a floor under the market.

Housing is starting to lose momentum elsewhere in the country, for some of the same reasons. But house prices are far less stretched outside Auckland, and with still-low interest rates and a good jobs market we foresee soft landings ahead.

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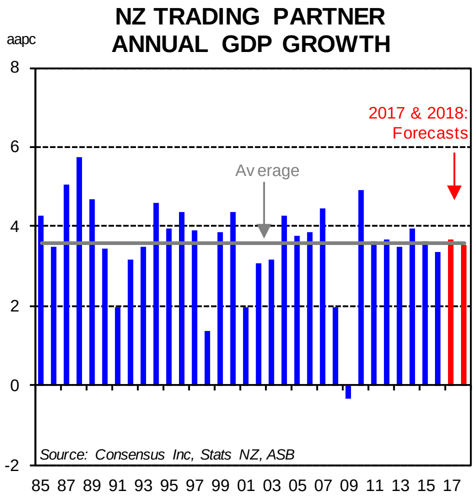
International outlook – weathering the political storm

The global economy is weathering the political storm. The world economic outlook for 2017 has held up so far this year, despite political developments, and the 2018 outlook is even hinting at improvement. Interestingly last quarter, we described this fact as a somewhat of surprise. But another quarter on and it is becoming a pattern. While political challenges are coming thick and fast, it does seem that maybe the global economy and its institutions are more resilient to global political challenges than we had thought previously.

Since our last quarterly update, **President Trump has continued to hog headlines, while achieving very little of his policy agenda**. His second failed attempt to repeal Obamacare in late July is the standout among general White House chaos. This experience reinforces our view that fiscal policy progress will remain slow, and that potentially it will take until 2018 or even 2019 to have any tax changes implemented.

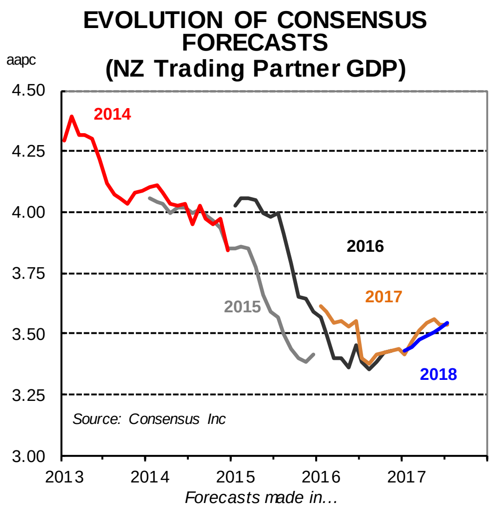


Importantly for NZ, Trump's trade protectionism bark continues to be worse than his bite. In particular, the US-China trade relationship has been amicable, although Trump's general contempt for traditional diplomacy does at times put this at risk.

Meanwhile, US economic activity softened a little over early 2017, with an accompanying slowdown in US inflation. This inflation slowdown has led us to change our US interest rate view: **we have delayed this year's interest rate hike to December, from September previously**. Also, we expect only one additional hike (in June 2018), whereas we had previously expected three additional hikes. That said, we have brought forward our expecation that the US Federal Reserve will begin reducing the size of its balance sheet from December 2017.

Elsewhere, political developments have been mixed. The British continue to make hard work of Brexit, particularly with the June's snap election backfiring and reducing the Conservative Party's majority. In contrast, the French Presidential election went as expected, with French President Macron now providing a confident and steady French political hand. But geo-political hot spots like North Korea remain. Indeed, we expect further political storms of varying intensities and locales over the remainder of 2017.

As mentioned above and despite the apparent geopolitical turmoil, **the combined economic prospects of our trading partners have held up.** Indeed since last quarter, Consensus forecasts for growth of our trading partners for both 2017 and 2018 have been steady at 3.5%. Similarly, the International Monetary Fund (IMF) kept its world growth forecasts unchanged in July.

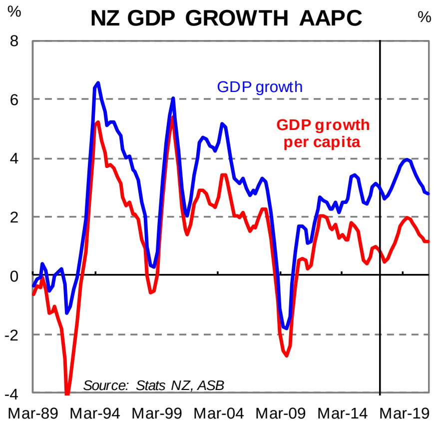


China continues to be both a key driver of global growth and a source of political calm. We expect China to grow at a healthy 6.8% over 2017, up 0.1 of a percentage point from 2016. Indeed, it appears that Chinese leaders are ensuring robust growth in order to secure their power base in the run-up to its leadership transition at the 19th Communist Party Congress in Q4 2017. Increasingly, other forecasters are coming to a similar view; the Consensus forecast has lifted to 6.6% from 6.2% at one stage.

Meanwhile over the Tasman, the Australian economy got off to a rocky start in the first quarter of 2017. The economy expanded at 0.3% over the quarter and 1.7% in annual terms. However, the outlook for the remainder of 2017 is better. In particular, commodity prices have strengthened, while jobs growth has been strong. As a result, **we expect Australian growth to improve to 1.9% by the end of calendar 2017, and then to 3.0% by 2018.**

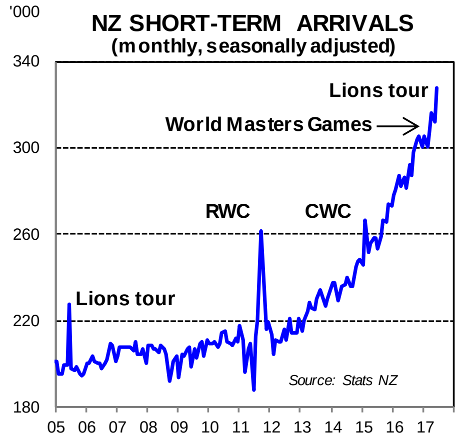
The New Zealand Economy – he tangata, he tangata, he tangata

It is the people that are currently at the heart and centre of NZ's growth story. In last 12 months, net migration has boosted New Zealand's population by 72,305, and 3,648,204 short-term visitors have flocked to our shores. Both figures represent record highs, dating back to when records began in 1970. The fact that people are integral to NZ's positive economic outlook is reflected in NZ's more lacklustre per-capita growth story. With people power behind us we are expecting GDP growth to average 2.7% over 2017 before lifting to 3.7% over 2018 and 2019.



Construction, a key driver of growth, is directly benefitting from the presence of more people. Residential construction has been growing steadily, reflecting the high demand for housing. Further, consents for hotels and motels are surging, much like our tourism numbers. However, the construction sector is beginning to show that it is suffering from growing pains. Capacity constraints have seen construction costs rise sharply, suggesting that growth rates will struggle to remain at these levels going forward.

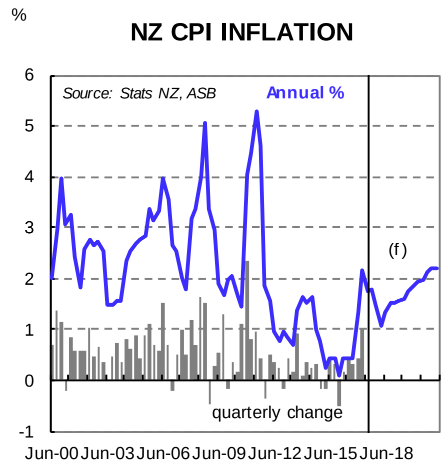
Interestingly, the housing market is not currently moving in line with population growth. In fact, Auckland prices have recently fallen slightly, despite Auckland absorbing the highest proportion of new immigrants. Outside of Auckland and the picture is more upbeat, but the fire has gone – for now. The RBNZ's Loan-to-Value ratio restrictions, slightly higher mortgage rats, and a loss of the fear of missing out have quelled market activity more than we expected. However, with poulation-driven housing demand expected to continue outpacing housing construction, the upward price trend is expected to re-establish itself; just at more muted levels.



Strong population growth is also supporting domestic demand, with consumption a key driver of growth in Q1. This is showing no signs of abating. For example, monthly car imports hit a record high in June with imports 31% higher than June 2016. NZ's healthy labour market, high levels of consumer confidence and low interest rates are also supporting consumption. But visitor arrivals are also making their mark on spending growth, particularly as tourism remains NZ's biggest export sector.

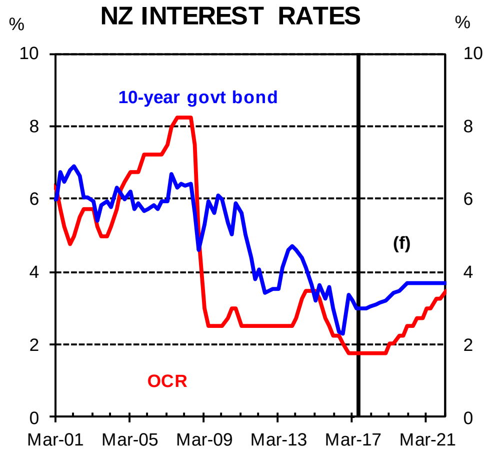
Even outside of tourism, the export sector continues to shine. Prices have lifted strongly for a number of our key exports including dairy, lamb, forestry and fruit. As a result, in Q1 the Terms of Trade (ToT) reached the highest level since 1973. With demand from emerging markets continuing to firm, the ToT look set to break through the 1973 record by the end of the year.

The elevated ToT also reflect low import prices; a phenomenon that is continuing to weigh on inflation growth. More recently domestically-generated inflation pressures have also been subdued (excluding housing and construction costs), suggesting current economic activity is not generating widespread capacity pressures. Wage inflation also remains muted, a direct consequence of NZ's high levels of net migration. However, we expect wages to shortly begin lifting off the back of a stronger labour market and a falling unemployment rate. Rising wages will support a lift in non-tradable inflation. We expect inflation will return to the RBNZ's 2% inflation target by Q2 2020.



Interest Rates and Exchange Rates – *OCR on hold well into 2018*

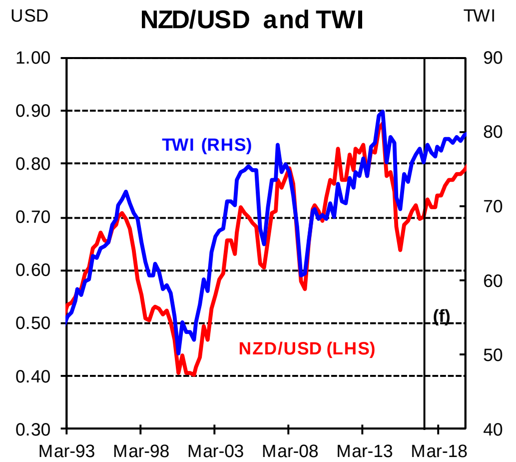
Short-term interest rates are likely to remain low, anchored by a low Official Cash Rate (OCR). We expect the Reserve Bank of New Zealand (RBNZ) to leave the **OCR unchanged at a historical low of 1.75% until early 2019**. Once interest rate hikes do begin, it will likely be a gradual process over a few years.



Short-term interest rates have recently been impacted by a bank 'funding squeeze' in New Zealand. A slowdown in NZ household deposit growth has coincided with an increase in credit demand. As a result, an increase in relatively expensive offshore borrowing has led to an increase in funding costs and interest rates, despite no change in the OCR.

Longer-term interest rates are heavily influenced by offshore developments. The **main influence has been the shifting US interest rate outlook**, which saw **NZ and US long-term interest rates lift sharply** when Donald Trump got elected to office on a policy platform of stimulatory tax reform. However, interest rates have since declined as market participants begun to doubt that the US policy makers will pass tax reforms this year. In addition, the US economy and US inflation have proved weaker than expected, which has also weighed on US interest rates. **We expect longer-term rates will continue to lift over the coming years**, as global economic growth and inflation improves. However, we believe this lift will be more gradual than previously thought.

The NZD has lifted strongly on a trade-weighted basis since late May. The lift in the NZD has been strongest against the USD, JPY and GBP. **The USD has weakened over this period** due to lack of US political reform and a weaker growth and inflation outlook. **We expect the USD to remain under pressure** unless tax reform is pushed through by the end of the year (in which case the USD will strengthen considerably).



The NZD will remain well supported by NZ's high Terms of Trade (high export prices relative to import prices). We expect NZ's Terms of Trade to set a new record high this year. The NZD will also remain well supported by **increased global investor demand for NZ assets**.

We expect the EUR to appreciate vs. the USD, but remain broadly steady against the NZD. The Eurozone economic and inflation outlook continues to strengthen and we expect the European Central Bank to taper its asset purchase programme in 2018. **Our medium-term view is for the NZD to outperform the GBP** as a result of Brexit, but in the near-term stronger than expected UK inflation and economic growth are providing some support to the GBP.

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Economic and Finanical Forecasts

ASB economic forecasts		Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<<actual	forecast >>									
NZ GDP real	**AA%**	**3.0**	**2.8**	**2.6**	**2.7**	**3.0**	**3.2**	**3.6**	**3.7**	**3.9**	**3.4**	**2.8**
private consumption	AA%	4.7	4.5	4.0	4.0	3.6	3.7	3.9	4.0	4.0	3.5	2.9
dwelling construction	AA%	10.2	6.8	4.6	3.3	4.3	5.9	6.5	6.4	5.1	-1.2	-2.4
other investment	AA%	3.7	4.4	6.3	7.0	7.0	7.1	6.2	5.2	5.0	5.3	4.3
exports	AA%	1.2	-0.1	-0.3	1.2	2.9	3.0	3.2	2.6	1.8	2.4	2.5
imports	AA%	5.1	6.1	6.1	5.4	4.6	4.2	3.9	3.7	3.6	2.9	2.6
NZ GDP real	A%	2.5	2.6	2.6	3.2	3.5	3.6	3.8	4.0	4.0	3.0	2.8
NZ GDP real	Q%	0.5	0.9									
NZ CPI	**A%**	**2.2**	**1.7**	**1.8**	**1.5**	**1.1**	**1.3**	**1.5**	**1.5**	**1.6**	**1.9**	**2.2**
NZ house prices (QV index)	A%	10.3	4.6	1.5	1.9	2.6	1.5	1.7	1.8	1.6	1.0	0.9
NZ unemployment (sa%)	Qtr	4.9	4.8	4.7	4.7	4.6	4.6	4.6	4.5	4.4	4.3	4.3
NZ private sector wages (LCI)	A%	1.5	1.6	1.9	1.9	2.0	2.1	2.0	2.1	2.2	2.6	2.6
NZ current account ($b)	Yr	-8.1	-8.1	-8.4	-9.4	-8.9	-9.8	-10.4	-10.6	-10.6	-10.3	-9.9
as a % of GDP	Yr	-3.1	-3.0	-3.1	-3.4	-3.2	-3.5	-3.6	-3.7	-3.6	-3.4	-3.1

A%=percentage change since same quarter the previous year

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

ASB interest rate forecasts	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
(end of quarter)		<<actual	forecast >>								
NZ cash rate target	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50	3.00
NZ 90-day bank bill	2.00	1.96	2.0	2.0	2.0	2.0	2.0	2.2	2.3	2.8	3.3
NZ 3-year swap rate	2.56	2.54	2.4	2.5	2.5	2.6	2.7	2.8	2.9	3.4	3.7
NZ 10-year gov't stock	3.21	2.97	3.0	3.0	3.1	3.1	3.2	3.2	3.3	3.7	3.7

ASB foreign exchange forecasts	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-20
(end of quarter)		<<actual	forecast >>								
USD per NZD	0.699	0.733	0.72	0.72	0.74	0.74	0.76	0.77	0.77	0.80	0.80
GBP per NZD	0.560	0.563	0.55	0.55	0.56	0.56	0.57	0.57	0.58	0.57	0.53
AUD per NZD	0.914	0.951	0.95	0.95	0.95	0.95	0.96	0.96	0.96	0.99	0.96
JPY per NZD	78.4	82.0	81	83	84	84	87	86	85	88	88
EUR per NZD	0.654	0.640	0.63	0.61	0.62	0.62	0.63	0.63	0.63	0.63	0.62
CNY per NZD	4.817	4.958	4.89	4.86	4.96	4.92	5.02	5.01	4.93	5.00	4.72
TWI - 17 country	76.1	78.4	77.2	76.7	77.9	77.5	79.0	79.0	78.7	80.0	78.3

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