Making hay while the sun shines

- We remain pretty optimistic about growth prospects for NZ over 2017.
- But there are a few clouds hanging offshore, and they appear to be the main threats to a strong NZ performance.
- We expect the RBNZ to keep the Official Cash Rate (OCR) on hold for a considerable period.

We are pretty **optimistic about the growth prospects for NZ over 2017**. Back in 2015 growth slowed to 2.5%. Last year's bounce-back brought growth back to an estimated 3.2%. For 2017 and 2018 we expect a pretty decent pace around 3.5%. And that growth is not just about the still-strong flow of people wanting to live in NZ: **per-capita growth is heading back to its long-run average.**

The drivers of growth remain a similar refrain. **Construction** continues to lift to meet the needs of a growing population. A number of export sectors are performing well, including **tourism and fruit**. Dairy prices have now recovered to a level that will **return most dairy farmers to profitability**, though added spending won't really filter through until next year. The economy is also weathering the considerable transport and local business disruption caused by last November's Kaikoura earthquake.

The perennial topic du jour, **housing, is on track for a soft landing this year**. The Auckland market was losing momentum even ahead of the most recent investor loan restrictions, but will remain well supported by continued undersupply. Other areas will return to a more moderate pace of price growth as construction steadily closes the gap.

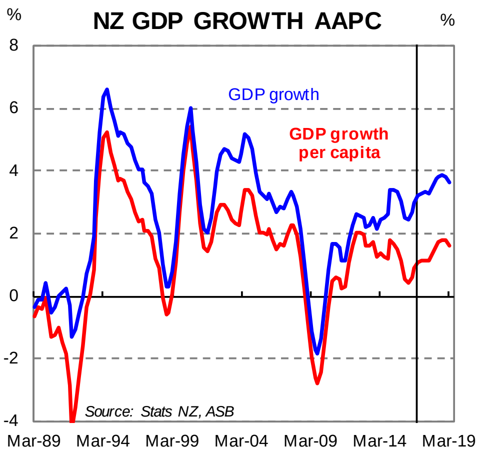
So **domestic conditions do appear sunny**. But there are a few clouds hanging offshore, and they appear to be the main threats to a strong NZ performance.

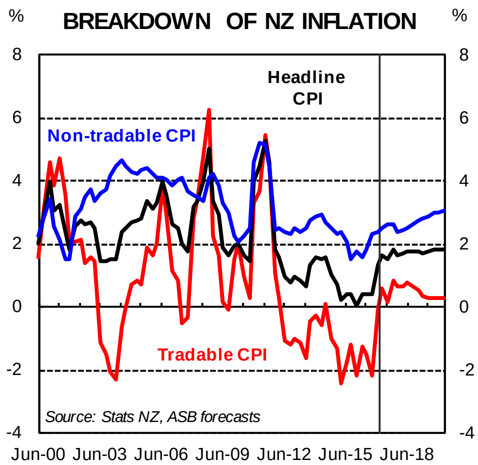
There is still a lot of **uncertainty over what impact Donald Trump's presidency will have**. For NZ the key influences are the positive impact of any fiscal stimulus against any negative impacts of greater trade protectionism. He has already started to follow through on some of his key election pledges, such as axing the TPP, cracking down on migrants and building the wall on the Mexican border. Follow-through on threats to crack down on Chinese imports would be a risk to NZ's export outlook, however.

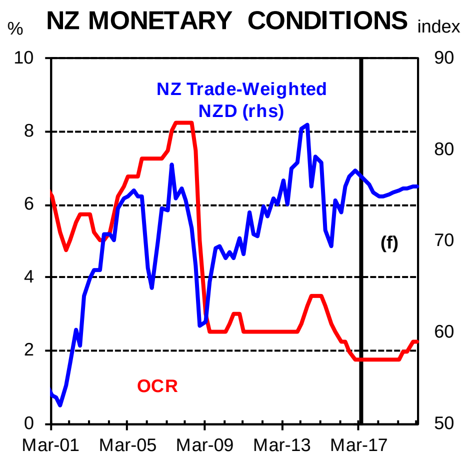
In the UK, **Brexit is heading towards a clean separation from the EU**, intending to move out of the customs area and likely leaving its large financial sector out in the cold. We can't help but see this as slowing UK growth and weakening the Pound even further. And several key elections will take place in Europe this year, keeping up the diet of political intrigue.

At this point though, NZ is sitting pretty, with plenty of monetary and fiscal ammunition to deal with any unexpected slowdown. **We expect the RBNZ to keep the Official Cash Rate (OCR) on hold for a considerable period (to the end of 2018)**, continuing to underpin the growth story. With inflation now back into the 1-3% target band and dairy prices now substantially higher, the RBNZ will be less concerned about the risks of inflation remaining unexpectedly low.

However, **there are still plenty of risks that inflation does struggle to sustain around the 2% level over the next few years**. The **NZ dollar is set to remain high**, apart from some Trump-induced softness against the USD. Term interest rates are also delivering a little restraint of their own, lifting as the prospect of OCR cuts recedes, as US interest rates charge higher via Donald Trump, and as banks face added challenges in obtaining sufficient funding to cover strong loan demand.







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International outlook – *the 'Trump effect'*

The global economic outlook improved at the end of 2016, but this momentum may be short-lived. The most likely catalyst for a reversal in global sentiment is the 'Trump effect'. That is, a President Trump-led switch to isolationist and protectionist US policies resulting in stalled global trade or even a global trade war. So far, the signs are not good, but there are offsetting positives in play such as planned global fiscal stimulus and lifting commodity prices. Of course, time will tell as to whether these other factors can offset Trump's best (or should that be worst) efforts.

After an initial bullish take on Donald Trump's election triumph, financial markets have started to fret about the potential for global political and economic fallout. In his first week in office, Trump promptly withdrew the US from the Trans Pacific Partnership (TPP) and signalled his intention to re-negotiate the North American Free Trade Agreement. While these moves were not unexpected given his campaign stance, the immigration bans surprised many with their swift and blunt implementation.

While Trump's early announcements have been controversial, his fiscal policy plans should eventually stimulate US and global growth. Indeed, by 2018 the OECD estimates that the planned stimulus could add 0.3% pts to global growth. Moreover, ongoing Chinese and Eurozone stimulus could have a similar impact on global growth over this period.

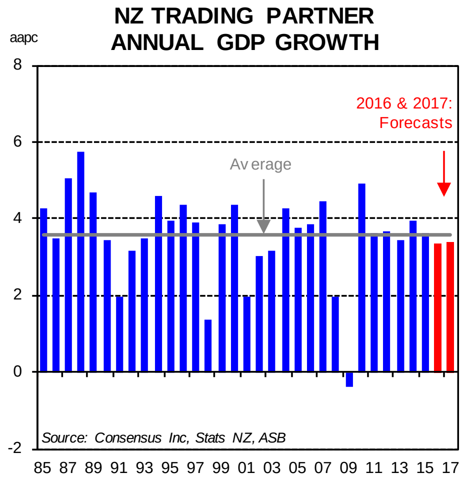
Trump aside, the US economy strengthened over 2016. With this in mind, the Federal Reserve lifted its benchmark rate back in December, signalling incremental hikes to come. Whether the *Trump effect* is enough to derail the Fed's planned hikes remains to be seen. However, at this juncture, Trump's announcements have offset the impact of the Fed's outlook on currency markets, with the US dollar weaker since Trump's inauguration.

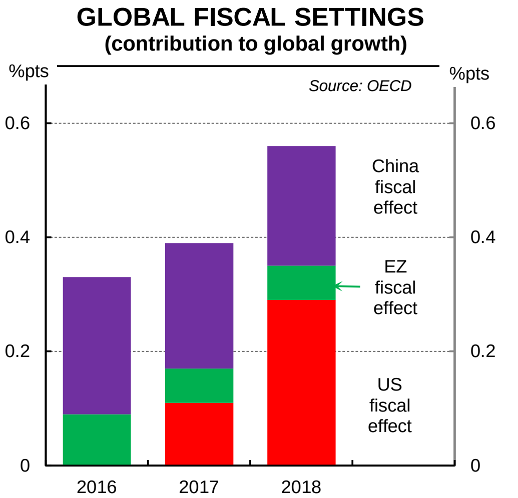
Meanwhile, **Chinese growth ended 2017 on a firm footing.** Q4 growth accelerated a touch to 6.8% in annual terms, compared to 6.7% over the first three quarters of the year. Over 2017, we expect China to grow by a similarly strong 6.8%, although this is dependent on a recovery in exports. Unsurprisingly, this export uptick is subject to the broader improvement in global growth as well as subject to any Trump-Sino trade war risks. That said, there is little appetite among Chinese politicians for economic weakness in the run up to the National Congress later in 2017.

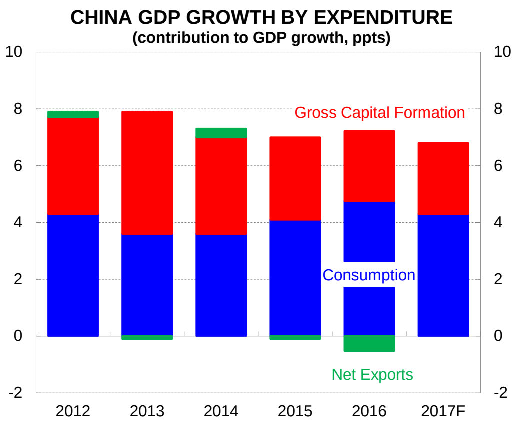
Over the ditch, the Australian economy went backwards over Q3; however, the 0.5% drop in GDP looks like a pothole rather than the start of something more sinister. Moreover, Australia's resource export prices spiked in Q4, with incomes likely to improve as a result over 2017. With the latter improvement in mind, we expect the RBA to leave the cash rate at 1.5% in 2017. From a New Zealand perspective, we expect the Australian labour market to remain relatively weak and for this to support NZ's historically strong net migration position with Australia.

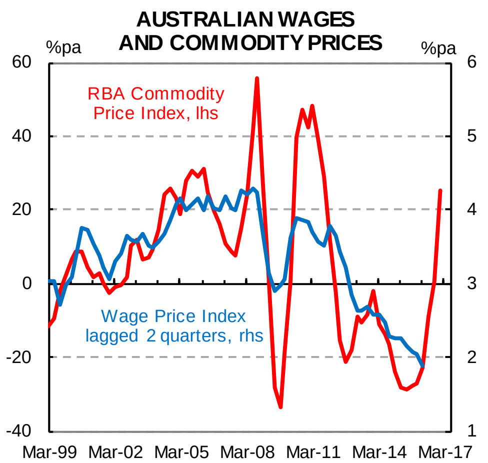
Turning to Europe and the UK, a hard (and long) Brexit looks like the most likely scenario for the UK. That along with a weak Eurozone economy, including financial institutions, offers little hope of a material change in either British or European economic fortunes over 2017 or 2018.

Overall, we continue to expect modest global growth over 2017 and 2018. Growth has the potential to accelerate a touch from 2016 levels and to support NZ's export outlook, particularly if the rebound in global commodity prices sticks. However, risks are likely to wax and wane. In particular, fallout from the *Trump effect* is likely to dominate Q1 as Trump makes a policy splash over the first 100 days of his term. Meanwhile, other risks such as a 'hard Brexit', weak Eurozone growth and ongoing Chinese growth concerns remain very much in play.









The New Zealand Economy – *moving from strength to strength*

New Zealand's economic performance continues to improve, following a slowdown in growth over 2015. We expect growth of 3.5% in calendar year 2017, with a further increase in growth to follow in 2018. Low interest rates, strong population growth and solid demand for NZ exports will remain key factors supporting NZ's strong performance. With a robust domestic demand outlook largely 'locked in', the key risks to NZ's prosperity are largely those stemming from global economic and political uncertainty.

Dairy prices have rebounded strongly, as predicted by ASB last year. A higher milk price for the current season will mean dairy will be less of a drag on consumer spending and business investment. However, even after cash flows improve from mid-year, we expect dairy-related spending growth will be muted given the need for debt repayment.

Tourism continues to perform strongly with arrivals continuing to grow. However, the elevated NZD appears to be crimping spending growth. **Tightening capacity (e.g. accommodation**) may also limit growth in the short term, but an increase in building consents for hotels/motels and hostels should boost capacity and growth in this sector longer term.

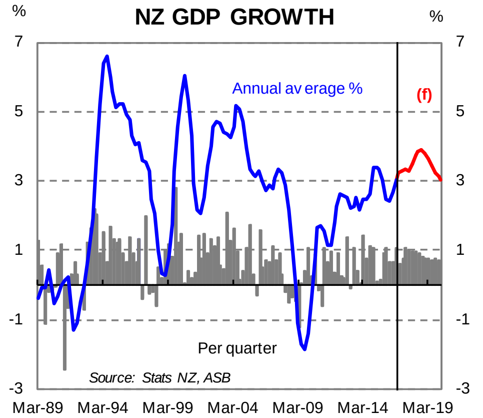
Construction activity has grown strongly over the past few years and **activity is now at record high levels.** While we expect construction demand to remain strong, we believe capacity constraints could slow the pace of growth over 2017 and 2018. The lift in construction demand has been broad-based across the country. Strong population growth has resulted in **increased housing requirements**. Strong **business confidence** and low interest rates continue to support commercial construction demand. Meanwhile, **infrastructure investment** is also set to remain elevated with a number of large projects taking place across NZ (including the Auckland City Rail Link and SH1 earthquake damage repairs).

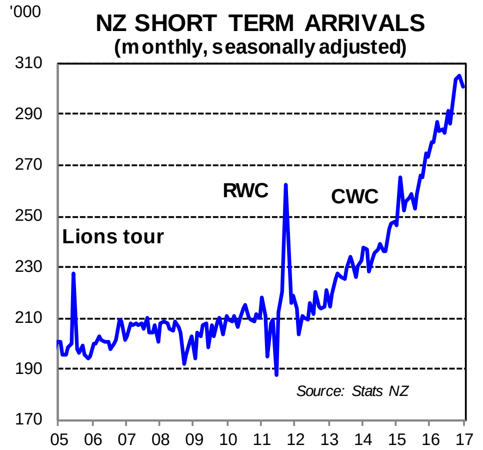
Migration continues to run at record levels, with strong population growth providing a boost to economic growth via increased consumer spending and housing requirements. Indicators suggest net migration will remain elevated, even if the number of international student arrivals slow. **An increasing share of arrivals is to meet labour shortages** (i.e. arriving on skilled migrant visas). Meanwhile, the **Australian labour market remains relatively soft** and likely to limit departures.

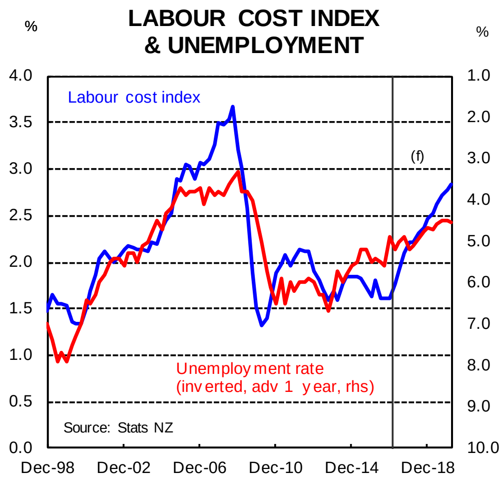
Household demand appears to have strengthened over the past year, with a **strong labour market and low interest rates** contributing to increased consumer confidence. Although interest rates are starting to lift off lows, we expect a steady OCR to keep short-term borrowing costs anchored at low levels for borrowers. Continued residential construction activity will support demand for household durables.

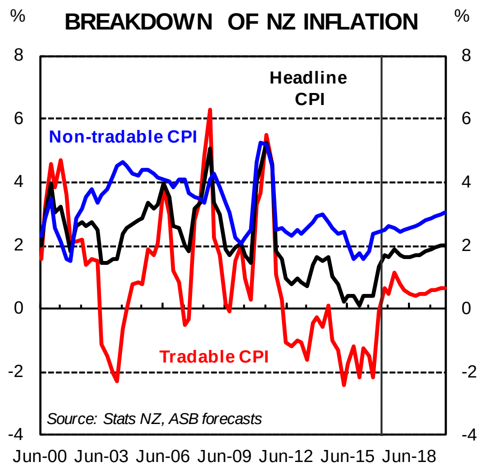
The **labour market has tightened slightly** over the past year – an impressive feat considering the very strong growth in labour supply. We expect this trend to continue, with the strong economy continuing to create new jobs and employers reporting increased difficulty finding labour. **A tighter labour market and a lower unemployment rate will see wage inflation lift over the next three years.**

Inflation has finally turned a corner, lifting off lows. At the end of 2016**, CPI inflation returned back within the RBNZ's target band of 1-3% for the first time in over 2 years.** The lift in inflation appears meaningful, with evidence of growing capacity constraints in construction and tourism sectors spilling over into prices. Meanwhile, there is also **tentative evidence of increased pricing power** as household demand improves. Going forward, while the domestic inflation outlook has improved, an elevated NZD and soft tradable inflation may be a restraint on headline inflation lifting much further.









Interest Rates and Exchange Rates – *on hold but offshore impacting*

After cutting the OCR in November to a record low 1.75%, the RBNZ now looks to be on-hold until late 2018. While NZD/USD upside will be limited in the near term, structural factors will continue to support the NZD.

The RBNZ cut the Official Cash Rate (OCR) to 1.75% in November but signalled that was likely the last move in the easing cycle. The RBNZ introduced a new OCR forecast track in the November Monetary Policy Statement (MPS), instead of the 90–day bank-bill rate previously used. **This track showed the OCR bottoming out at 1.7%,** hinting at the time that the balance of risks was skewed fractionally down.

We expect the RBNZ will hold the OCR at 1.75% in February. However, in the wake of stronger economic data we expect the RBNZ's risk assessment to shift to a more neutral stance. We expect the RBNZ will acknowledge the robust domestic outlook, but remain wary of the **downside risks stemming from global uncertainty, the high NZD and lift in bank funding costs.**

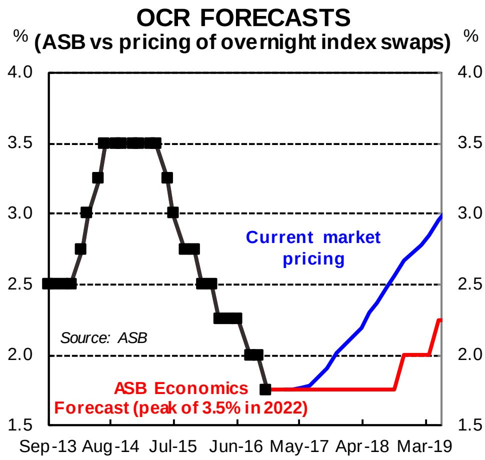
The market focus has shifted to the potential timing of rate hikes. We expect the RBNZ will not start hiking the OCR until late 2018. However, at the time of writing, market interest rates imply OCR hikes from late 2017, with 125 basis points of rate hikes by mid-2019. Our interest rate forecasts assume market expectations for OCR hikes cool slightly in the near term.

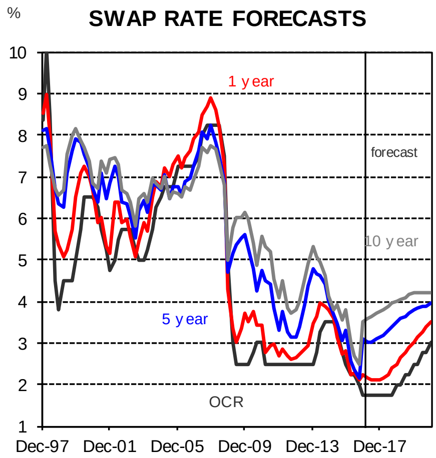
A steady OCR will anchor short-term interest rates. However, we expect longer-term interest rates to continue to increase over the coming years. These lifts reflect expectations of OCR increases from 2018 and higher offshore interest rates (led by increases from the US). Higher bank funding costs are likely to also influence borrowing rates across all terms.

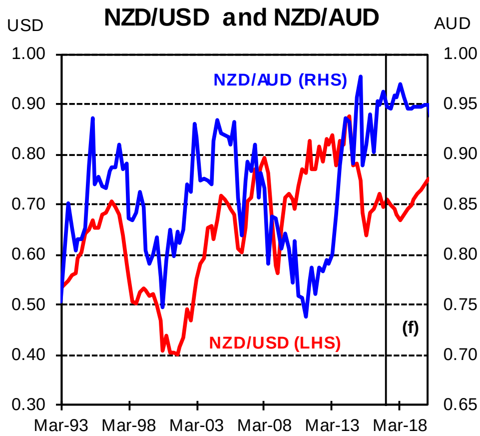
The New Zealand Dollar trade-weighted index has been higher than forecast for months, posing risks to the inflation outlook. Structural factors including the high Terms of Trade and relatively high interest rates have been supporting the NZD. Delayed US Fed rate hikes have also limited NZD/USD downside, although going forward the Federal Reserve is expected to pick up the pace. Further, the unexpected Brexit vote continues to keep the NZD higher against both the GBP and the EUR.

We expect the NZD to retain a degree of strength given the supportive structural factors, but US Fed rate hikes and US tax cuts will put the NZD/USD under pressure this year. The NZD will firm over time against the EUR and GBP as these currencies continue to be impacted by ongoing Brexit-related and political uncertainty. Meanwhile, the NZD/AUD is likely to hold up given both central banks are on hold and NZ's economic performance is a touch firmer than Australia's.

Finally, we expect the NZD/JPY to continue to grind higher over time. Ongoing and increasingly unorthodox monetary policy stimulus from the Bank of Japan will continue to weigh on the JPY.







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Economic Forecasts

ASB economic forecasts		Sep-16 <<actual	Dec-16 forecast >>	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Mar-19	Mar-20
NZ GDP real	**AA%**	**3.0**	**3.2**	**3.3**	**3.3**	**3.3**	**3.5**	**3.8**	**3.6**	**3.0**
private consumption	AA%	4.0	4.5	5.2	5.3	5.2	5.2	5.1	5.1	4.5
dwelling construction	AA%	9.5	13.2	15.0	13.7	12.2	9.0	6.2	-0.4	-0.3
other investment	AA%	2.0	2.3	1.6	1.3	1.9	3.5	4.9	5.7	5.2
exports	AA%	3.1	2.3	2.3	0.6	-0.1	0.0	0.2	2.5	2.5
imports	AA%	2.0	3.1	4.3	4.9	4.6	4.9	5.1	6.2	5.4
NZ GDP real	A%	3.5	3.1	3.1	3.6	3.5	3.9	4.1	3.3	2.9
NZ GDP real	Q%	1.1	0.6	0.7						
NZ CPI	**A%**	**0.4**	**1.3**	**1.7**	**1.7**	**1.9**	**1.7**	**1.7**	**1.8**	**2.0**
NZ house prices (QV index)	A%	12.6	13.7	11.4	5.2	2.7	3.4	3.1	1.8	0.9
NZ unemployment (sa%)	Qtr	4.9	5.2	5.1	4.9	4.8	4.7	4.7	4.5	4.6
NZ private sector wages (LCI)	A%	1.6	1.6	1.8	1.9	2.1	2.2	2.2	2.5	2.8
NZ current account ($b)	Yr	-7.5	-7.7	-7.9	-8.1	-8.4	-8.7	-9.3	-13.4	-15.4
as a % of GDP	Yr	-2.9	-3.0	-3.0	-3.0	-3.1	-3.2	-3.3	-4.6	-5.0

A% = percentage change since same quarter the previous year

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

Financial Forecasts

ASB interest rate forecasts (end of quarter)	Sep-16	Dec-16 <<actual	Mar-17 forecast >>	Jun-17	Sep-17	Dec-17	Mar-18	Mar-19	Mar-20
NZ cash rate target	2.00	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50
NZ 90-day bank bill	2.20	2.00	2.0	2.0	2.0	2.0	2.0	2.4	2.9
NZ 3-year swap rate	2.05	2.75	2.6	2.6	2.6	2.6	2.7	3.2	3.6
NZ 10-year gov't stock	2.31	3.36	3.4	3.5	3.5	3.6	3.6	3.9	4.0

ASB foreign exchange forecasts (end of quarter)	Sep-16	Dec-16 <<actual	Mar-17 forecast >>	Jun-17	Sep-17	Dec-17	Mar-18	Mar-19	
USD per NZD	0.723	0.697	0.71	0.70	0.69	0.68	0.67	0.71	0.75
GBP per NZD	0.558	0.567	0.58	0.59	0.62	0.62	0.64	0.70	0.71
AUD per NZD	0.949	0.962	0.95	0.95	0.96	0.96	0.97	0.95	0.95
JPY per NZD	73.1	81.0	83	84	84	84	84	86	89
EUR per NZD	0.645	0.660	0.68	0.69	0.69	0.69	0.71	0.66	0.62
CNY per NZD	4.82	4.85	5.01	4.97	4.93	4.90	4.89	4.86	4.69
TWI - 17 country	77.0	77.8	77.4	76.7	76.1	75.3	74.8	75.5	76.1

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