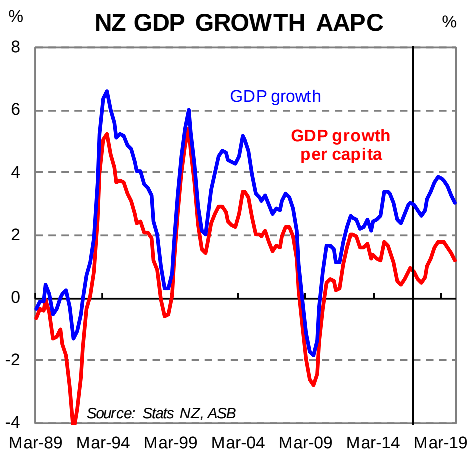
Tempest in a teacup

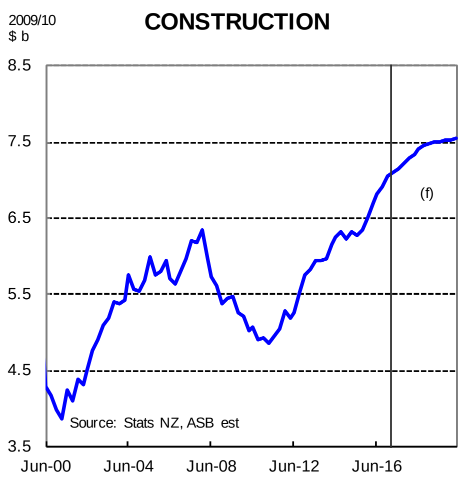
- Despite the potential for stormy conditions offshore, the global outlook is in reasonable shape.
- We expect NZ growth to hit 3.5% next year, though tourism and construction won't sustain their recent growth pace.
- The RBNZ will remain firmly on hold until late next year, even though headline inflation has hit 2% again.

NZ's weather has literally been surprisingly stormy so far this year, though fortunately the damage has been relatively contained compared to some of the fears beforehand. Meanwhile, **some of the large storm clouds overseas are proving smaller or more distant than feared**, though still have potential to whip up into a full-blown cyclone.

It **is now over 100 days since President Trump took office**. Yet, rather than the tornado of activity promised, so far it has been more a stiff breeze of change. There have been **no big bangs yet on the policy front from the US**. Fiscal policy has not made much progress, and looks like **it could even take until 2019 to have tax changes implemented**. The other key area of focus has been trade protectionism, which is relatively quiet for now from a NZ perspective. Yes, Donald Trump is still making noises about renegotiating the NAFTA agreement with Canada and Mexico. But **with China, Donald Trump has made soothing noises that he is not going to label China a currency manipulator.** For now, at least, **that reduces the 'what if' risk of a trade war between the world's two biggest economies**. There is still uncertainty about the exact impact on NZ of US economic policies, but the impacts (positive or negative) are potentially modest, and slow in coming.

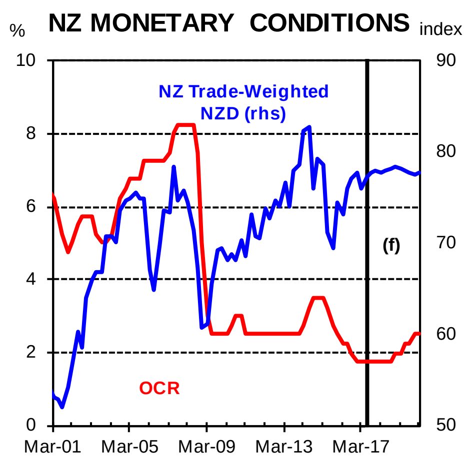


The main tempests have occurred on the geopolitical front. We have been reminded of the **simmering tensions between nations**, and the risks of outright conflict. The **risks seem more numerous**, but we emphasise they are very much at the tail. But **when we step back from the noise, global growth is in reasonable shape** and providing a good foundation for NZ.



Barring any major storms (literally and metaphorically), we expect NZ growth to be fairly steady this year at around 3% growth, stepping up to 3.5% next year. Consumer spending growth will continue to propel growth, in part aided by still-strong migration. Solid growth will increasingly encourage businesses to invest at a greater pace. And export volumes will lift, particularly as the dairy and meat sectors take advantage of healthy prices.

But **NZ is suffering from some growing pains**. Some of the growth drivers of the past few years will move forward at a slower pace now. The surge in visitors to NZ over the past few years is increasingly stretching accommodation capacity. That is in turn spurring more hotel investment, though it will still take some time to catch up.



At the same time, **overall construction growth will slow**. In most regions new building supply over the next couple of years will catch up with recent population spurts. **Growth will mainly be reduced to areas such as Auckland and Wellington which will continue to struggle to build fast enough to meet population growth demands.** The pressures in Auckland are nothing new. Since 2009, through periods of both strong and weak population growth, Auckland has consistently seen fewer dwelling consents issued than are needed.

One area that we do expect to be a sea of tranquillity is NZ's Official Cash Rate –unless, of course, there is a major Trump Tempest. Yes, inflation is back to a normal level, but mainly through jumps in fuel and food prices. **Low interest rate rates will still be needed to keep pushing the economy along and generate a greater degree of inflation pressure.**

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International outlook – *white noise*

In the face of frequent geopolitical storms, the global economic outlook has improved ever so slightly over 2017. That's the somewhat surprising conclusion, despite what has been an incredibly eventful geopolitical year. For now though, the global economy is shrugging off this political noise. However, while the global economy has shrugged off the year's challenges to date, there are more on the way. In that sense, **the improving growth prospects still hinge on the global political order holding.**

Not surprisingly, President Trump has contributed a great deal to global political noise. However, his first 100 days since in office have disappointed in terms of policy achievements, whatever Trump may say to the contrary. In particular, fiscal policy progress has been very slow, and it looks like it will potentially take until 2018 or even 2019 to have tax changes implemented.

Importantly for NZ, the Trump-led swing to trade protectionism has not been as bad as feared. In particular, the prospects of a trade war with China have receded, with the Trump administration indicating that it is not going to label China a currency manipulator. In contrast, Trump continues to 'squabble' with Canada and Mexico over NAFTA; but the potential impact on NZ is small compared to that from a potential trade war with China.

Meanwhile, the **US economy continues to gradually gather pace**, allowing the **Federal Reserve to continue its policy normalisation process**. We continue to expect 2 further interest rate hikes in June and September this year, followed by 3 more over 2018. We also expect the Fed to reduce the size of its balance sheet (unwinding Quantitative Easing) from 2018.

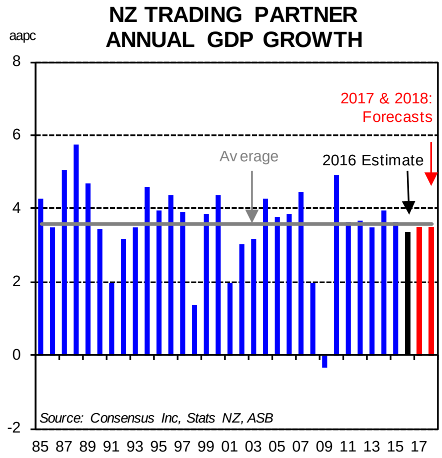
In other political hotbeds, it has been a mixed bag. UK Prime Minister, Teresa May, has called a snap election for 8 June in an attempt to solidify her party's majority ahead of Brexit negotiations. Meanwhile, Emmanuel Macron has triumphed in the French Presidential election, allaying fears of swing to the right with Marine Le Pen. For once it seems, the polls have been a reliable predictor of the election outcome. However, North Korea and Syria remain diplomatic powder kegs. And without resolutions to these conflicts forthcoming in the short term, **we are likely to see sporadic military and political flare-ups that add to financial market volatility from time to time.**

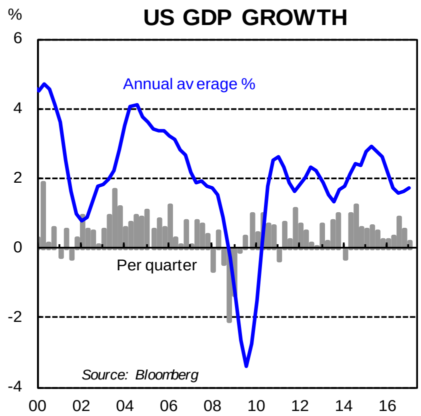
As mentioned above and despite the apparent geopolitical turmoil, the **combined economic prospects of our trading partners have ticked higher**. Consensus forecasts show a 0.1 percentage point lift in the 2017 and 2018 forecast growth of our trading partners over the last three months; both years now sit at 3.5%. Similarly in April, the International Monetary Fund (IMF) made a 0.1 percentage point upward revision to its 2017 global growth projection relative to January.

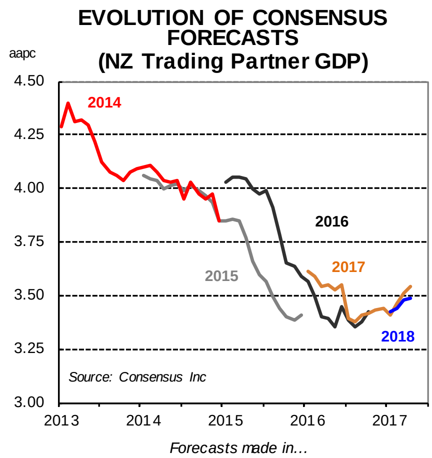
Much of the improvement has come via China and the subsequent spill over into other Asian economies. In particular, the prospects for Chinese growth, according to the Consensus forecast, have lifted to 6.5% from 6.2% at one stage. Indeed, with the **recovery in industrial production growth in full swing**, our own forecast for 2017 Chinese growth stands at 6.8%.

Meanwhile over the Tasman, the **Australian economy has bounced decisively out of the Q3 GDP "pothole"**. Moreover, the income dynamics underlying the economy have improved significantly. Australian growth is supported by the ramping up in resource exports, the residential construction boom, higher public spending and some surprising growth in consumer activity. From a **NZ perspective, we expect the Australian labour market to remain relatively subdued and for this to support NZ's historically-strong net migration position with Australia**.

All up, we expect subdued, albeit slightly improved, trading partner growth over 2017 and 2018. That said, **geopolitical risks remain front of mind**.







The New Zealand Economy – *building up*

New Zealand's economic performance remains positive, with annual growth of 3.1% over the December 2016 year. **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.

Non-dairy exports have performed well over the past year, particularly fruit. The recovery in dairy prices is also a positive for the NZ economy, although we expect a degree of farmer austerity to remain, given a focus on repaying debt and restoring savings.

The tourism sector has boomed over recent years with NZ hosting 3.5 million visitors over the past year. However, the strain is starting to show as the rapid increase in visitors is beginning to place pressures on resources. Short-term visitor arrivals appear to have plateaued for now. Following on from the World Masters Games, this year's Lions Tour is expected to provide another boost to the tourism sector. These events fall in NZ's quieter "shoulder season" for visitor arrivals.

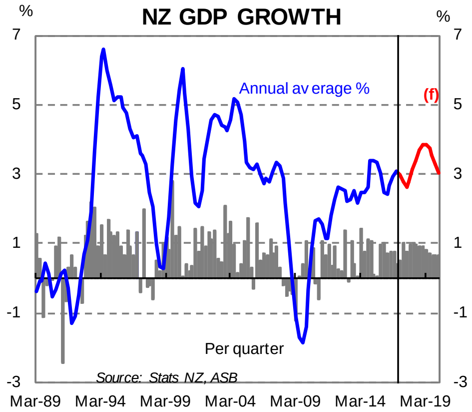
Construction has been a key driver of economic growth over recent years, although emerging **capacity constraints could be a headwind to further growth.** Despite recent lifts in residential construction, it has not matched pace with population growth and **undersupply of housing continues to grow in Auckland and Wellington**. Excess demand will continue to support construction demand in these cities. However, we may start to see some slowdown in housing construction in other areas of NZ (albeit from high levels). Non-residential demand also remains strong, more recently supported by a surge in consent applications for hotel/motel construction in response to NZ's tourism boom. 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 Kaikoura earthquake damage repairs).

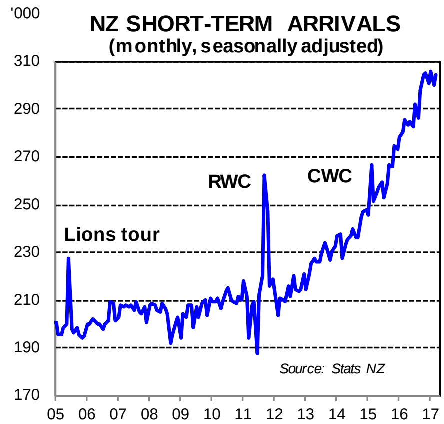
Net migration continues to run at record levels and is likely to remain at high levels. NZ's favourable labour market conditions, particularly relative to Australia, are a key factor supporting our strong net migration outlook. Work-visa arrivals have continued to move higher, accounting for 34% of all arrivals over the past 12 months. Meanwhile, student arrivals have weakened over the past year, particularly from India.

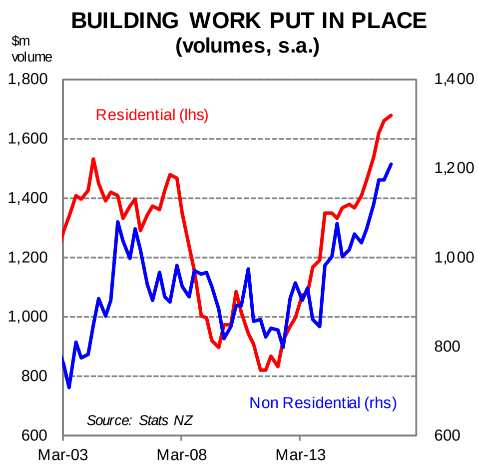
Household demand appears to have strengthened over the past year, with a strong labour market and low interest rates contributing to increased consumer confidence. Although interest rates are starting to lift off lows, we expect a steady OCR to keep short-term borrowing costs anchored at low levels for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

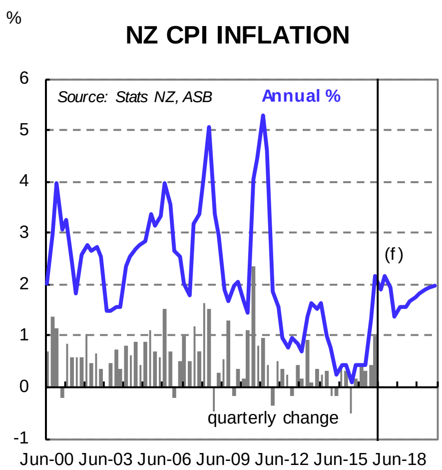
The labour market has tightened slightly over the past year and we expect this trend to continue. Employers are reporting increased difficulty in finding labour. A tighter labour market and a lower unemployment rate will see wage inflation lift over the next three years.

CPI inflation has surged over the past 6 months, lifting from an annual pace of just 0.4% in September 2016 to 2.2% by March 2017. The lift has been underpinned by stronger food and fuel prices. Nonetheless, with evidence of capacity pressures beginning to translate into stronger domestic inflation, **we expect inflation will now remain comfortably within the RBNZ's target band of 1-3%.**









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

Since our last quarterly update the RBNZ has not made any adjustments to the 1.75% OCR. In addition, official comments and statements continue to suggest there will be no change for some time to come.

The RBNZ's February OCR forecast showed the Bank was not expecting to start lifting the OCR until late 2019. In meantime, the RBNZ did lift the bottom of its OCR forecast track from 1.7% to 1.8%, suggesting any near-term risks lie to the high side, even if only marginally.

We expect the RBNZ to lift interest rates sooner than that, **from late 2018**. We expect **capacity pressures to gradually rise** and to broaden beyond the current hotspots of construction and tourism. Part of that story will be stronger wage growth, responding to incremental tightening of the labour market and even to the mere fact that the rebound in headline inflation resets the starting point for wage negotiations. But **we emphasise there is very little need for the RBNZ to lift interest rates in the immediate future, particularly while sustaining inflation near 2% is not yet a done deal**.

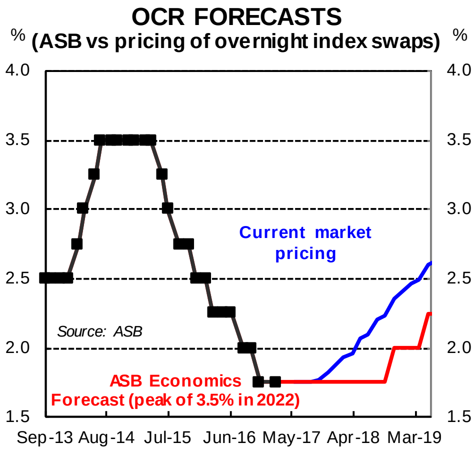
Market pricing is, nevertheless, looking for the RBNZ to take action sooner. A full 25bp OCR increase is fully factored in by May 2018. By September 2018 the market expects 2 full hikes to have occurred.

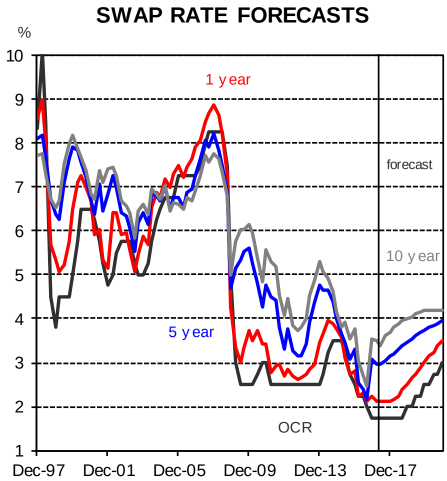
Only a few months ago, markets had a 25bp hike fully priced in for November 2017. Pricing has been slowly moving towards our view as the economic data underline that the need for higher interest rates is relatively distant. We expect that short-term interest rates will remain anchored by the lack of near-term action, while the **longer-end continues to be driven by expectations of rate hikes as well as offshore developments**.

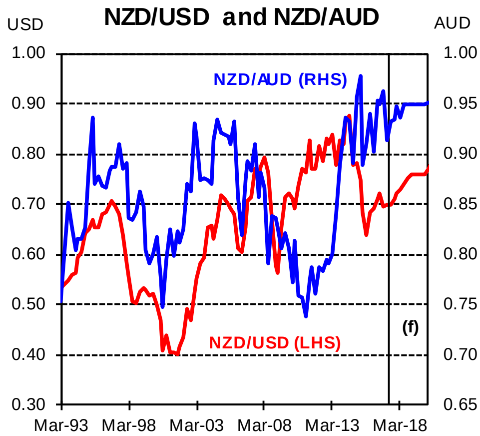
The caveat for interest rates and the NZD is the international outlook. In particular, it looks as if the long-awaited fiscal stimulus plans from the Trump Administration may be delayed, perhaps not coming into force until late 2018 or even 2019. In turn, that delay is likely to keep the USD on the back foot, and could slow the pace of US Federal Reserve tightening.

The **NZD trade-weighted index (TWI) has moved lower over the last few months against the major currencies**. The US dollar has benefitted at times from geopolitical tensions, the Australian dollar from relatively stronger moves in its commodity prices. Concerns over EU elections have diminished, and the UK Conservative Government is going to the polls to get a clear Brexit policy mandate.

We expect that the NZD will gradually lift across the board. The USD remain bogged down by a lack of policy action, the NZ economy will perform well relative to Australia's, and some further lifts against the Pound are likely as some of the negative impacts of Brexit start showing up in the UK economy. NZD/EUR may be flat to down marginally over the next year. Political concerns are easing, and we expect the ECB will reach the point where the improving economy warrants tempering of Quantitative Easing.







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Economic Forecasts

ASB economic forecasts		Dec-16 <<actual	Mar-17 forecast >>	Jun-17	Sep-17	Dec-17	Mar-18	Mar-19	Mar-20
NZ GDP real	**AA%**	**3.1**	**3.0**	**2.8**	**2.6**	**2.8**	**3.1**	**3.8**	**3.0**
private consumption	AA%	4.2	4.6	4.3	3.5	3.2	2.9	3.9	3.6
dwelling construction	AA%	11.0	10.6	7.6	5.3	3.6	3.2	1.9	-1.6
other investment	AA%	3.5	3.6	4.1	5.5	5.7	6.4	6.0	5.3
exports	AA%	1.6	1.3	-0.3	-0.7	0.9	1.6	2.1	2.4
imports	AA%	4.0	5.8	6.5	6.1	5.0	4.1	3.7	4.0
NZ GDP real	A%	2.7	2.4	2.7	2.7	3.3	3.8	3.7	2.7
NZ GDP real	Q%	0.4	0.5						
NZ CPI	**A%**	**1.3**	**2.2**	**1.9**	**2.2**	**1.9**	**1.4**	**1.8**	**2.0**
NZ house prices (QV index)	A%	13.8	11.9	5.5	3.0	3.8	3.1	1.7	0.9
NZ unemployment (sa%)	Qtr	5.2	4.9	4.8	4.6	4.6	4.6	4.3	4.3
NZ private sector wages (LCI)	A%	1.6	1.5	1.6	2.0	2.1	2.2	2.6	2.9
NZ current account ($b)	Yr	-7.1	-6.7	-5.7	-4.9	-4.8	-4.8	-6.8	-8.2
as a % of GDP	Yr	-2.7	-2.5	-2.1	-1.8	-1.7	-1.7	-2.3	-2.7

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)	Dec-16	Mar-17 <<actual	Jun-17 forecast >>	Sep-17	Dec-17	Mar-18	Mar-19	Mar-20
NZ cash rate target	1.75	1.75	1.75	1.75	1.75	1.75	2.00	2.50
NZ 90-day bank bill	2.00	2.00	2.0	2.0	2.0	2.0	2.4	2.9
NZ 3-year swap rate	2.75	2.60	2.5	2.6	2.6	2.7	3.1	3.6
NZ 10-year gov't stock	3.36	3.21	3.2	3.4	3.5	3.6	3.9	4.0

ASB foreign exchange forecasts (end of quarter)	Dec-16	Mar-17 <<actual	Jun-17 forecast >>	Sep-17	Dec-17	Mar-18	Mar-19	Mar-20
USD per NZD	0.697	0.699	0.70	0.71	0.72	0.73	0.76	0.77
GBP per NZD	0.567	0.560	0.55	0.55	0.55	0.56	0.57	0.55
AUD per NZD	0.962	0.914	0.93	0.93	0.95	0.94	0.95	0.95
JPY per NZD	81.0	78.4	77	77	78	78	79	78
EUR per NZD	0.660	0.654	0.65	0.65	0.64	0.64	0.64	0.65
CNY per NZD	4.85	4.817	4.82	4.86	4.90	4.93	5.00	4.81
TWI - 17 country	77.8	76.1	77.3	77.6	78.0	77.8	78.1	77.6

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