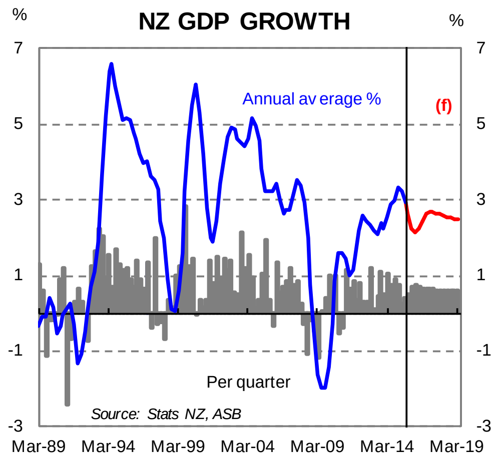
A cautionary tale

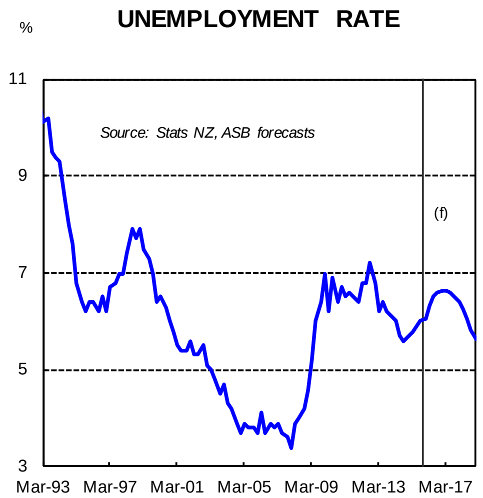
- The growth outlook has softened, as dairy production contracts and businesses become more cautious.
- Strong net migration is likely to push the unemployment rate higher, keeping wage and domestic inflation pressures low.
- The inflation outlook is mild and we believe the RBNZ has scope to cut the OCR below 2.5%.

The **NZ economic outlook is for moderate growth, though the economy still faces a number of risks**. **Business confidence has fallen**, with an uncertain outlook threatening to delay hiring and investment plans. Dairy incomes will be squeezed this year and **dairy production is already contracting sharply**, directly dragging on GDP growth. Tourist inflows and strong population growth have supported retail spending growth, but **per-capita consumer spending has slowed.** We expect annual-average GDP growth to slow to a low of 2.1% in early 2016 before gradually recovering through the twin tailwinds of lower interest rates and exchange rates.



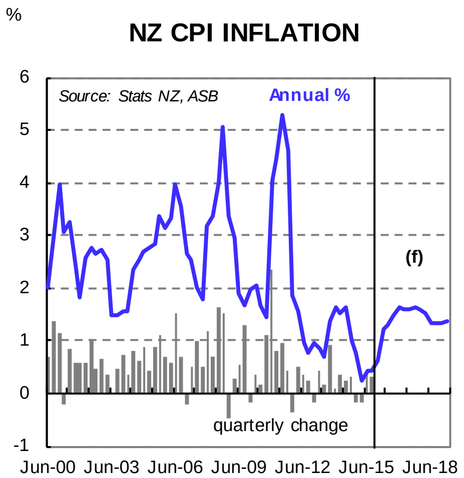
We are still keeping a watchful eye on global risks. While the growth outlook for our key trading partners remains reasonable overall, it has the usual stress fractures. **Question marks still hang over China's growth outlook.** Looming US interest rate increases have increased nervousness about the potential impact on emerging economies of capital flight and rising servicing costs of USD-denominated debt.

Some recent regathering of dairy prices is welcome news. We expect an eventual milk price for this season of $5.00/kg milk solids, a little higher than Fonterra's September forecast of $4.60. The price outlook is better, though largely because milk production will fall this season. **We still expect dairy farmers to be very cautious given that cashflows throughout the season will be weak compared to the previous season's.**



Net migration continues to run at record levels, a reflection of NZ's superior economic performance back in 2014. But slowly the sands are shifting. Strong population growth is fuelling an increase in the labour supply. But against a back drop of slowing labour demand, **the unemployment rate will rise**. This extra slack in the labour market will keep a lid on wage inflation pressures, and provide an **extra drag to domestic inflation when inflation pressures are already so low.**

Indeed, **we expect inflation pressures to remain very mild over the next few years**. Weak wage inflation pressures are part of the story. Weak global inflation pressures are also contributing. We do not expect inflation to reach 2% at any point over the next few years.



Due to low inflation and a subdued global backdrop, we expect **a low interest rate environment will prevail for 2-3 more years**. In fact, our inflation outlook is so low now that it is screaming out for us to forecast even lower interest rates than we already are. However, **whether or not the RBNZ will eventually cut the OCR below 2.5% depends on a couple of things.** First, that inflation pressures do indeed turn out to be weaker than the RBNZ is currently envisaging. And the other is whether the RBNZ comes to that realisation soon enough to warrant doing something about it.

The world is uncertain, and the RBNZ is forced to make decisions knowing it takes a couple of years until it finds out how prophetic its decisions were. The world won't end if the RBNZ doesn't cut the OCR substantially further. But, **in the absence of OCR cuts, we sense a foregone opportunity for the economy to grow a little faster in an environment of benign inflation.**

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International outlook

The global growth outlook has softened slightly according to the IMF and OECD. Both have recently trimmed their growth outlooks for 2015 and 2016 for a second time in a row. Much of the revisions were for emerging economies that depend heavily on commodities, for which prices have weakened. The outlook for NZ's main trading partners has also moderated slightly, to a pace around the long-run average. The future path of China is crucial and very much in the limelight. The other key global risk is the impact the US Federal Reserve's eventual interest rate rises will have on global capital flows, particularly for emerging economies.

China is still the biggest cause of unease about the pace of global growth. The equity market gyrations from a few months ago have subsided with no obvious economic impacts – yet. But **China has yet to convincingly show its pace of growth has bottomed out.** Its import demand has slowed this year: even Germany, for example, is experiencing slowing growth in exports to China of cars and of industrial equipment destined for factories.

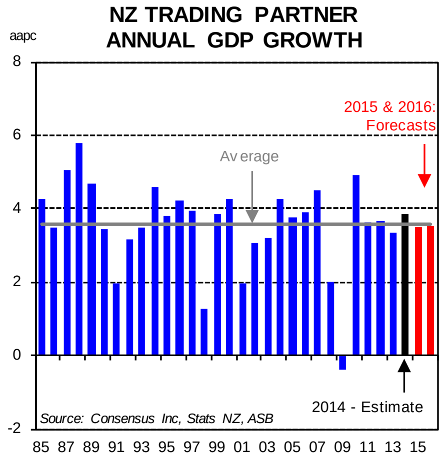
We expect China's reported growth to slow to 6.5% before recovering slightly as the various stimulus measures put in place this year take effect. At this point, China remains on track for a soft landing. But it has its fragilities, such as a large run-up in debt levels. As well as a cyclical slowdown in the economy, **China is also undergoing a shift to structurally lower growth, with greater roles for consumer spending and service sectors.** These transitions will have wobbles along the way. Efforts to stamp out corruption, for example, can hurt growth in the short term but longer term will mean more economically efficient decisions are made. But, in the event of some economic calamity, the Chinese authorities will step in to shore growth up if needed.

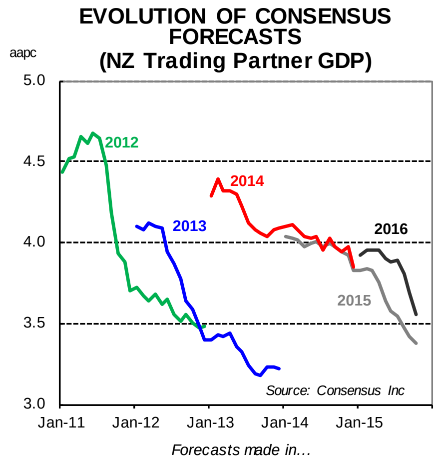
NZ's direct trade links are to China's consumers, whereas much of China's economic deceleration (beyond car sales) is happening in the capital investment and industrial sectors. **But Australia, our other significant trading partner, is heavily exposed to those areas of slowdown. We expect Australia to record sub-trend growth of 2.4% this calendar year, but with some recovery to 3% for 2016.** Lower interest rates and a weaker Australian dollar are helping the transition away from mining-intensive growth to wider sources, but the shift is taking time.

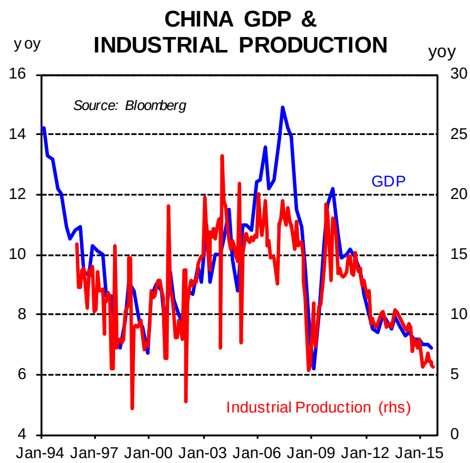
The US Federal Reserve has kept markets guessing over the timing of the first interest rate increase. The Fed's decision to keep interest rates on hold in September was heavily influenced by the financial market volatility being generated by China's sharemarket freefall. That volatility has abated, but the Federal Reserve remains wary about the pace of global growth and the impact a strengthening USD would have on the US economy. **Recent US momentum has been strong enough that the odds remain in favour of the Fed starting to lift interest rates in December.**

When US rate increases start, there will be broader implications for the global economy. Higher US interest rates will encourage further capital flows back to the US. Governments and businesses in emerging markets that have borrowed in US dollars will face higher debt-servicing costs. Instability in emerging markets will be something to watch out for.

Even as the US contemplates reducing economic stimulus, the Eurozone and Japan will continue with quantitative easing. **Europe's domestic demand has improved somewhat**, with household spending lifting. **But growth headwinds remain** through still-high debt levels and slower growth in emerging markets like China. **Japan's economy, meanwhile, is on the brink of recession**, hurt by reduced demand for industrial goods.

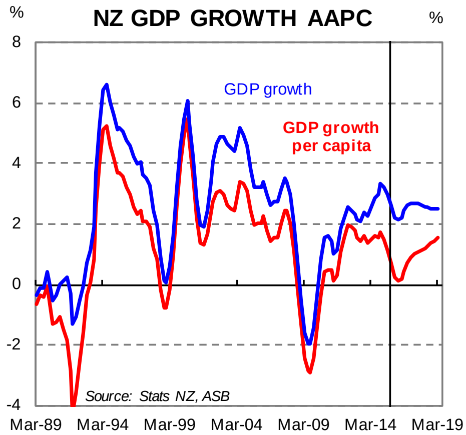




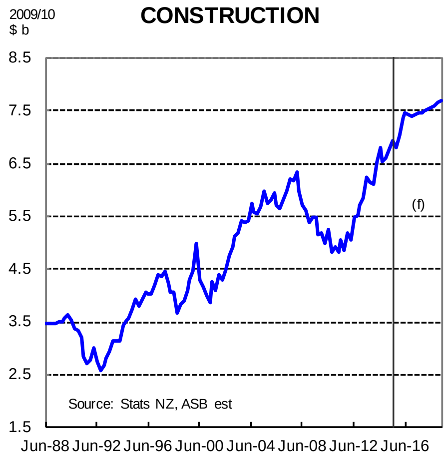


The New Zealand Economy

NZ economic growth is likely to slow over the coming year as confidence remains fragile. The dairy sector is set for challenging year, construction growth is slowing and consumer sentiment is cautious. But there remain some bright spots. Non-dairy exports are performing well, particularly tourism. Net migration remains at record highs and strong population growth is providing support to domestic demand. We expect growth to slow to 2.1%. However, a lower NZD and lower interest rates should help lift growth back up to 2.7% by the first half of 2016.

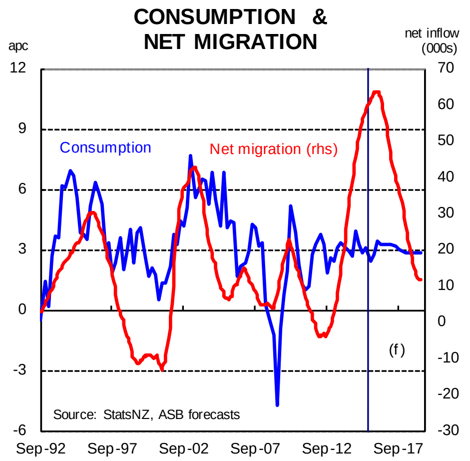


The **dairy sector will be a drag on growth this year**, via a **sharp 6% drop in production and a pull-back in investment and discretionary spending**. The small recovery in dairy prices since mid-August is likely to stop confidence from deteriorating further, but dairy incomes will still remain under heavy pressure this season**. El Nino remains an additional downside risk**, although our expectations are that increased use of irrigation in highly-impacted areas may mitigate the impact on dairy production. The key driver of weak production this season will be farmers' responses to lower prices.



Non-dairy exports are performing relatively well and should remain well supported by a competitive NZD. While Chinese growth is slowing, we anticipate demand for NZ exports will remain resilient. Demand for NZ exports is more closely linked to a structural lift in household disposable incomes rather than the weakening Chinese investment cycle. Meanwhile, the **rebalancing in Australian growth toward the household sector will also be beneficial to NZ exporters.**

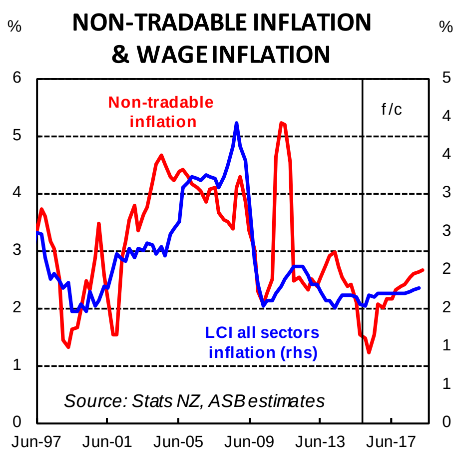
Construction demand has proved more resilient than expected over recent months. Canterbury consent issuance, particularly non-residential, shows there remains plenty of rebuild demand in the pipeline. Residential consent issuance has lifted throughout the country. We expect that construction growth will slow this year, but the level of construction activity will remain very high. **Slowing demand growth may allow construction capacity pressures and skill shortages to ease somewhat over the coming year.**



Retail trade has performed strongly this year, in part due to strong visitor numbers. **Domestic demand has remained reasonable largely due to population growth** and increased consumer purchasing power (through weak inflation). Going forward, the impact of slowing population growth on consumer spending should be offset by lower interest rates boosting per-capita demand.

Net migration continues to run at record levels. One observation about the current economic cycle is the **more muted impact of net migration on domestic demand relative to historical experience.** Student visas make up 23% of arrivals, and this may explain some of the difference - but not all of it. **Households do appear to remain relatively cautious about spending**.

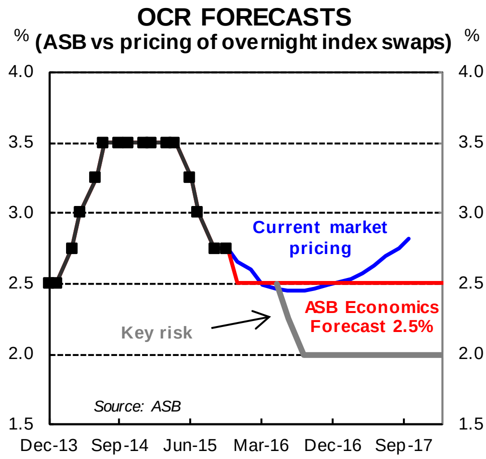
We do expect net migration to eventually decline and when it does, it may do so swiftly. But, for the time being, strong net migration has lifted NZ's population growth. However, we also anticipate that labour demand is likely to slow over the coming year. Over this period, it's likely that job creation will not keep up with labour supply, and as a result the **unemployment rate will start to trend higher**. This in turn will keep **wage inflation modest and contribute to muted domestic inflation pressures**.



Tradable inflation (largely import prices) may temporarily lift over the coming year, reflecting the lower NZD. However, **we expect the pass through to retail prices will be muted in a competitive environment** with fragile consumer sentiment. All up, inflation pressures are likely to remain subdued and remain in the lower half of the RBNZ's 1-3% target band.

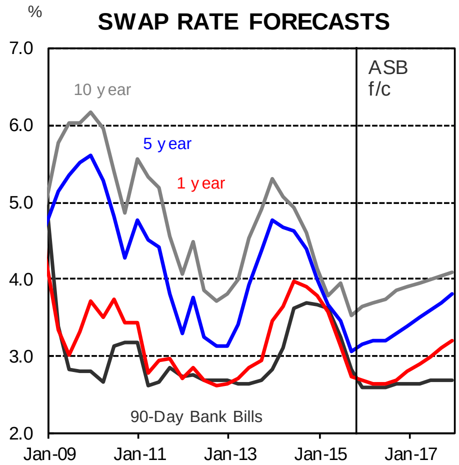
Interest Rates and Exchange Rates

The RBNZ has cut the Official Cash Rate by 75bp to 2.75% this year, with the most recent 25bp cut coming at the September Monetary Policy Statement. We think the RBNZ will cut another 25bp in December, with some risk that further cuts eventually follow in 2016 if inflation is more subdued than the RBNZ anticipates.

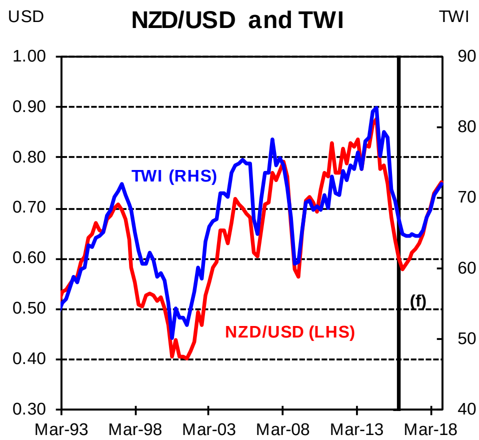


We think it is likely the RBNZ cuts the OCR to 2.5% in December, and the risk is the OCR gets cut even more over the course of 2016. **In our view, inflation will struggle to rebound to 2%. Either the RBNZ will respond by cutting interest rates further, or simply accept that both inflation and growth outcomes could have been more optimal.** Additional OCR cuts next year will depend on whether inflation duly proves to be more subdued than expected and on how soon the RBNZ comes to that realisation – the sooner the more likely it is the RBNZ responds.

Looking ahead, **longer-term rates will be less influenced by the OCR, but more influenced by developments offshore. US long-term rates are expected to lift as the US economy continues to improve**, and the US Federal Funds Rate gets gradually lifted. That's the theory anyway! So far, we haven't seen a dramatic lift in US long-term rates. Beyond the US, long-term rates are very low in the other important bond markets of Europe and Japan. This mix is likely to keep most global rates historically low, even as interest rates lift in the US. All up, NZ long-term rates are likely to lift modestly.



The NZD has rebounded to a degree since September, but we anticipate further weakness into early 2016. The recent lift will be a source of frustration for the RBNZ, who back in September made growth and inflation forecasts based on the NZD easing significantly, not strengthening. For one thing, the RBNZ's medium-term inflation outlook is heavily dependent on tradable inflation rebounding through a weaker NZD.



An expected OCR cut from the RBNZ and interest rate increase from the US Federal Reserve should renew the NZD/USD's fall. The RBNZ had an encouraging preview of the Fed's impact after strong US jobs growth over October prompted markets to firm up expectations of a December rate lift, knocking back the NZD/USD. But, the RBNZ's own actions matter too. **Unless the RBNZ cuts the OCR further, NZ's interest rate differentials will remain wide – and could widen further if other major central banks ease. In turn, the NZD wouldn't weaken to the extent we forecast.**

Summing all this up, our forecasts for a lower NZD/USD over the year ahead are based on both NZD weakness to come as the RBNZ eases further, and USD strength as the Fed begins its tightening cycle. More generally, **we see some scope for the NZD to fall slightly further across the board**.

Our forecasts to March 2016 should – more than usual – be taken as a directional guide and not a hard target. They are heavily contingent on the timing of impending actions of central banks.

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Economic Forecasts

ASB economic forecasts		Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Mar-18	Mar-19
			<<actual	forecast >>								
NZ GDP real	AA%	**3.2**	**3.0**	**2.6**	**2.2**	**2.1**	**2.2**	**2.4**	**2.6**	**2.7**	**2.6**	**2.5**
private consumption	AA%	3.1	3.2	2.9	2.8	2.9	3.0	3.2	3.3	3.2	3.0	2.8
dwelling construction	AA%	12.3	8.9	8.2	6.2	6.7	7.4	7.3	6.2	5.0	1.3	0.0
other investment	AA%	4.4	3.5	1.1	-0.9	-0.6	-0.7	1.0	3.0	3.0	3.7	4.9
exports	AA%	4.2	5.4	7.6	6.3	4.6	3.3	0.4	0.7	1.6	3.5	3.2
imports	AA%	7.5	6.6	6.7	5.5	4.7	3.5	2.6	2.3	2.2	3.2	3.3
NZ GDP real	A%	2.7	2.4	2.0	1.9	2.4	2.6	2.8	2.7	2.7	2.5	2.5
NZ GDP real	Q%	0.2	0.4	0.5								
NZ CPI	**A%**	**0.3**	**0.4**	**0.4**	**0.6**	**1.2**	**1.3**	**1.5**	**1.6**	**1.6**	**1.5**	**1.4**
NZ house prices (QV index)	A%	9.0	10.6	14.4	14.6	13.4	10.6	6.4	3.9	2.6	1.3	0.9
NZ unemployment (sa%)	Qtr	5.8	5.9	6.0	6.0	6.3	6.5	6.6	6.6	6.6	6.2	5.4
NZ private sector wages (LCI)	A%	1.8	1.8	1.7	1.6	1.8	1.7	1.8	1.8	1.8	1.8	1.9
NZ current account ($b)	Yr	-8.1	-8.3	-8.1	-9.1	-9.3	-8.9	-9.2	-7.9	-7.1	-6.5	-5.7
as a % of GDP	Yr	-3.4	-3.5	-3.4	-3.7	-3.8	-3.6	-3.6	-3.1	-2.8	-2.4	-2.1

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	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Mar-18	Mar-19
(end of quarter)			<<actual	forecast >>							
NZ cash rate target	3.50	3.25	2.75	2.50	2.50	2.50	2.50	2.50	2.50	2.50	3.25
NZ 90-day bank bill	3.63	3.26	2.84	2.6	2.6	2.6	2.7	2.7	2.7	2.8	3.5
NZ 3-year swap rate	3.59	3.21	2.82	2.9	2.8	2.8	2.9	3.0	3.1	3.5	3.8
NZ 10-year gov't stock	3.23	3.62	3.27	3.2	3.1	3.0	3.0	3.1	3.2	3.6	3.8

ASB foreign exchange forecasts	Mar-15	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Mar-18	Apr-18
(end of quarter)			<<actual	forecast >>							
USD per NZD	0.749	0.682	0.637	0.60	0.58	0.59	0.60	0.61	0.62	0.70	0.75
GBP per NZD	0.506	0.434	0.421	0.39	0.38	0.38	0.38	0.38	0.39	0.43	0.46
AUD per NZD	0.979	0.889	0.909	0.91	0.89	0.88	0.87	0.87	0.87	0.88	0.90
JPY per NZD	90.0	83.5	76.5	71	68	68	71	73	74	83	89
EUR per NZD	0.692	0.609	0.567	0.56	0.55	0.55	0.55	0.54	0.54	0.56	0.58
CNY per NZD	4.649	4.235	4.056	3.93	3.80	3.84	3.84	3.84	3.84	4.13	4.43
TWI - 17 country	78.6	71.3	69.5	67.0	64.8	64.7	64.6	64.8	64.7	68.2	72.1

** Forecasts to March 16 are heavily conditional on central bank actions over the coming months*

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