Quarterly Economic Forecasts

February 2016

Déjà vu all over again

- Bumpy ride ahead for 2016 with Chinese growth concerns and market volatility back on centre stage.
- NZ growth has slowed, but should pick up over 2016 and 2017 with support from lower interest rates and NZD.
- Further reductions in interest rates in 2016 will reduce the risk of inflation remaining too muted.

To quote former US baseballer and part-time philosopher Yogi Berra, **the start of 2016 feels a bit like déjà vu all over again**. In a flashback to mid-2015, **Chinese equity markets have slumped and worries about the underlying health of the Chinese economy have risen** to the top of the watchlist. Add in some geo-political risk, slumping oil prices and Eurozone banking concerns and the year has started off on the back foot.

There are some legitimate worries about the global economy. Chinese growth is slowing, but doubts over the accuracy of the official growth figures mean no-one is entirely sure of the extent of that slowdown. But there is a definite trend of slowing growth in industrial activity and capital spending. And industrial overcapacity could spread disinflation. **The lift in US interest rates, and prospect of more, has ripple effects over and above the US economy.** Emerging economies, particularly in Asia, are vulnerable to both China's slowdown and the impacts of rising US interest rates. **Lastly, falling commodity prices are affecting incomes of commodity producers.**

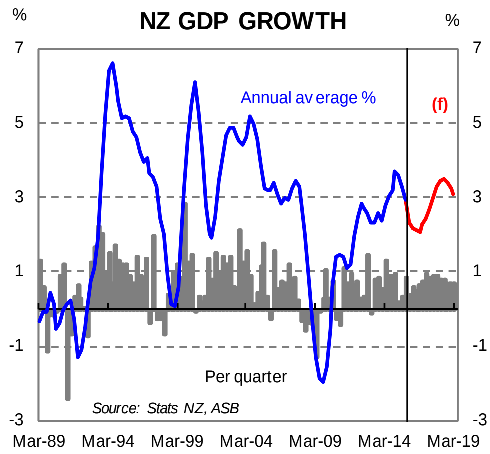
But, even so, the global growth outlook for 2016 doesn't look too different from the performances achieved over the past few years. And for NZ, developments like low oil prices are overall a distinct net positive.

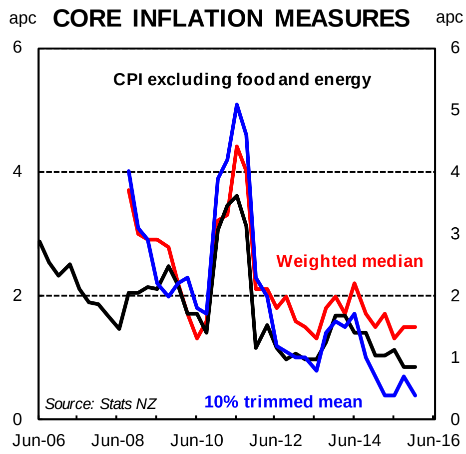
The NZ outlook itself is actually quite reasonable. The economy did hit a very soft patch in the first half of 2015. But annual growth will bottom out above 2% and steadily increase as supportive factors continue. Yes, dairy incomes will remain a drag on growth. But the impact of lower interest rates and the NZ dollar are increasingly evident. Tourism, in particular, is charging along with strong growth in visitors and in per-person spending.

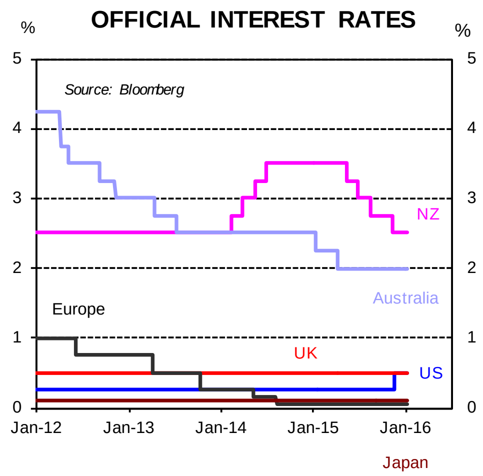
The cautionary tale about NZ's overall growth performance is that population growth is accounting for much of NZ's growth at present: 2% growth in the number of people is twice the historical average rate, yet the overall economic growth at present is not much more than that figure. The drag from low dairy incomes is there, just hidden by all the extra people and confined largely to the regions. So **although the overall economy is doing reasonably well, at an individual level the progress feels more pedestrian.**

A theme we having been banging the drum over for months is the lack of inflation. NZ inflation is now so missing that Where's Wally is at risk of losing his job. **The trend over the past few years is for inflation to surprise with its weakness**, even against forecasts that have also become weaker over time. Further plunges in the price of oil are a part of it, just as they were a year ago. However, **putting oil prices aside, inflation is very subdued and wage inflation remains weak.** NZ is not alone in experiencing muted inflation, but it was notable that inflation remained inert even during NZ's strongest period of post-recession growth in 2014.

For that reason, we expect the RBNZ to cut interest rates further this year. As the focus goes back on the easings of large central banks (and timid rate hikes, in the case of the US Federal Reserve), **the RBNZ's reluctance to cut the OCR means the NZD risks remaining one of the taller hobbits in the room.** Further OCR cuts are by no means assured, but around June we expect the RBNZ will respond to added risks of low inflation persisting.







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International outlook – *Bumpy ride ahead*

Global financial markets have made a rocky start to 2016. In particular, **Chinese growth concerns** have spilled over into sharemarkets as well as commodity markets, including dairy. The market gyrations foreshadow what is shaping as a **bumpy ride this year for the global economy and markets** generally. While questions over the Chinese economy and its impact on our exports loom large this year, equally offsets like **lower oil prices and looser monetary and fiscal policy are in play.**

The Chinese economy is in a sticky patch. Official estimates of economic growth ended 2015 at their lowest level in 25 years. Moreover, we expect China's reported growth to slow further to 6.4% over 2016, before recovering slightly. Various stimulus measures, while less effective than in the past, should bear fruit over the year. But high debt levels, particularly in heavy industries, leave the Chinese economy vulnerable to shocks.

As well as a cyclical economic slowdown, **China is also structurally shifting away from industry- and export-led growth in favour of larger household and service sector expenditure.** In the short term, this transition is unlikely to be smooth, particularly over the next couple of years. Efforts to stamp out corruption, for example, can hurt growth in the short term, but in the longer term less corruption should support more sustainable growth.

NZ's direct trade links to the relatively robust Chinese consumer (as opposed to weak Chinese industry) should limit the impact of slowing Chinese growth on NZ's exports. For example, Chinese tourist visitor growth to NZ is booming. Nonetheless, Chinese economic concerns can spill over to the household sector, hurting demand for NZ exports. In this regard, job security measures, housing market data along with direct measures of household confidence remain key indicators to watch for NZ exporters.

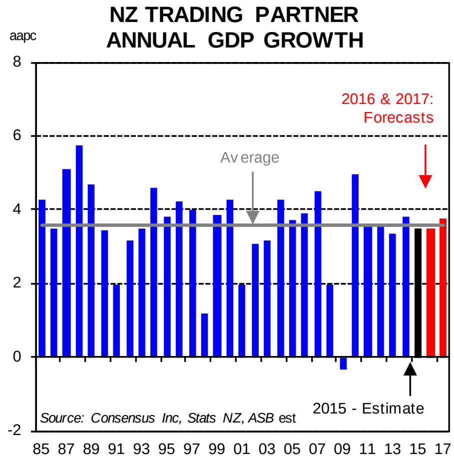
But Australia, our 2nd largest trading partner, is not so lucky. **We expect that Australia's exposure to China's industrial slowdown will contribute to a year of below-trend growth.** Lower interest rates and a weaker Australian dollar are helping the transition away from mining-intensive growth to wider sources, but the shift is proving slow.

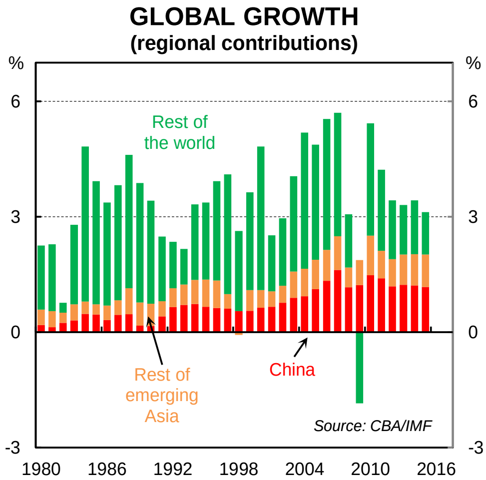
Meanwhile, the US economy is better, although the US strength is not a free lunch for the rest of the global economy. The US labour market is healthy, with unemployment at or below the natural rate. Indeed with this strength in mind, the US Federal Reserve began lifting interest rates in December 2015. From here, we expect up to three more US Federal Reserve rate hikes this year, assuming further US economic improvement.

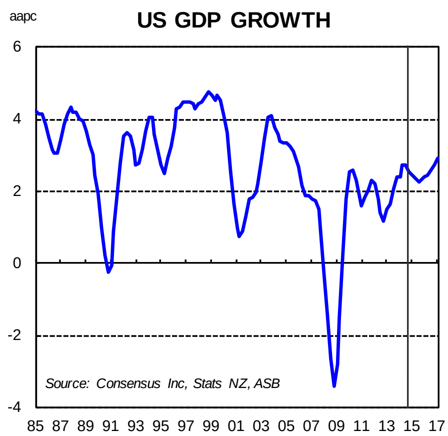
While the US economy may cope with further US rate increases, **emerging economies may not fare so well.** Higher US interest rates will encourage further capital flows back to the US. Governments and businesses in emerging markets that have borrowed in USD will face higher debt-servicing costs. As a result, instability in emerging markets like Brazil, Russian and South Africa, for example, is possible at some point during the year.

Even as the US reduces economic stimulus, **the Eurozone and Japan continue with quantitative easing.** Europe's domestic demand has improved somewhat, with household spending lifting. But growth headwinds remain for both Europe and Japan from high debt levels and slower growth from previously strong emerging markets like China. In light of these concerns, Europe's banking sector is facing closer scrutiny.

All up, **we expect below average global growth over 2016 followed by modest improvement over 2017**. At the same time, **we highlight the fragility of the global economy, with the accompanying risk that growth undershoots our current expectations.**

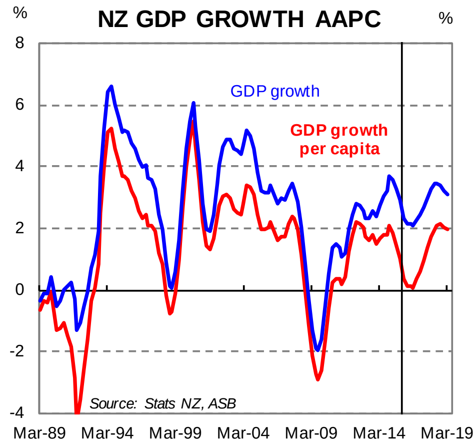






The New Zealand Economy – *Uneven footing*

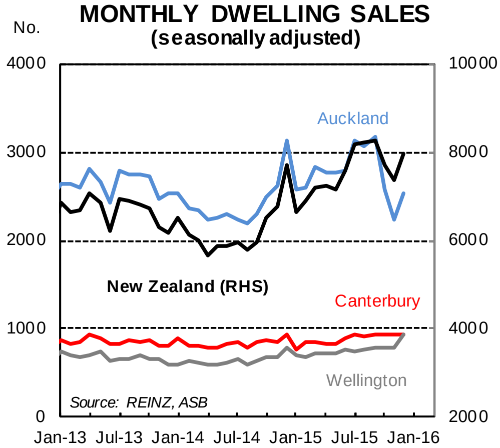
Economic growth continues to slow, from a peak of 3.7% at the end of 2014, to a forecast trough of 2.2% over the first half of 2016. The slowdown in economic momentum comes despite **net migration at record levels**, boosting population growth by 2% over the past year. Indeed, on a **per-capita basis, there has essentially been no growth over the past year**. We do expect growth will stabilise then **recover over 2016 and 2017**. **Declines in interest rates and the NZD** over the past year will help support growth – and **further rate cuts later this year should provide an extra boost** ensuring inflation lifts firmly back into the RBNZ's target band.



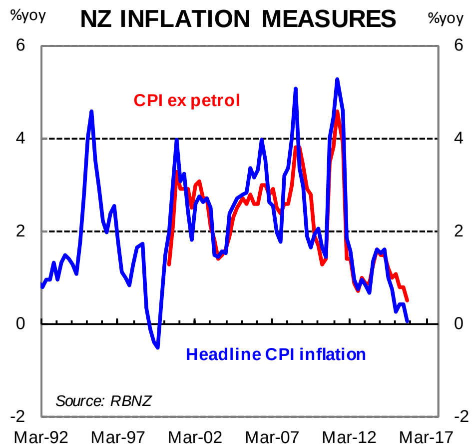
Falling dairy incomes remains the key headwind for the economy. Consumer spending growth has slowed (at a time when population growth and lower petrol prices should be boosting domestic demand) and investment activity has also started to slow.

There are some **bright spots in the economy** – **most notably tourism**. This has boosted retail and hospitality spending, masking a slowdown in domestic demand. Other **non-dairy goods exports** have also performed will over the past year. The strength of these sectors is largely owed to continued resilience in **Chinese and Australian *consumer* demand**. As NZ exports are more exposed to disposable income growth rather than the investment cycle, we expect the Chinese economic slowdown to have relatively limited impacts on the bulk of NZ exports.

Construction has been a strong performer over recent years. With the overall level of construction activity now exceeding previous highs, we **expect some capacity constraints will start to bite** and potentially slow the pace of growth going forward. **Nonetheless, the outlook for construction demand remains encouraging**. On the commercial front, business confidence remains reasonable and there is a solid pipeline of consents. Infrastructure-related investment will continue at a steady pace: the Auckland CBD rail loop will commence just as work on the western motorway upgrade is completed. **On the residential side, strong population growth over the past year and existing supply shortages should encourage continued house building demand.** However, in Canterbury, with rebuild activity past its peak, we do expect construction activity will continue to gradually ease over the coming year. However, this may free up construction-related resources and potentially ease bottle necks forming elsewhere.



Housing market trends over the coming year remain a key uncertainty. In **Canterbury, rental demand has fallen** as residential repair work appears to have peaked. With supply shortages now abated, much of the heat has come out of the housing market and prices now appear to be settling. In **Auckland,** initial signs suggested the RBNZ's investor LVR restrictions and the new tax rules were having quite an impact. **Activity immediately slowed and price growth appears to have moderated significantly.** However, there are some early signs that perhaps the initial slowdown was a **knee jerk reaction**, with sales starting to lift again and a lack of new houses listed for sales keeping market conditions very tight.



Inflation pressures remain muted. **Domestic inflation pressures remain at cyclical lows,** with the exception of construction and housing shortage related price increases. A **competitive labour market means that wage inflation remains muted** which continues to contribute to weak services inflation. Meanwhile, weak tradable inflation has dragged inflation below the RBNZ's target band of 1-3%. **Global commodity prices and inflation pressures remain subdued, reflecting weaker than expected demand growth and excess capacity.**

Interest Rates and Exchange Rates – *One direction*

The RBNZ cut the Official Cash Rate back down to a record low of 2.5% last year, with the most recent 25bp cut coming at the December Monetary Policy Statement. Although the RBNZ appears somewhat reluctant to lower the OCR further, we think the central bank will end up doing just that the course of this year. Short-term rates should decline from current levels over the coming months if our forecast of two more OCR cuts proves correct.

Longer-term rates are still very low. On top of the RBNZ's actions, longer-term rates (5-10 years) will also be 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. But, so far, we haven't seen any dramatic lift in US long-term rates. In fact the global growth concerns of early 2016 have renewed the downward pressure on long-term rates in the US.

Long-term rates are also very low in the other important bond markets of Europe and Japan. In some cases interest rates are still negative. This mix is keeping most global rates historically low, even as the Fed Funds Rate (which is an overnight interest rate) gets slowly lifted.

The NZD has weakened in early 2016, but remains above the levels reached in 2015. The NZD's strength remains a source of frustration for the RBNZ. The RBNZ's medium-term inflation outlook is heavily dependent on tradable inflation rebounding through a weaker NZD.

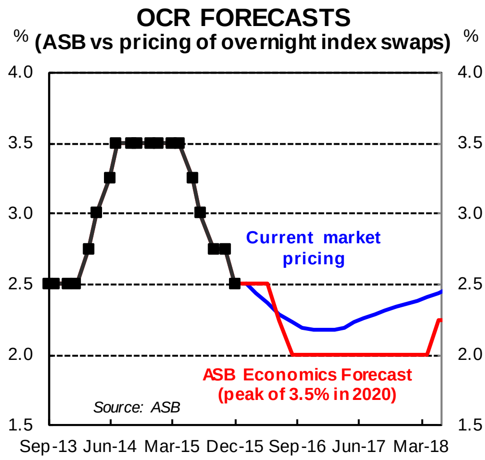
Global growth concerns, ongoing expectations of more rate cuts from the RBNZ and interest rate increases from the US Federal Reserve should renew the downward pressure on NZD/USD over the coming months. However, unless the RBNZ cuts the OCR further, NZ's interest rate differentials will remain wide. In turn, the NZD may not weaken to the extent the RBNZ (or ASB) forecast. We got a taste for the influence of the RBNZ's stance when the NZD firmed significantly after the RBNZ's December policy announcement.

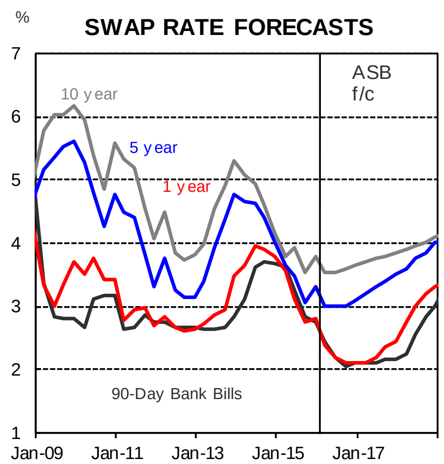
Summing all this up, our forecasts for the NZD/USD over the year ahead are based on both NZD weakness to come as the RBNZ eases further, and USD strength as the Fed continues its tightening cycle. **But we think the NZD is near the bottom of its down cycle which started back in mid-2014.**

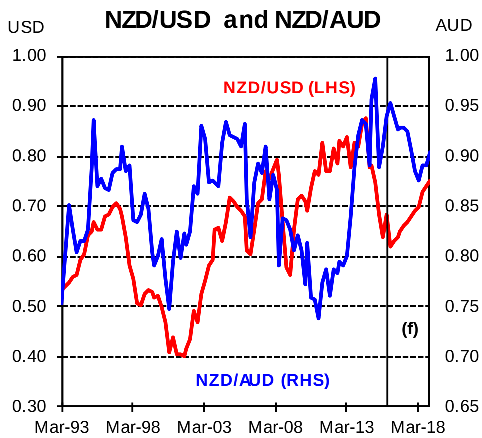
The NZD/AUD is expected to ease from current levels if the RBNZ cuts the OCR while the RBA remains on hold over 2016.

We don't anticipate the NZD will fall too much further against the GBP and EUR, but we may see a lower NZD/JPY if the Yen continues to firm, as it has been doing in recent months.

Our current FX forecasts are tabled on page 5.







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Economic Forecasts

ASB economic forecasts		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%**	**3.3**	**2.9**	**2.3**	**2.2**	**2.2**	**2.2**	**2.5**	**2.7**	**3.5**	**3.1**
private consumption	AA%	2.7	2.4	2.3	2.3	2.2	2.2	2.3	2.6	3.5	3.2
dwelling construction	AA%	8.6	7.8	5.7	5.9	6.5	7.1	6.9	6.7	4.4	2.7
other investment	AA%	7.4	4.9	2.0	1.9	1.9	1.3	2.6	2.5	5.9	5.0
exports	AA%	5.7	7.5	7.1	6.2	5.0	3.0	1.8	1.4	2.7	3.1
imports	AA%	6.6	5.7	3.5	1.6	-0.3	-0.3	0.4	1.5	4.1	3.8
NZ GDP real	A%	2.4	2.3	1.7	2.2	2.5	2.4	2.7	3.0	3.5	2.9
NZ GDP real	Q%	0.3	0.9	0.4							
NZ CPI	**A%**	**0.4**	**0.4**	**0.1**	**0.5**	**0.5**	**0.9**	**1.6**	**1.7**	**1.7**	**1.6**
NZ house prices (QV index)	A%	10.5	14.2	11.2	8.8	5.8	1.4	2.2	1.9	1.4	0.3
NZ unemployment (sa%)	Qtr	5.9	6.0	5.3	5.8	6.0	6.0	6.1	6.1	5.6	5.0
NZ private sector wages (LCI)	A%	1.8	1.7	1.6	1.8	1.7	1.8	1.8	1.8	1.9	2.1
NZ current account ($b)	Yr	-8.3	-8.1	-7.8	-7.4	-7.4	-7.3	-7.0	-6.7	-6.6	-6.5
as a % of GDP	Yr	-3.4	-3.3	-3.2	-3.0	-3.0	-2.9	-2.8	-2.6	-2.4	-2.3

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	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	3.25	2.75	2.50	2.50	2.25	2.00	2.00	2.00	2.00	3.00
NZ 90-day bank bill	3.26	2.84	2.75	2.5	2.2	2.1	2.1	2.1	2.3	3.3
NZ 3-year swap rate	3.21	2.82	3.02	2.8	2.6	2.5	2.6	2.7	3.2	3.7
NZ 10-year gov't stock	3.62	3.27	3.58	3.1	3.0	3.0	3.1	3.2	3.5	3.8

ASB foreign exchange forecasts	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	0.682	0.637	0.685	0.62	0.63	0.64	0.65	0.66	0.70	0.75
GBP per NZD	0.434	0.421	0.462	0.43	0.44	0.44	0.43	0.43	0.44	0.46
AUD per NZD	0.889	0.909	0.940	0.95	0.94	0.93	0.93	0.93	0.88	0.90
JPY per NZD	83.5	76.5	82.5	71	74	74	73	73	83	89
EUR per NZD	0.609	0.567	0.626	0.59	0.58	0.58	0.58	0.57	0.56	0.58
CNY per NZD	4.235	4.056	4.444	4.06	4.10	4.10	4.10	4.09	4.13	4.43
TWI - 17 country	71.3	69.5	74.4	69.4	69.4	69.2	69.1	68.9	68.6	72.4

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