Quarterly Economic Forecast

May 2018

Proceed with less caution

- Trade tensions have escalated; local businesses need more convincing that the Government has “got this”.
- The growth outlook remains reasonable beyond some near-term slowing, but some risks loom larger.
- The ingredients for growth remain widespread, apart from construction’s ability to keep up.

Our growth outlook for the next couple of years is still a fairly healthy one, with growth expected to gradually accelerate to 3.4% by the end of 2019. However, some of the potential threats to that outlook have started to loom a little larger.

The most concerning development is the rapid escalation of trade tensions, primarily between the US and China. The US has long had concerns about some of China’s trade practices and its treatment of intellectual property. However, Donald Trump’s proposed tariffs on various Chinese products have shifted the method of attempted resolution away from the World Trade Organisation’s dispute resolution process to taking (characteristic) unilateral direct action. After a measured initial response, Chinese started to hit back swiftly and in turn the US upped the ante just as quickly. At this stage the overall volume of trade involved is very small. But the risk is that, if future negotiations don’t resolve the tensions, the protectionism escalates and spreads – and starts to impact on global growth. At that point, NZ’s exports will be at risk.

A home-grown development is the still-wary attitude businesses have of the new Government. Business confidence has yet to recover materially from its post-election slump, even allowing for surveys’ historical downward bias during Labour Government terms. It is understandable that a change of government has created uncertainty while key policies are being fleshed out and the country gets more familiar with the key Ministers. However, we would like to see more recovery in sentiment soon, otherwise there is a risk that economic growth gets impacted beyond a short-term speed bump. From the Government’s perspective, providing as much certainty, assurance and rationale as possible around government policies will help mitigate this risk.

But the above are risks, and not all risks become reality. NZ continues to enjoy some good tailwinds. The Terms of Trade have set a fresh high, emphasising the strong global purchasing power of what we export. Interest rates are set to remain low into next year, which will support the cashflow of businesses and household borrowers (though partly offset still by low returns for savers). Net migration inflows, although slowing, will still deliver above-average population growth for some time. And accelerating wages will support consumer spending growth.

Nevertheless, there is one sector – construction – for which there is a lot of demand, but it will struggle to grow under the weight of capacity constraints, rising costs, and on-going regulatory hoops. Even KiwiBuild will confront the same issues, which puts the onus on adopting more productive and innovative ways of developing housing. This evolution will take time. In the meantime, Auckland housebuilding activity will struggle to lift much further from its current high level, though some winding down in other regions could see some capacity redirected north.

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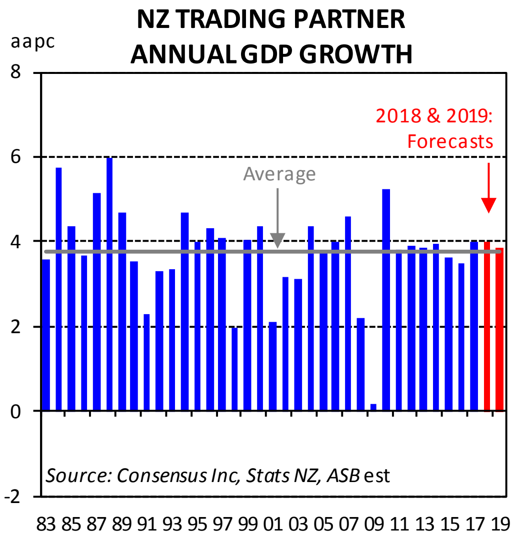
International outlook – carrots and sticks

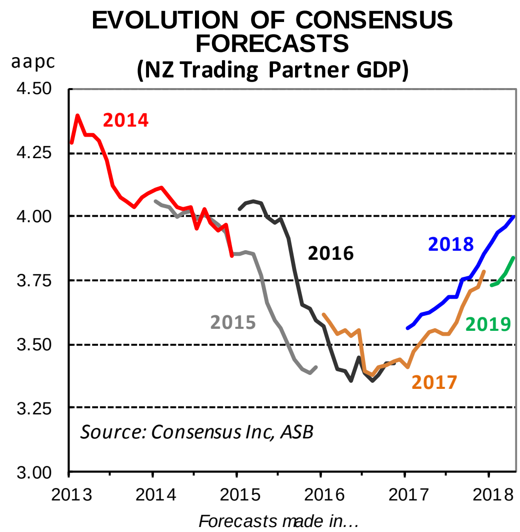
Geopolitical tensions have escalated sharply with the global economy recently taking a few steps closer to the trade war precipice. A flurry of tit-for-tat tariffs between the US and China has put the world on edge. However, so far it seems that calm heads will prevail and the US Administration's China visit is a strong signal that diplomatic reasoning will ultimately win out. And, **if you put the trade risks to the side for a moment, the global economy is still firing on many cylinders.**



The US Federal Reserve raised interest rates again in March and continues to signal at least another two rate hikes over the remainder of 2018. The US growth outlook has firmed (we now expect growth of 2.9% over 2018, up from 2.8%), the labour market continues tightening **and inflation pressures are lifting back towards 2%.** This backdrop has also seen US 10-year bond rates lift above 3% for the first time in 4 years. However, the US economy does remain vulnerable to an uncertainty-induced slowdown. Indeed, recent data suggest that the manufacturing sector is feeling the negative impacts of the tariff uncertainty.

The Eurozone surged into the end of 2017 with annual GDP growth hitting 2.5%, the fastest growth rate since 2007. We are expecting growth momentum to ease slightly following this period of above-trend growth, but to remain healthy. In fact, we have revised our 2018 growth forecasts slightly higher to 2.4% (from 2.2%) and expect growth of 1.9% in 2019. Despite the strong growth however, **inflation pressures remain soft.** As a result, we are expecting the ECB to leave deposit rates on hold well after the asset purchase programme ends in Q4 2018.

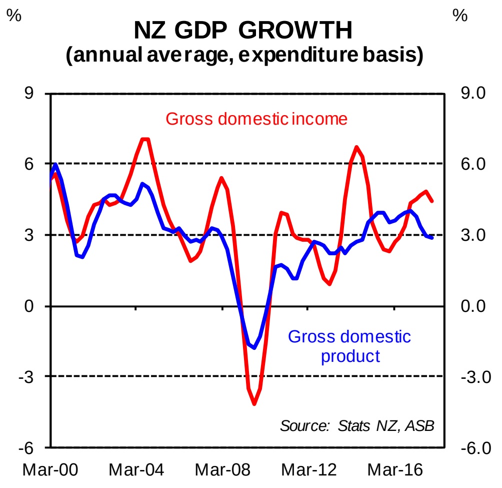
China has proven to be surprisingly resilient in recent months, despite the strong focus by the Chinese Government to de-leverage and reduce risks within the Chinese economy. GDP growth has, so far, held up better than expected, with annual growth at 6.8% yoy in Q1. In light of this, we have revised our 2018 and 2019 GDP forecasts higher to 6.6% and 6.4% respectively (from 6.5% and 6.3%). However, the focus on deleveraging, as well as environmental reform is expected to weigh on growth in the coming years. **From New Zealand's perspective however, Chinese consumer demand remains strong and is providing solid support for NZ exports.** In saying this, trade tensions between China and the US do remain a key risk to this view.



The Australian economy also continues to perform well, with higher commodity prices and firm non-mining investment intentions sending positive signals for future economic performance. The incredibly strong growth in the labour market over the last 18 months also highlights the strength of the economy. However, this strength does suggest that NZ migration will continue to ease as the Australian labour market begins to look increasingly appealing to NZ workers. But, **the Australian economy is also struggling with low wage growth (despite the tightening labour market) and low inflation and as a result, we are expecting the RBA to remain on hold until early 2019.**

There are always risks to the economic outlook and at the moment, the risks stemming from escalating trade tensions feel particularly ominous. So far, however, the global economy is continuing to perform well and this is providing a powerful tailwind to the NZ economy. **If calm heads do manage to quell the current tensions, NZ is well situated to benefit from continuing strong global demand.**

The New Zealand Economy – positive thinking



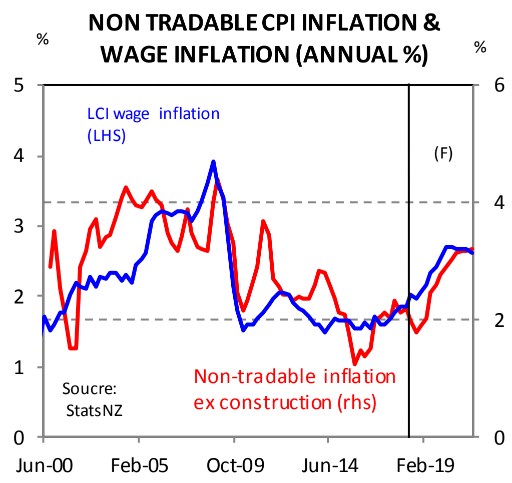
NZ economic output growth slowed over 2017, in both aggregate terms and on a per-capita basis. Slowing construction growth and a patchy export volume performance were key elements of NZ's economic growth slowdown. However, once accounting for prices, our strong Terms of Trade saw NZ's nominal GDP and domestic income growth pick up. Looking ahead, **we expect strong income growth to be a key support for the economy**, supporting a recovery in NZ GDP growth to reach 3.4% annual average growth by the end of 2019.

Business confidence plunged following the 2017 General Election and change in Government. While a fall in business confidence is not unusual in the first term of a new Labour Government, current levels of confidence are nonetheless low and risk spilling over into weaker business investment and employment demand over the coming year. **We expect business confidence will recover**, but a risk to our forecasts is that confidence remains low over the coming year, which may constrain economic growth.

The **external outlook remains promising, with robust growth among NZ's key trading partners supporting our historically high Terms of Trade and the demand for NZ exports**. The risk of an escalation in trade tensions between the US and China is not inconsequential, but we expect that cooler heads will prevail and negotiations between the two countries will see the threat of higher tariffs/less openness to trade recede. Tourism is one sector where demand is strong, but limited accommodation capacity is likely constraining growth, with the high (but easing) NZD a headwind for spending by foreign visitors in NZ. Continued focus on boosting shoulder season demand and attracting higher spending tourists should continue to generate further growth in this sector.

Construction activity is likely to be at (or close to) peak levels. The housing stock has not kept up with demand posed by increased population in Auckland and Wellington. Increasing house building activity faces headwinds from limited construction sector capacity (particularly labour supply), rising construction costs, finance constraints and (anecdotally) higher land prices. KiwiBuild will gradually ramp up, and a Government-backed programme may help to overcome some of these constraints, but some constraints will likely remain a binding limit on how much further residential construction activity can rise.

Net immigration remains at very high levels, although it has started to show signs of turning with permanent and long-term departures from NZ picking up from low levels. Nonetheless, arrival numbers remain at historically high levels. With announcements yet to be made on the Government's changes to migration policy, **we have revised up our net immigration forecasts**. Nonetheless, we continue to expect population growth to slow, weighing on NZ household spending growth and likely exacerbating labour shortages.

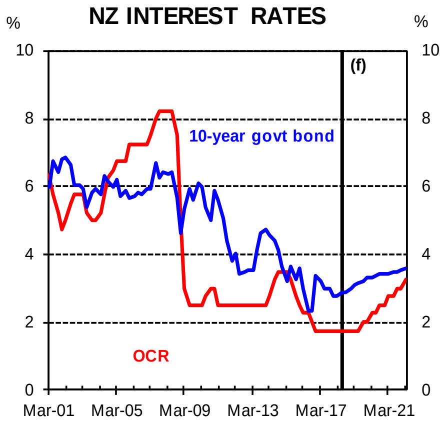


NZ household spending growth is expected to slow, reflecting slowing population growth and less support from new housing construction (which has boosted demand for household durable goods). Nonetheless, we expect per-capita household demand to recover over 2018, boosted by increased wage growth.

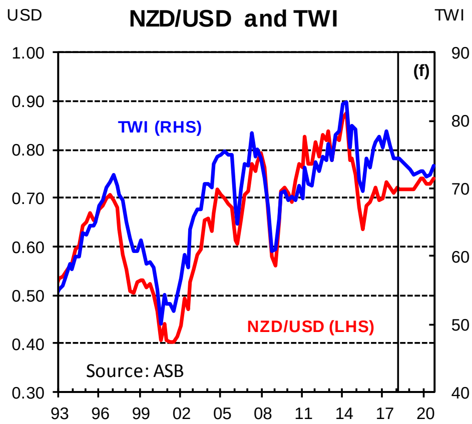
Wage growth is a major determinant of domestically-generated inflation. To date, wage inflation has remained surprisingly muted considering the tight labour market. Nevertheless, **we expect wage inflation to start to lift, in part due to the series of large increases in the minimum wage expected over the next four years.**

Interest Rates and Exchange Rates – RBNZ still firmly on hold

NZ short-term interest rates remain low. The RBNZ has left the Official Cash Rate (OCR) on hold at 1.75% since November 2016, reflecting the ongoing benign inflation environment. This and the increasingly neutral tone of RBNZ policy assessments (see our latest MPS review here) have seen markets scale back the timing of OCR hikes, with a full hike not priced until late 2019, consistent with the published RBNZ interest rate projections and ASB's August 2019 view. Once the RBNZ does resume lifting the OCR, it is likely to be a gradual process, culminating in a low endpoint this cycle (around 3.50% by 2022). **While OCR expectations have eased, short-term money market rates have nudged up,** with the 90-day bank bill rate close to 20bps higher than at the start of the year. Bank bill spreads to Overnight Index Swap (OIS) rates have widened by more in the US and Australia. Our expectation is that NZD spreads will slowly decline towards historical averages (see our note here).



Longer-term rates tend to be more influenced by movements in offshore interest rates. US 10-year Treasury yields are currently hovering around 3%, a close to 55bp rise over 2018. There have been more sizeable lifts for short-term US rates, with two-year Treasury yields around their highest since mid-2008. In part this reflects greater conviction that the tight US labour market and rising US inflation will prompt more monetary tightening by the Fed. The three 2018 hikes signalled by Fed are now fully priced in, although markets remain sceptical on whether a further three 2019 hikes will be made (we expect only two). The NZD yield curve has also flattened, and NZD yields have fallen in relation to US counterparts. NZD swap yields are lower than US equivalents out to the 7-year tenor, with 10-year spreads close to record lows. With the RBNZ on hold, and with the NZ fiscal position in better shape than that in the US, NZ bond yields are expected to remain below US counterparts for a little while yet.



Since peaking in mid-April, The NZD is close to 4% lower on a TWI basis. This is mostly attributable to the strengthening USD, which has risen by 6% against the NZD over that period. Markets are refocusing on yield differentials, with positive (and widening) US spreads supporting the USD. **We have changed our currency forecasts, with the USD to remain supported given the slight moderation in global growth over 2018, with the US Federal Reserve is now expected to tighten rates at a faster pace than other central banks. The NZD TWI is expected to remain broadly supported** by NZ's solid economic outlook, strong NZ commodity export prices, historically-high Terms of Trade and strong demand as global central banks/other real money managers continue to increase NZD exposures. **We expect the NZD to ease slightly over the projection period relative to EUR and AUD,** partly as a consequence of the European Central Bank to contemplate rate hikes in 2019, and the Reserve Bank of Australia hiking rates from February 2019. The **JPY** is also expected to strengthen. Finally, we expect the **NZD/GBP to remain just above 0.50 over the remainder of the year,** with Sterling past its post-Brexit lows.

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Economic and Financial Forecasts

ASB economic forecasts		Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-21
		<<actual	forecast >>						
NZ GDP real	**AA%**	**2.9**	**2.8**	**2.6**	**2.6**	**2.6**	**2.8**	**3.4**	**3.2**
private consumption	AA%	4.5	4.2	4.1	4.2	4.2	4.1	3.5	2.9
dwelling construction	AA%	0.6	0.3	1.4	0.8	0.1	-0.2	-1.6	-2.6
other investment	AA%	4.5	4.9	4.6	4.2	2.4	1.3	3.6	3.7
exports	AA%	2.6	4.0	3.4	2.3	0.9	0.4	2.5	2.5
imports	AA%	6.6	5.9	5.5	4.7	2.4	2.1	3.5	3.1
NZ GDP real	A%	2.9	2.6	2.4	2.6	2.8	3.3	3.3	3.0
NZ GDP real	Q%	0.6	0.4						
NZ CPI	**A%**	**1.6**	**1.1**	**1.5**	**1.4**	**1.2**	**1.0**	**1.9**	**2.0**
NZ house prices (QV index)	A%	6.4	8.1	7.7	7.6	5.3	3.9	0.9	0.7
NZ unemployment (sa%)	Qtr	4.5	4.4	4.4	4.4	4.2	4.1	4.1	4.1
NZ private sector wages (LCI)	A%	1.9	1.9	2.1	2.0	2.0	2.1	2.7	2.7
NZ current account ($b)	Yr	-7.7	-6.8	-7.1	-7.3	-7.3	-7.3	-8.2	-8.6
as a % of GDP	Yr	-2.7	-2.4	-2.4	-2.5	-2.4	-2.4	-2.6	-2.6

A%= percentage change since same quarter the previous year

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

ASB interest rate forecasts	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	2.25	2.75
NZ 90-day bank bill	1.88	1.96	2.00	2.00	2.00	2.00	2.50	3.00
NZ 2-year swap rate	2.21	2.22	2.22	2.30	2.40	2.50	3.25	3.65
NZ 10-year gov't stock	2.75	2.74	2.85	2.90	3.00	3.10	3.30	3.40

ASB foreign exchange forecasts	Dec-17	Mar-18	Jun-18	Sep-18	Dec-18	Mar-19	Mar-20	Mar-20
(end of quarter)		<<actual	forecast >>					
USD per NZD	0.710	0.720	0.72	0.72	0.72	0.72	0.74	0.75
GBP per NZD	0.528	0.512	0.52	0.51	0.51	0.50	0.49	0.53
AUD per NZD	0.910	0.941	0.95	0.94	0.92	0.91	0.90	0.94
JPY per NZD	80.1	77.0	77.8	77.0	75.6	74.9	74.0	81.0
EUR per NZD	0.594	0.585	0.59	0.59	0.58	0.58	0.57	0.57
CNY per NZD	4.64	4.53	4.54	4.52	4.50	4.46	4.51	4.58
TWI - 17 country	74.3	74.3	74.5	74.0	73.3	72.7	72.5	74.4

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