NEW ZEALAND ECONOMICS
ANZ PROPERTY FOCUS

MARCH 2016

INSIDE

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JEKYLL AND HYDE

SUMMARY

Our monthly *Property Focus* publication provides an independent appraisal of recent developments in the property market.

THE MONTH IN REVIEW

The RBNZ cut the OCR by 25bps this month citing global fragilities and declining inflation expectations; an even lower OCR is on offer. Despite ongoing strong net immigration and low interest rates, the Auckland property market remained in something of a hiatus, with the median days to sell higher than the nationwide average for the first time in nine years. But it's full steam ahead for other regions, with the Wellington market showing notable strength. Annual residential consent issuance hit an 11-year high, but the trend is pointing downwards in Auckland and Wellington. Households are exhibiting leveraging-style behaviour, which looks set to continue for a while yet. That is concerning.

PROPERTY GAUGES

Historically low mortgage interest rates, tight dwelling supply and booming net immigration continue to support the housing market, with lower trend consent issuance in Auckland and Wellington expected to maintain demand for existing dwellings. Despite manageable debt serviceability, existing house prices remain stretched relative to both incomes and rents, particularly in our largest city and there is considerable scope for other centres to outperform, with the Wellington region starting to play catch-up.

MORTGAGE BORROWING STRATEGY

Over the last month carded mortgage interest rates have fallen by less than the 25bp OCR cut, with higher bank funding costs partially offsetting lower wholesale interest rates. Current borrowing costs are historically very low for the one and two year windows and continue to offer the best value. Our expectation of a further 50bps of OCR cuts over 2016 suggests that borrowers should opt for the one-year term, although borrowers could also lock in a portion of borrowing at the two-year window to provide more protection. With OCR cuts on the cards and no OCR hikes until 2018 by our reckoning, longer-term rates don't offer the same value at present.

FEATURE ARTICLE: THE ECONOMIC OUTLOOK

The economy looks in reasonable shape, with a number of supportive factors and we are forecasting 2½-3% growth over the coming three years. However, good economic momentum is masking more mixed sector performance as firms deal with both structural shifts and cyclical business cycle challenges. The mix of growth (borrow and spend) is not sustainable, inflation is low and a lower OCR (we expect 50bps of cuts by the end of the year and no OCR hikes until mid-2018) will mean more housing largesse at a time of high household leverage. A lower NZD would not go amiss but good growth means a stronger-than-desired currency. Amidst huge uncertainties, businesses are getting on with it, and we're backing more of the same. Our forecasts for the global economy depict a moderate growth backdrop overall. But this seemingly benign expectation belies the extent of risks evident. Credit spreads remain elevated, and while they have closed a tad in recent weeks, there is a risk that they widen further.

THE MONTH IN REVIEW

The RBNZ cut the OCR by 25bps this month citing global fragilities and declining inflation expectations; an even lower OCR is on offer. Despite ongoing strong net immigration and low interest rates, the Auckland property market remained in something of a hiatus, with the median days to sell higher than the nationwide average for the first time in nine years. But it's full steam ahead for other regions, with the Wellington market showing notable strength. Annual residential consent issuance hit an 11-year high, but the trend is pointing downwards in Auckland and Wellington. Households are exhibiting leveraging-style behaviour, which looks set to continue for a while yet. That is concerning.

MARCH *MONETARY POLICY STATEMENT*

RBNZ cuts OCR by 25bps and signals further easing.

The RBNZ's decision to cut the OCR to 2.25% was a surprise to markets, given a relatively hawkish speech preceding it. The more fragile global scene and the recent decline in inflation expectations were key factors behind the decision. The published forecasts had the 90-day rate easing to 2.1% by the start of 2017, signalling the likelihood of another cut, probably by around mid-year. Given recent funding pressures (which were not incorporated in the RBNZ's central scenario), and our view that more downside risks around the globe will materialise as the year progresses, we expect a further 50bps of OCR cuts by the end of the year.

REINZ, HOUSE SALES – FEBUARY

Nationwide market firming. Wellington leads, Auckland lags

Volumes rose just 3.3% sa (+5.7% y/y) in February after the 10% drop in January. The median number of days to sell fell to a 9-year low (31.1 days), indicating that momentum in the market is still strong. Strong lifts in seasonally adjusted sales activity were evident for Wellington, Hawke's Bay, Nelson/Marlborough and Otago. Auckland sales volumes fell, and were down 17% y/y, while they are up 21% y/y for the rest of the country. The nationwide REINZ Stratified House Price Index rose 1.6% sa (+11% y/y) in the month. Large price increases were seen in Wellington (+3.1% m/m) and the regional North Island (+2.9% y/y). Auckland prices rose 1.2% but this followed some soft months.

STATISTICS NZ, BUILDING CONSENTS – FEBRUARY

Upward trend for nationwide issuance, but trend falling in Auckland & Wellington

The number of residential dwelling consents rebounded 10.8% m/m sa after their sharp January fall. A total of 27,661 residential consents were lodged over the year – the highest in a decade. Supported by stronger issuance in regional North Island, nationwide dwelling issuance has continued to trend up. An easing in Canterbury issuance was to be expected post the rebuild peak, although lower trend issuance in Auckland (-2.6% m/m) and Wellington (-4.8% m/m) will not help address housing shortages in these regions.

STATISTICS NZ, EXTERNAL MIGRATION – FEBRUARY

Strong net immigration adding to housing demand

February saw a net inflow of 6,070 (sa) migrants, a continuation of similarly-sized net inflows seen over recent months (5,950 average over the past six months), with the annual inflow rising to 67,400 persons. Strength is due to both fewer departures to Australia and increased arrivals of those on student and work visas. In the current environment it is difficult to see the current migration backdrop changing dramatically.

RBNZ, HOUSEHOLD CREDIT – JANUARY

Lending growth strong and approvals suggest continued momentum

The value of mortgage lending to households rose 0.7% sa in January, with annual credit growth (7.7%) hitting an 8-year high. That pace of growth is well in excess of household income growth. The household debt-to-income ratio is rising and is now higher than it was prior to the global financial crisis. However, the serviceability of the debt is better, courtesy of lower interest rates.

RBNZ, MORTGAGE APPROVALS – MARCH

Approval values and numbers have moved higher over the last few weeks and were 5.4% and 14% higher than this time last year respectively. They point to solid rates of credit growth over the next six months.

PROPERTY GAUGES

Historically low mortgage interest rates, tight dwelling supply and booming net immigration continue to support the housing market, with lower trend consent issuance in Auckland and Wellington expected to maintain demand for existing dwellings. Despite manageable debt servicing, existing house prices remain stretched relative to both incomes and rents, particularly in our largest city and there is considerable scope for other centres to outperform, with the Wellington region starting to play catch-up.

We use ten gauges to assess the state of the property market and look for signs that changes are in the wind.

AFFORDABILITY. For new entrants into the housing market, we measure affordability using the ratio of house prices to income (adjusted for interest rates) and mortgage payments as a proportion of income.

SERVICEABILITY/INDEBTEDNESS. For existing homeowners, serviceability relates interest payments to income, while indebtedness is measured as the level of debt relative to income.

INTEREST RATES. Interest rates affect both the affordability of new houses and the serviceability of existing mortgage payments.

MIGRATION. A key source of demand for housing.

SUPPLY-DEMAND BALANCE. We use dwelling consents issuance to proxy growth in supply. Demand is derived via the natural growth rate in the population, net migration, and the average household size.

CONSENTS AND HOUSE SALES. These are both key gauges of activity in the property market.

LIQUIDITY. We look at growth in private sector credit relative to GDP to assess the availability of credit in supporting the property market.

GLOBALISATION. We look at relative property price movements between New Zealand, the US, UK and Australia in recognition of the important role that global factors are playing in NZ's property cycle.

HOUSING SUPPLY. We look at the supply of housing listed on the market, recorded as the number of months needed to clear the housing stock. A high figure indicates that buyers have the upper hand.

RENTAL GROWTH. We look at growth in the median market rent as an indication of whether it is a better time to buy versus rent, and how rental yields are shaping up for the property investor.

Indicator	Level	Direction for prices	Comment
Affordability	Chasing your tail	↔/↓	Houses severely unaffordable in Auckland. Becoming increasingly less affordable in most regions as prices lift.
Serviceability/ indebtedness	Hard work	↔/↓	Low mortgage interest rates are helping contain debt-servicing costs despite a debt-to-income ratio at historic peaks.
Interest rates / RBNZ	Watch & wait	↔/↑	Historically low mortgage rates supportive. Pressures on bank funding costs likely to offset the impact of OCR cuts.
Migration	Record high	↔/↑	Regularly hitting new records, with few signs of turnaround.
Supply-demand balance	Akld vs Rest of NZ	↔/↑	Auckland shortages are growing; Canterbury shortages have eased; more balanced elsewhere.
Consents and house sales	Catching up	↔/↑	Continued upward trend in nationwide residential issuance, but falling in Auckland and Wellington.
Liquidity	Firming	↔	Credit is rising faster than incomes, but high debt levels will limit how long this can continue.
Globalisation	In synch	↔/↓	Moderation in some global markets; Auckland is one of the most expensive cities globally relative to domestic incomes.
Housing supply	Low	↔/↑	Auckland inventories ticking up, but market generally tightening elsewhere, particularly in Wellington.
House prices to rents	Squeeze	↔/↓	Rents drifting up, given strong demand. Auckland prices elevated to rents, other regions less so.
On balance	**Holding**	↔	**Regions strengthening and Auckland toppy.**

PROPERTY GAUGES

FIGURE 1: HOUSING AFFORDABILITY

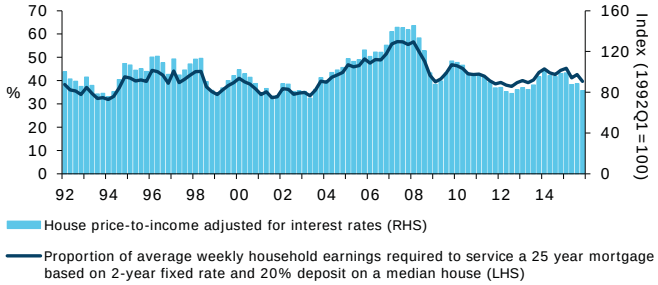


FIGURE 2: SERVICEABILITY AND INDEBTEDNESS

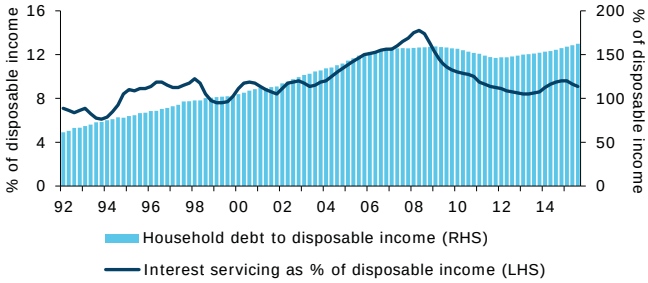


FIGURE 3: NEW CUSTOMER AVERAGE RESIDENTIAL MORTGAGE RATE (<80% LVR)

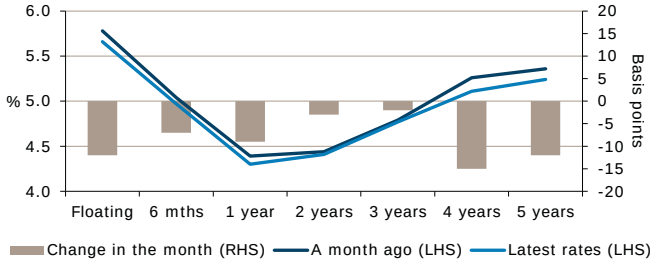


FIGURE 4: NET MIGRATION

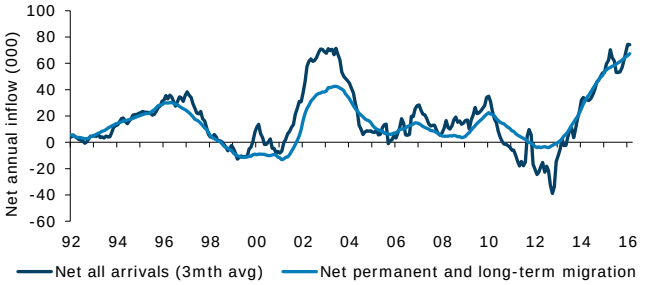


FIGURE 5: HOUSING SUPPLY-DEMAND BALANCE

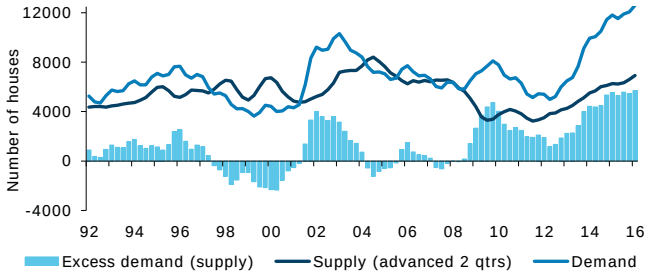


FIGURE 6: BUILDING CONSENTS AND HOUSE SALES

FIGURE 7: LIQUIDITY AND HOUSE PRICES

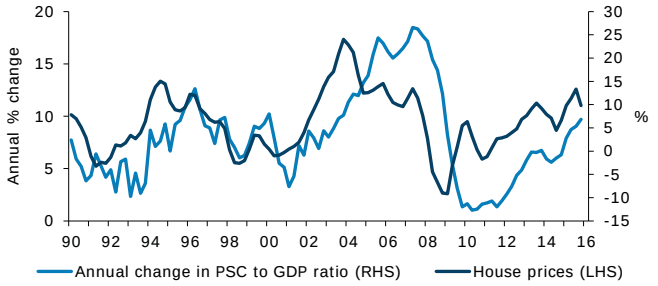


FIGURE 8: HOUSE PRICE INFLATION COMPARISON

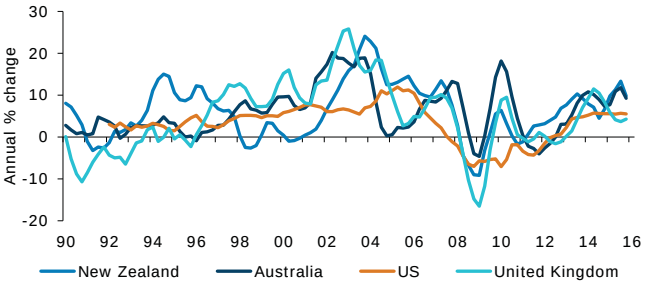


FIGURE 9: HOUSING SUPPLY

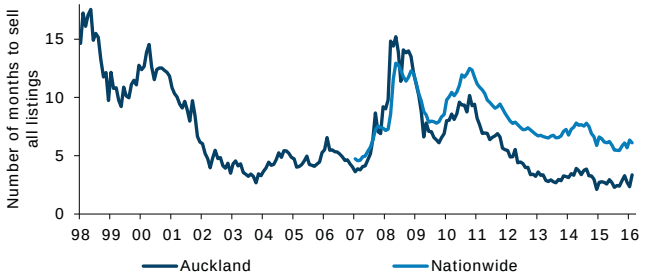
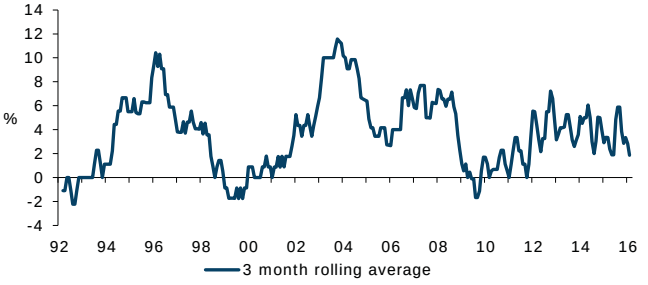


FIGURE 10: MEDIAN RENTAL, ANNUAL GROWTH



Source: Statistics NZ, REINZ, RBNZ, www.interest.co.nz, QVNZ, Nationwide, Bloomberg, Barfoot & Thompson, www.realestate.co.nz, Department of Building and Housing, ANZ

MORTGAGE BORROWING STRATEGY

SUMMARY

Over the last month carded mortgage interest rates have fallen by less than the 25bp OCR cut, with higher bank funding costs partially offsetting lower wholesale interest rates. Current borrowing costs are historically very low for the one and two year windows and continue to offer the best value. Our expectation of a further 50bps of OCR cuts to come over 2016 suggests that borrowers should opt for the one-year term, although borrowers could also lock in a portion of borrowing at the two-year window to provide more protection. With OCR cuts on the cards and no OCR hikes until 2018 by our reckoning, longer-term rates don't offer the same value at present.

OUR VIEW

Falls in carded mortgage interest rates have fallen short of the 25bp OCR cut. Our estimates suggest the average variable rate from the 'big 4' banks have fallen by about 12bps. There has been a 9bps to 17bps fall in standard fixed mortgage interest rates, with special fixed rates 2bps to 19bps lower (see chart).

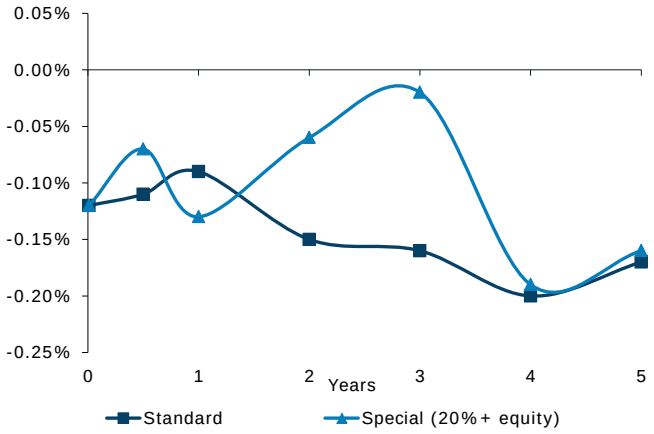
In part, this mostly reflects more modest falls in wholesale interest rates. Ninety-day bank bill rates are about 20bps lower than they were the day prior to the March *MPS* cut, with NZD swap yields about 6-21bps lower since then. Rising funding costs for banks are likely to account for the remainder.

The lowest part of the curve is one to two year fixed rates, particularly for mortgage specials, with average rates around multi-decade lows. All fixed carded terms are below current average effective borrowing rates on existing lending (around 5.30%).

So what should borrowers do? **This will largely depend on individual circumstances and attitudes to risk**, but our breakeven analysis is useful in comparing various options. **For those accessing specials, one and two-year terms (top table) remain the standout.** Borrowers could choose to spread fixed terms across both tenors to stagger rollovers, but we have a preference for locking in a greater proportion for one year, offering greater scope to take advantage of further falls in fixed rates, should those arrive. We note that the 50bps in OCR cuts we expect over the remainder of the year is not fully priced in, and wholesale interest rates could well move lower. Somewhat offsetting this are expected pressures from credit spreads, so it is not immediately clear how much further mortgage interest rates have to fall. We suspect they'll go more, but not completely in step with OCR moves.

Locking in for terms longer than two years would provide more certainty, but it is costlier. Our breakeven analysis shows fixed rates would have to rise by close to 140bps in two years' time to make it more attractive to fix for four years rather than two. Given that we do not expect OCR hikers until well into 2018 this implies a high cost for certainty.

CARDED MORTGAGE RATES^
Change since last month



Special Mortgage Rates		Breakevens for 20%+ equity borrowers			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.66%				
6 months	4.97%	3.55%	4.44%	4.56%	5.36%
1 year	4.26%	4.00%	4.50%	4.96%	5.55%
2 years	4.38%	4.48%	5.03%	5.37%	5.76%
3 years	4.77%	4.91%	5.34%	5.54%	5.75%
4 years	5.07%	5.16%	5.44%		
5 years	5.20%	#Average of "big four" banks			

Standard Mortgage Rates		Breakevens for standard mortgage rates*			
Term	Current	in 6mths	in 1yr	in 18mths	in 2 yrs
Floating	5.66%				
6 months	5.06%	4.48%	4.94%	5.05%	5.23%
1 year	4.77%	4.71%	4.99%	5.14%	5.30%
2 years	4.88%	4.92%	5.15%	5.26%	5.38%
3 years	5.02%	5.08%	5.25%	5.38%	5.51%
4 years	5.13%	5.21%	5.38%		
5 years	5.26%	*may be subject to a low equity fee			

^Average of carded rates from ANZ, ASB, BNZ and Westpac. Sourced from interest.co.nz

FEATURE ARTICLE: THE ECONOMIC OUTLOOK

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This month's special topic provides a detailed summary of our March *Economic Outlook* publication.

DR JEKYLL

The economy looks to be in reasonable shape. The economy ended 2015 showing strong momentum, with annualised growth of close to 3½% over the final six months (belying annual growth at just 2.3%). The labour market has recovered after a mid-year hiatus (although admittedly a 5.3% unemployment rate perhaps overstates strength) and consumer and business sentiment have held at decent levels despite dairy and global concerns. While there are the usual vagaries and volatility of the data to deal with, the general message is that the economy has carried this momentum into 2016 and is expanding solidly.

Importantly, this positive momentum story is not a one or two trick pony. There are a number of factors contributing (with many now quite familiar):

- **Tourism is strong.** While total visitor spending did dip a touch in Q4, it remains near record levels. Arrivals are growing at a 9% y/y pace and average spend per visitor has surged. China is a big part of the story, although it is much broader than that.
- **The construction pipeline is large.** The drag from a peak in the Christchurch rebuild is no myth. Yet work elsewhere is offsetting it. Dwelling consent issuance continues to trend higher and it is not just about Auckland. Large infrastructure projects not only add to the positivity but are spurring increased commercial activity too.
- **Record net immigration.** Net inflows are annualising at over 70k; that's a gain of 1½% of the population. While that is dampening per capita GDP growth in the interim, it still supports overall demand. And the associated lift in labour supply is helping to keep widespread capacity issues at bay. We expect net immigration to ease over the forecast period, but to hold at elevated levels. New Zealand's growth profile still looks better than many others and as long as this is maintained, migration trends will be favourable.
- **Regional housing markets are surging.** Housing market strength is no longer about Auckland alone. At a time when the Auckland market has cooled for a variety of reasons, regional markets (with the exception of Christchurch) are booming, buoyed by low interest rates, cash chasing investment outside of Auckland on a valuation and yield basis, and loan-to-value ratio tweaks that favour the regions over Auckland. This strength shouldn't be surprising. The Auckland – non-Auckland rubber band became taut and history shows numerous instances where Auckland strength eventually spills over and regions close the valuation gap. Regional lifts in house prices have further to run.
- **Financial conditions (a key lead indicator) are still supportive**, despite the restraining influence of the elevated NZD and lower dairy prices. Commercial property prices are up, as are equities. Interest rates are low, and the economy's credit wheels are still turning.
- **There is more cash in households' pockets.** Petrol prices have fallen, real wages are rising modestly (2.0% in the past year), food price inflation is low and the effective mortgage rate continues to ease. Combining these factors with the strongest gross labour earnings growth since 1994, we estimate that household discretionary cash flow (what is left over after paying the big bills) has lifted by close to 30% in the past 12 months, after falling 15% over the prior year. More money in the pocket equals more spending.
- **Borrow-and-spend type behaviour has returned, providing a near-term boost.** Growth in credit is outstripping growth in incomes. While this leveraging behaviour has concerning aspects, it is also a sign of confidence in prospects. Household savings are being run down. That's borrowing growth from the future,

FEATURE ARTICLE: THE ECONOMIC OUTLOOK

which can only be temporary, but we'll take it for now. Encouragingly, borrow-and-spend behaviour has not been matched by a meaningful deterioration in the current account, as yet. However, this is expected to some degree over the forecast period.

- **Firms remain in a fairly buoyant mood.** People are spending. Employment intentions are robust, and there are signs of capacity pressures (skill shortages) emerging. That's a sign of an economy where success can breed more success. Such positive momentum can be hard to derail.
- **The economy has a lot of "small" things going for it.** The big picture macro stuff only takes an economy so far. Any economy is a collection of small performing parts. Examples of "small" things across the economy include an increase in the number of airlines flying into New Zealand (more tourists), projected rises in kiwifruit production, growth in boutique sectors such as Manuka honey, a burgeoning IT sector and slowly increasing depth across the stock market. Moreover, the Government is being smarter with its balance sheet – both in a social and economic investment sense. Such dynamics "round out" the macro story.

These positive forces are expected to persist over the next year or so, and for some, throughout the entire projection period.

MR HYDE

Good economic momentum is masking mixed performance both across sectors and within them as firms deal with both structural shifts and cyclical business cycle challenges. Both are typical at any one time, but it's atypical to see the degree of structural shift that's occurring at present overlaid on normal business cycle trends. Examples of the former include trade patterns (more Asia focused), attitudes to saving (KiwiSaver is now engrained in the national psyche), diluted wage bargaining power amidst the fourth industrial revolution, and demographics. However, there are also more direct challenges.

- **Success is no longer about managing macro shifts; disruptive technology and innovation mean ongoing change at a non-linear rate for all and sundry.** This has put pressure on firms to be even more flexible and adaptable than normal. Some can make that transition and others cannot. Performance within sectors is diverging as firms either deal with change or fail to do so.
- **The global scene is wobbly.** It's the biggest downside risk facing the economy and uncertainty and challenges are multi-faceted. Much of our focus is on China, which faces a real test rebalancing its economy, deleveraging, and balancing a social objective (more people in jobs) with an economic one (rebalancing the economy, which means near-term job displacement). Elsewhere, there is an unhealthy dependence on liquidity and policy support, an unbalanced global economy (too much saving by some and too little by others), excess leverage to still be worked through, overvalued asset prices, a lack of microeconomic reform, and increasing political fracturing making microeconomic reform and sound policy even more difficult to achieve. Our base case is that the global economy will experience modest growth overall, with risks remaining contained. However, we expect volatility to be high and with the policy support coffers looking reasonably bare, we need to be on the lookout for negative shocks.
- **Dairy: there is no way to sugar-coat the challenges.** The sector is in the midst of its second low-payout year and a third (the 2016/17 season) beckons. Price action is poor. Pressures have only really just started, and we don't see positive cash-flow into the sector being restored until 2018. Sector-wide borrowing is close to $40 billion (17% of GDP). That's non-trivial. Land prices are under pressure and costs are facing intense scrutiny. For a sector that directly contributes 5% to GDP and at least 10% indirectly, addressing its specific challenges will result in wider economic consequences.
- **Broader export prices are also under pressure.** While dairy prices may be stabilising at low levels, other export prices, particularly red meat, have recently faced some pressure. Together with a modest lift in oil prices off lows, we see the terms of trade falling by circa 10% over 2016. This comes on the heels of a 3% fall in 2015. Collectively we forecast a peak-to-trough fall in the terms of trade of 17%. That's a major drop in purchasing power and a collective hit to real GDP growth of around 2.5%pts between 2015 and 2017.
- **Financial conditions have tightened.** Financial conditions are supportive overall, but have tightened materially of late. Export price falls, weaker credit markets, a stubbornly elevated NZD, and moderation in some asset prices such as farm values are a nasty mix. The tightening so far is enough to potentially knock 1%pt off real GDP growth over the next 12 months, all else equal.

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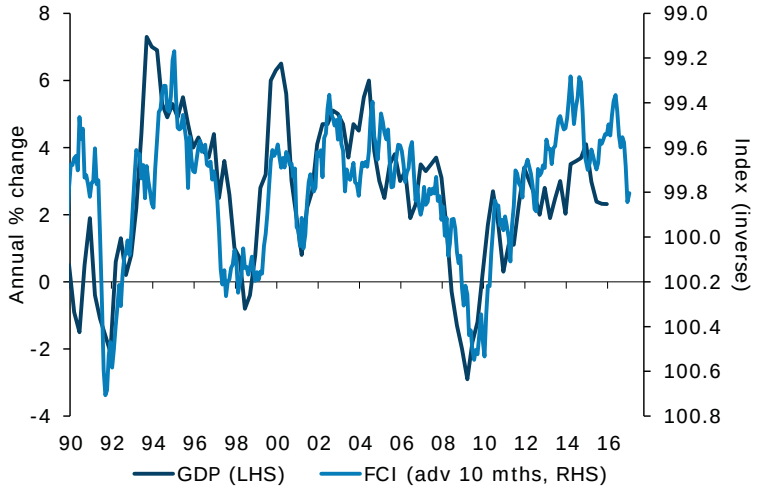
- **Asset valuation largesse together with deterioration in some structural indicators is an 'amber alert' combination.** The excesses associated with New Zealand house prices are well documented. A shortage of housing is only partly to blame. Globalisation, the chase for yield, connectivity with China, urbanisation, New Zealand's economic success, surging migration, cheap credit, high construction costs, lack of land availability, a lack of intensification and ambitious expectations about peoples' first home (since when is four bedrooms and two bathrooms normal?) are also influential. What concerns us is the combination of largesse with re-leveraging behaviour. The household debt to income ratio peaked at 159% prior to the GFC; it is now 162%, an all-time high, and rising. While low interest rates means serviceability is manageable at present, the debt still needs to be repaid and that is an impediment to future growth. Another year or two of strong credit growth and surging house price gains (particularly if Auckland fires up again) would turn us very bearish towards prospects for 2018.

FIGURE 1. GDP VERSUS FINANCIAL CONDITIONS



Source: ANZ, Statistics NZ, Bloomberg

TREND IS YOUR FRIEND

The economy has enough momentum and support to achieve modest growth over the coming years. Positives still dominate the scorecard. However, dairy sector weakness, global headwinds and tighter financial conditions should see growth moderate over the course of 2016. We are not talking about a full-blown slowdown, but moderation. Part of this is the natural braking effect from fewer available resources such as labour (despite booming net immigration). Whereas annualised GDP growth of over 3% is being recorded at present, rates of growth closer to 2½% are forecast over the years ahead. In other words, we see a growth backdrop that, while not remarkable, is certainly still solid – although quarterly volatility is likely to be high.

New Zealand has a number of key dynamics that will be influential over the coming years as challenges are navigated.

- **Policy firepower.** The OCR, while on the way down, still has a long way to go to get to levels comparable to offshore.
- **The fiscal position is strong**, with relatively low levels of net public debt (26% of GDP). There's scope for an expansionary fiscal stance. The 2017 Budget will likely deliver that via tax cuts; it's an election year after all. There is scope to boost infrastructure spending further if economic momentum wanes, though the construction industry is facing capacity bottlenecks so this lever could be challenging to pull effectively.
- **A free-floating currency.** It will adjust lower just as it did in mid-2015 if the growth picture warrants it. A strong economy equals a strong currency and the reverse applies too.
- **Better microeconomic foundations, building macroeconomic resilience.** We have some concerns over leverage ratios, but there is no doubting the economy is better placed all round than in the not-too-distant past. The financial system is well capitalised and profitable. More term funding is in place (a protective device against credit market palpitations). The synergy benefits of previous micro tweaks (the tax system,

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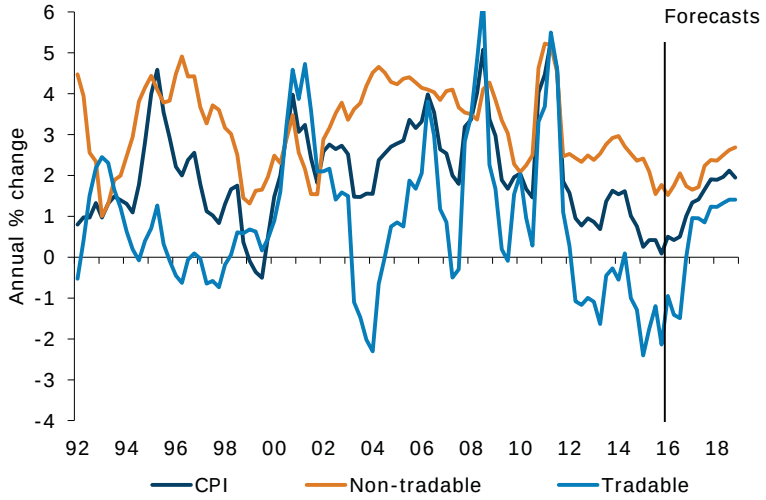
more roading investment, improving education and beneficiary outcomes, to name but a few) are only now coming together. The post-GFC era (2009 to 2011) has hardened the business sector. New Zealand is now like Australia (in prior years, not today!), which was buffeted by the likes of the Asian Crisis and dot-com bubble, but navigated them better than most.

- **Low levels of corporate debt.** Household and agriculture debt levels are high but corporate debt is low.

PLENTY OF CHALLENGES TO GET INFLATION UP

Despite respectable growth and falling unemployment, inflation has remained low. Headline inflation has been outside of the RBNZ's target band for 18 months, reflecting a combination of transitory (NZD and oil prices) and more enduring factors. Even core inflation measures are well below the middle of the 1-3% policy band.

FIGURE 2. NEW ZEALAND CPI INFLATION



Source: ANZ, Statistics NZ

As the temporary factors wane (oil prices need only stabilise, for instance), **our projections naturally show inflation rising.** Annual headline inflation is forecast to firm towards 1% by the end of the year, largely on the back of a lift in tradables inflation. Non-tradable inflation, after also being weighed down in part by temporary factors (ACC levy reductions), is expected to increase above 2% from the second half of next year. Pressure from demand-style factors (i.e. capacity constraints) are expected to exert a slight upwards influence on non-tradable inflation.

But this conceals considerable tensions. Capacity pressures are already evident locally, yet a number of factors are conspiring to dampen the traditional Phillips Curve relationship between capacity and inflation. Disruptive technologies are not only affecting firms' margins but also workers' job security, and hence wage-bargaining power. Legacy issues such as excess leverage post the GFC remain (deleveraging is deflationary), as does global overcapacity in some industries. Commodities have been swinging around for both cyclical and structural reasons. Inflation expectations have fallen and risk becoming embedded. We assume that cyclical forces will eventually win out and headline inflation settles around the 2% midpoint as the margin squeeze hits its limits. That's implicitly a vote of confidence in the monetary policy framework.

OTHER FEATURES OF OUR FORECASTS INCLUDE

- **Household consumption; buoyant:** Strong population growth, an improving labour market, petrol price and mortgage rate falls and a rundown in saving rates has boosted real spending growth. Annual growth looks set to peak close to 4%. However, deteriorating debt metrics and a moderation in net migration gains will eventually cap growth – we see real spending growth slowing towards 2½%. In short, we don't see recent borrow-and-spend style growth being sustained. Renewed vigour in spending and housing enthusiasm is temporary. It's a key judgement that ensures the current account and balance sheet metrics don't completely blow out.

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- **Investment; an outperformer:** Modest residential investment growth of circa 5% is expected over the next year, masking divergence between Canterbury and the rest of the country. Other fixed asset investment is forecast to achieve decent growth rates (3-5%), as a low cost of capital and emerging capacity constraints drive firms' investment plans.
- **Labour market; jobs aplenty:** While the unemployment rate should rebound in Q1 from its sharp fall in Q4 2015, we see it moderating towards 5% over the next few years, with employment growth strong enough to absorb a slowing rate of new entrants into the labour force.
- **Current account; modest deterioration:** A record services balance surplus provides an offset, but the current account deficit is forecast to widen towards 5% of GDP by early 2017, largely on a further widening in the goods deficit (on assumed terms of trade falls). We're not picking it widening beyond that, based largely on our belief that current boosts to spending will prove temporary.
- **Fiscal; pristine numbers compared to fiscally profligate peers.** Our economic projections are broadly similar to those contained in the Half-Year Update, although a slightly softer nominal GDP profile corresponds with a more gradual pace of fiscal improvement, and an OBEGAL surplus of around 1% of GDP in 2018/19.

STOP START GLOBAL SCENE

Financial markets have stabilised after their tumultuous start to the year. 'Down the elevator' has been replaced by 'up the stairs' for equities, commodities and emerging markets. More policy support (ECB, BoJ, PBoC) and a winding back of expected rate hikes by the US Federal Reserve have once again worked their magic.

We question the sustainability of the rebound.

- **Asset valuations need to transition away from liquidity-driven support to reflecting economic fundamentals (i.e. growth).** That's a tough transition to make if a) central banks keep offering more low-interest-rate stimulus in response to every market wobble, and b) fundamentals such as growth don't stack up.
- **The global economy is still lopsided;** too much saving by some (China, Japan, Germany), and not enough by others (the US).
- **The world's actions are dominated by self-interest and not group interest.** We need the reverse, but game theory tells us we won't get it.
- **Debt levels are still high around the globe.** The average level of government gross debt across the OCED is in excess of 85% of GDP.
- **China is an economic enigma.** Corporate debt is high, the return on equity for many industries is receding, non-performing loans are rising and with that follows questions towards the banking system, and the economy needs to transition from investment to consumption-centric growth. However, policymaker firepower is huge. Watch for the RMB to be a mechanism that exports "problems" as officials try to navigate the impossible trinity (a trilemma that states that it is impossible to have a fixed currency, free capital movement and independent monetary policy). Depreciation risks destabilising the Asian region.
- **The side effects of additional stimulus (i.e. negative interest rates) are becoming more apparent and openly debated.** We've seen credit spreads widen to partially compensate for negative rates. It's a farce to see negative rates and a world where creditors pay to lend and debtors are paid to borrow.
- **Microeconomic and structural reforms have been missing in action.** There has been too much central bank heavy lifting and insufficient government action.
- **Politics has moved more towards the "extremes".** Social unease, mistrust in the establishment and a failure to address growing inequality is seeing rising popularity of fringe politicians and parties in key jurisdictions. Witness the UK, Brexit debate and the US presidential campaigns. That portends poorer microeconomics, not stronger.

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That said, there are bright spots. The world's largest economy – the US – is on a firm footing, although this is creating tensions over what the Fed ought to be doing locally (lift rates), versus globally (proceed cautiously). Europe is back recording anaemic but at least positive growth. China is seeing strong growth in service sector activity. The clamp-down on corruption – while painful in the short-term – is a huge plug for the medium-term picture. Australia is navigating its shift from mining to non-mining led growth in a reasonably orderly fashion.

Our forecasts for the global economy depict a moderate growth backdrop overall. But this seemingly benign expectation belies the risks.

THE OCR IS GOING LOWER

A backdrop of barely trend growth domestically with low inflation and global challenges means further OCR cuts are more likely than not. We see the OCR being cut twice more this year to 1.75% (most likely in June and November), and holding there for an extended period. While we are backing a respectable growth picture, it needs more stoking to get inflation embers glowing brighter amidst an array of deflationary global forces. The unemployment rate still sits above our estimate of the NAIRU (non-accelerating inflationary rate of unemployment). Wage inflation is low and inflation expectations are below the inflation mid-point, for short-term measures anyway. China and global risks abound. Credit market price action is poor. We've already seen one cut in the OCR not fully passed into retail borrowing rates. The longer credit markets remain in a sombre mood –and we are picking that will remain the case for a while – the more pressure will come on banks' average cost of funds, and borrowing rates. So the OCR partly needs to drop just to keep retail rates unchanged, let alone drag them materially lower still.

With market expectations for OCR cuts still shy of what we expect, front-end yields remain biased lower. At the time of writing, the market was pricing between one and two cuts by the end of the year, and for the first cut to occur by August. By contrast, we expect cuts in June and November. Moreover, with the OCR forecast to remain on hold through all of 2016 and 2017, and the first hike not expected until mid-2018, rates in the belly of the curve look set to remain low.

Despite this, a lower OCR is not a view that sits overly comfortably with us. The pitfalls of deflation – central bank's current bug-bear – are clear; people will not spend if they expect prices to fall! You end up with an economy in a rut. So the RBNZ is focused on lifting inflation and expectation measures towards a more acceptable level (2% as mandated). Inflation is certainly low, but deflation is not around the corner. Witness rising construction costs, rents and accommodation charges, to name but a few (no coincidence that these are in the parts of the economy running hottest). We are not headed for a deflationary rut. Yet, a lower OCR penalises savers (the post-financial crisis era doesn't look pretty for retirement nest-eggs in a low interest rate world) and encourages leveraging behaviour at a time debt is already high and asset values (house prices) are booming. The trade-offs for additional monetary policy stimulus need to be weighed carefully. Some sit under the realm of financial stability but there is overlap with monetary policy. To be fair, the trade-offs leave us scratching our heads over the end-game.

Our forecasts have US 10-year Treasury bond yields moving gradually higher over the course of 2016 and 2017 (to 2.2% and 2.8% respectively, from a current level of around 1.9%). Given the close correlation between US and New Zealand bond yields, we also expect local interest rates to rise over the next two years, with the bulk of the rise occurring over 2017. Over 2016, we expect New Zealand 10-year bond yields to hold broadly stable, with the rise in US yields absorbed via a narrowing in the NZ/US spread.

This forecast is built on our expectation that the New Zealand market continues to trade as a "low beta" market with respect to the US. Furthermore, we assume that upcoming RBNZ OCR cuts (pencilled in for June and November) come at approximately the same time as Fed hikes (which we have pencilled in for June and December).

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This forecast is also consistent with the "interest rate convergence" theme, which remains in play. With currencies now implicit vehicles for expressing monetary policy loosening and tightening, currency divergence from economic fundamentals necessitates interest rate convergence to realign the former. Countries where both rates and currencies diverge see an aggressive tightening in financial conditions that eventually rolls the economy. Witness the nations that tried lifting rates after the GFC; hikes rapidly became cuts. If anything, it is now even more relevant than it has been in years gone by, with the emergence of negative bond yields shining a light on New Zealand's (and Australia's) much higher yields.

NZD BIASED LOWER TOO

Assuming that the yield differential is also narrowed from the US side via two Fed hikes this year, that implies that the NZD will also go a lot lower, all else equal. This is particularly the case given the tendency for markets to respond more to the direction of policy moves than to interest rate differentials per se. Interest rate differentials have always been important for currencies, but correlation analysis shows that since 2012, the NZD has been more responsive to *six month changes* in the OCR than it has been to short-end interest rate differentials.[1] This should not be particularly surprising given the mass of ultra-low (or negative) policy rates. Countries that have tended to pursue non-conventional or novel policy approaches have often seen their currencies face severe downward pressure. By contrast, those currencies with more normal policy settings have tended to be overvalued, making them vulnerable to a correction back towards fair value as policy rates converge.

While we have pencilled in a reasonably large fall in the NZD/USD (to 0.59) over the rest of calendar 2016, it needs to be put in perspective.

- While it is around 12% below the average level of the NZD/USD over 2016 to date, it is a much more modest reduction than was seen over the year to August 2015, for example, when it experienced a peak-to-trough fall of 30%.
- We reside in a world where currency volatility is high; 2 cent intra-day moves are now common-place, and the last two months has seen a 10% range – a low of 0.6348 on January 20th to a high over 0.6900 at the time of writing.
- It's a modest currency cycle on the downside. Typically, currencies overshoot and undershoot for material periods. The last two currency cycles have seen the NZD/USD hit 0.3915 and 0.4927 at the low point. This dynamic is somewhat tempered this time around, given:
  - We still expect NZD to remain attractive despite OCR reductions. Even if the OCR gets to 1.75%, it will still be 0.75%pt above where we expect the Fed Funds rate to be – and well above yields on offer across most of the OECD. In fact, yields are negative across a fair share of countries.
  - The NZD/USD is already around 22% off its 2014 peak of 0.88, and will have declined by 34% if it reaches our forecast level.
  - Of the seven total 25bp cuts we envisage at the completion of the RBNZ's easing cycle, five have already been delivered. The easing cycle is nearing maturity.
  - Growth in New Zealand is set to slow, but from a gallop to a canter. Financial conditions are flagging a growth slowdown, not a hard landing. It's the hard landings that have been associated with material undershoots in the NZD.
  - Outright New Zealand longer-term yields remain attractive on the global stage. Ten year yields are running at 3% compared with 1.8% in the US, and close to zero in Japan and Germany.
  - Global policy settings are also getting easier – it is not just the RBNZ that is easing.

These considerations point to a mildly lower NZD, rather than a dramatic fall. They also point to a more demure trough in the currency cycle compared to previous cycles.

If there is a risk to the forecast it is that the NZD remains more elevated than projected. Put simply, New Zealand's economic credentials could continue to look decidedly stellar across global peers, particularly with the economy showing less hi-beta characteristics to the global economic cycle.

[1] Since 2011, the simple correlation between the NZD and 2 year swap rate differentials was 36%. By contrast, the NZD's correlation with the 6 month change in the OCR was 72%.

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CREDIT SPREADS: MIND THE GAP

Credit spreads remain elevated, and while they have closed a tad in recent weeks, they are generally wider than they were in Q4 last year. Going forward, **the risk is they widen further.** What particularly concerns us is the harm being done to credit markets in countries with negative interest rates. As interest rates go lower, end investors in those markets are becoming increasingly disillusioned, which in turn leads to a reduction in issuance and liquidity. Price-makers respond to this by lifting bid/offer spreads, which leads to a downward spiral in market confidence as even less liquidity leads to even wider spreads, and so on.

Eventually the market reaches a point where the spread required to attract investors is uneconomic to issuers, and the market dries up. This has happened in some market segments in Europe. But because the issuers still need to fund, they look elsewhere, to markets where yields are still relatively normal, like New Zealand. As those issuers (who are typically global issuers) tap investors in the local market, that puts more supply into the market, which in turn leads local investors to become more price sensitive, with the end result being wider spreads here too.

This "downward spiral" is exacerbated by the deeper inversion of basis swap spreads that has occurred in Europe (which is itself a by-product of excess savings). As basis swap spreads in those markets move further into negative territory, it tends to lift credit spreads here, as it makes it even cheaper for European issuers to fund in New Zealand dollars, further crowding out domestic issuers.

All else equal, if sustained, wider credit spreads will have an adverse impact on financial conditions, which in turn poses downside risks to the OCR.

FORECAST SUMMARY

Calendar Years	2013	2014	2015	2016(f)	2017(f)	2018(f)
New Zealand Economy						
Real GDP (annual average %)	2.4	3.7	2.5	2.8	2.5	2.6
Unemployment Rate (Dec quarter)	6.1	5.8	5.3	5.5	5.3	5.0
CPI Inflation (annual %)	1.6	0.8	0.1	1.0	1.9	1.9
Terms of Trade (OTI basis; annual %)	20.2	-5.0	-3.2	-7.8	7.2	1.0
Current Account Balance (% of GDP)	-3.1	-3.1	-3.0	-4.7	-4.6	-4.1
Government OBEGAL (% of GDP)	-2.0	-1.2	0.2	-0.2	0.0	0.2
Global Growth (annual average %)						
US	1.5	2.4	2.4	2.3	2.3	2.3
Australia	2.0	2.6	2.5	3.0	3.2	3.1
China	7.7	7.4	6.9	6.4	6.0	6.0
Trading Partners	3.0	3.6	3.5	3.5	3.5	3.5
NZ Financial Markets (end of Dec quarter)						
TWI	77.3	79.4	73.7	63.4	63.1	
NZD/USD	0.82	0.78	0.69	0.59	0.62	
NZD/AUD	0.92	0.96	0.94	0.88	0.89	
Official Cash Rate	2.50	3.50	2.50	1.75	1.75	2.50
10-year Bond Rate	4.7	3.7	3.6	2.9	3.5	3.6

KEY FORECASTS

Weekly mortgage repayments table (based on 25-year term)

Mortgage Size ($'000)	Mortgage Rate (%)													
	4.00	4.25	4.50	4.75	5.00	5.25	5.50	5.75	6.00	6.25	6.50	6.75	7.00	7.25
200	243	250	256	263	270	276	283	290	297	304	311	319	326	333
250	304	312	320	329	337	345	354	363	371	380	389	398	407	417
300	365	375	385	394	404	415	425	435	446	456	467	478	489	500
350	426	437	449	460	472	484	496	508	520	532	545	558	570	583
400	487	500	513	526	539	553	566	580	594	608	623	637	652	667
450	548	562	577	592	607	622	637	653	669	684	701	717	733	750
500	609	625	641	657	674	691	708	725	743	761	778	797	815	833
550	669	687	705	723	741	760	779	798	817	837	856	876	896	917
600	730	750	769	789	809	829	850	870	891	913	934	956	978	1,000
650	791	812	833	854	876	898	920	943	966	989	1,012	1,036	1,059	1,083
700	852	874	897	920	944	967	991	1,015	1,040	1,065	1,090	1,115	1,141	1,167
750	913	937	961	986	1,011	1,036	1,062	1,088	1,114	1,141	1,168	1,195	1,222	1,250
800	974	999	1,025	1,052	1,078	1,105	1,133	1,160	1,188	1,217	1,246	1,274	1,304	1,333
850	1,035	1,062	1,089	1,117	1,146	1,174	1,204	1,233	1,263	1,293	1,323	1,354	1,385	1,417
900	1,095	1,124	1,154	1,183	1,213	1,244	1,274	1,306	1,337	1,369	1,401	1,434	1,467	1,500
950	1,156	1,187	1,218	1,249	1,281	1,313	1,345	1,378	1,411	1,445	1,479	1,513	1,548	1,583
1000	1,217	1,249	1,282	1,315	1,348	1,382	1,416	1,451	1,486	1,521	1,557	1,593	1,630	1,667

Housing market indicators for February 2016 (based on REINZ data)

	House prices (ann % change)	3mth % change	No of sales (sa)	Mthly % change	Avg days to sell (sa)	Comment
Northland	7.1	-3.4	228	-6%	46	Median sales price at 8-month low.
Auckland	11.0	-0.2	2,196	-2%	34	Auckland's share of nationwide sales volumes at 8-year low.
Waikato / BOP / Gisborne	16.7	0.2	1,388	+2%	29	Market tight, given days to sell has averaged 47 last decade.
Hawke's Bay	13.9	5.7	275	+15%	28	Days to sell at 12-year low, prices just 0.3% off peak.
Taranaki	2.8	-1.4	327	+5%	37	Median price ($237k) 6% below peak.
Manawatu / Whanganui	3.5	1.6	180	+3%	48	Highest days to sell of the regions.
Wellington	9.8	1.6	847	+26%	27	Record median price ($435k), lowest days to sell of regions.
Nelson / Marlborough	9.1	2.1	283	+9%	33	Record median sales price ($396k).
Canterbury / Westland	4.0	1.4	926	+4%	36	Days to sell at 5-year high.
Central Otago Lakes	13.4	14.2	124	-6%	39	Sales volumes -17% 3m/3m, days to sell at 4-month low.
Otago	0.9	0.1	295	+9%	29	Sales volumes +4% 3m/3m.
Southland	12.2	2.2	162	+4%	32	Days to sell at a 4-year low.
NEW ZEALAND	4.7	-1.8	7,317	+3%	31	Days to sell at 9-year low, sales volumes -3.9% 3m/3m, median prices 7% below peak.

Key forecasts

	Actual			Forecast						
Economic indicators	Jun-15	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17
GDP (Ann Avg % Chg)	3.3	2.9	2.5	2.4	2.6	2.7	2.8	2.7	2.5	2.4
CPI Inflation (%)	0.4	0.4	0.1	0.5	0.4	0.5	1.0	1.3	1.4	1.7
Unemployment Rate (%)	5.9	6.0	5.3	5.8	5.7	5.6	5.5	5.5	5.4	5.4
	Actual			Forecast (end month)						
Interest rates (carded)	Jan-16	Feb-16	Latest	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Official Cash Rate	2.50	2.50	2.25	2.00	2.00	1.75	1.75	1.75	1.75	1.75
90-Day Bank Bill Rate	2.7	2.6	2.4	2.1	2.1	1.9	1.9	1.9	1.9	1.9
Floating Mortgage Rate	5.8	5.8	5.7	5.4	5.4	5.2	5.2	5.2	5.2	5.2
1-Yr Fixed Mortgage Rate	5.0	4.7	4.6	4.5	4.5	4.4	4.4	4.4	4.5	4.5
2-Yr Fixed Mortgage Rate	5.2	4.9	4.7	4.6	4.5	4.4	4.4	4.5	4.5	4.6
5-Yr Fixed Mortgage Rate	5.8	5.4	5.4	5.3	5.2	5.2	5.2	5.3	5.3	5.3

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