insightpaper

NEW ZEALAND INSIGHTS

DECEMBER 2015

GDP growth in the first half of 2015 turned out to be the weakest six month period for growth since 2010. But growth in activity appears to have recovered in the second half of the year, assisted by an easing in financial conditions as the exchange rate has moved lower and the Reserve Bank of New Zealand (RBNZ) has fully reversed last year's interest rate increases. Business and consumer confidence have also recovered following sharp falls in the middle of the year. This sets the scene for another year of solid growth in the New Zealand economy in 2016.

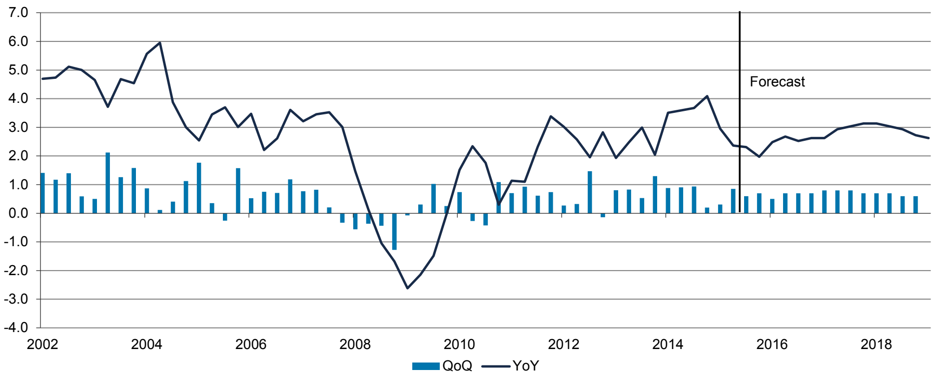
BEVAN GRAHAM
AMP Chief Economist

GROWTH RECOVERS FROM WEAK PATCH

The New Zealand economy struggled in the early half of 2015 as weaker dairy prices, lower business and consumer confidence, and the still high New Zealand dollar (NZD) all took their toll. GDP expanded a miserly 0.5% in the January to June 2015 period, the weakest six month period for growth since 2010.

Thanks largely to easier financial conditions, the economy was bouncing back by the third quarter of the year. GDP came in at a better-than-expected 0.9% in the September quarter. Annual growth came in at 2.3%, with annual average growth holding up at a still impressive 2.9%.

NEW ZEALAND GDP
% change



Source: Statistics New Zealand and AMP Capital

The strong quarterly growth rate is part solid underlying growth (which we think is running at around 0.7% per quarter), part pay-back for the weak start to the calendar year, and part higher meat processing reflecting low dairy/high meat prices and the impending drought. With all that going on, it's important not to take the strength in the result at face value, especially when compared to the RBNZ's forecast of 0.6% for the quarter.

Lower interest rates, the weaker exchange rate, stronger business and consumer confidence, continued strong population growth, Auckland replacing Christchurch as the centre of growth in residential construction, and a modest improvement in global growth all combine to set the scene for continued solid growth in 2016.

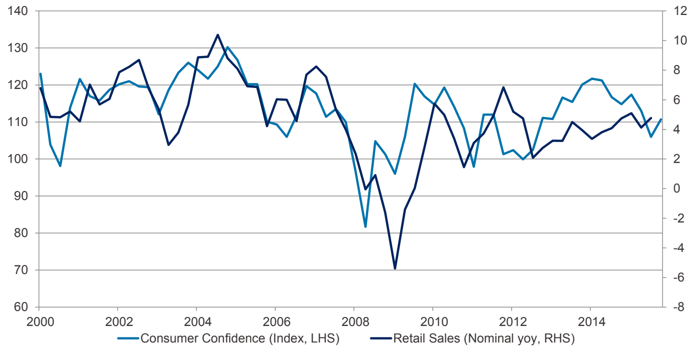
Lower dairy incomes will continue to provide a drag on consumer spending. We expect supply and demand conditions to rebalance towards higher prices as the year progresses, although likely higher oil prices will remain a drag on the terms of trade. And then there's the weather. Drought seems certain to have at least some negative impact on agricultural and horticultural production in the early part of 2016. The extent remains to be seen.

We expect annual average growth will come in at around 2.4% for calendar year 2015. This is still a solid performance by post-Global Financial Crisis (GFC) mature economy standards, but a marked slowdown on the stellar 3.7% growth achieved in 2014. We are forecasting growth of 2.5% in calendar year 2016 followed by 2.9% in 2017.

CONSUMERS HAPPIER HEADING INTO CHRISTMAS...

There's been a mix of positives and negatives for the retail sector over 2015. The positives include low goods prices, lower interest rates, strong population growth and the wealth effect of rising house prices, at least in some parts of the country. The negatives include lower dairy incomes and some softening in the labour market. Retail spending volumes increased 5.7% in the year to September indicating that, at least up to that point, the positives have been dominating the negatives.

NEW ZEALAND RETAIL SPENDING



Source: Statistics New Zealand, Westpac-McDermott Miller

The negative factors have been weighing on consumer confidence as it moved lower over the course of the year, although we did see a bounce into year end. The Westpac McDermott Miller Consumer Confidence Index started 2015 at 117.4 (neutral benchmark = 100), dropped to a low of 106.0 in September, before recovering some of that lost ground to 110.7 in December. We put some of the drop in confidence in September down to heightened concerns about global growth at that time, particularly around China, which had abated by the end of the year.

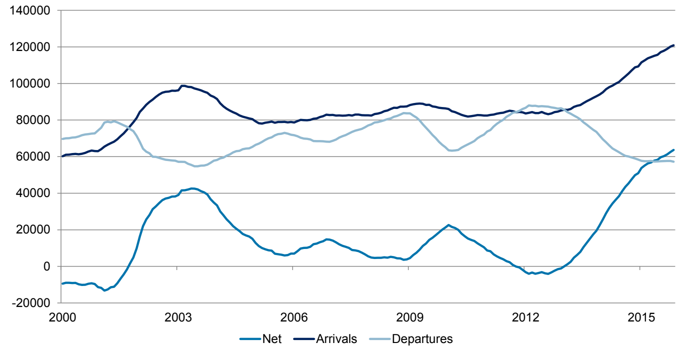
Nevertheless we think the trend decline in confidence over the year reflects factors that will weigh on consumer spending as we head into 2016. These include lower rural incomes, slower employment growth (and along with that, rising unemployment), as well as increasing signs of a slowdown in the Auckland property market.

WHILE WE THINK THE AUCKLAND HOUSING MARKET IS COOLING THANKS TO CHANGES IN TAX POLICY ALONG WITH NEW LENDING RESTRICTIONS, IT REMAINS TO BE SEEN THE EXTENT TO WHICH THIS IS ANYTHING MORE THAN THE NORMAL SEASONAL WEAKNESS IN THE PROPERTY MARKET.

We will be watching the data post the holiday season for confirmation of a slowdown, or otherwise.

On the upside, spending growth has benefited from strong population growth over the year, and while we expect this will continue into 2016, flows from net migration will peak at some point. Latest data for the year to November shows net permanent and long term inflows of 63,659, representing population growth of 1.4%.

NEW ZEALAND PERMANENT AND LONG TERM MIGRATION
Number/year to date



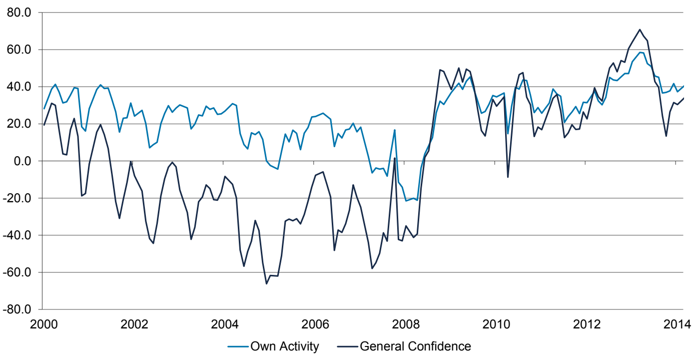
Source: Statistics New Zealand

... AND BUSINESS MOOD HAS IMPROVED TOO

The mood among business owners has also improved following a brief flirtation with pessimism in the middle of the year. As with consumers, we think this spike lower in the third quarter of the year had a lot to do with the negative China and global growth sentiment at the time, and various predictions of New Zealand recession which we thought was way overdone. Also, dairy prices appear to be stabilising at a level off the lows seen earlier in the year.

As those concerns have diminished, we have seen a marked recovery in confidence. The ANZ business confidence index reached an eight month high in December, with a net 23% of businesses optimistic about the general economy in the year ahead. Firms are more optimistic about their own outlook (34%), but then that reading didn't fall as much as far in the prior months, supporting our view that external influences had a part to play in the drop in general confidence.

NEW ZEALAND BUSINESS CONFIDENCE
Index



Source: ANZ Bank

There are still a few challenges to traverse in 2016, not the least of which will be whatever the weather throws at us over summer. As we head into 2016, businesses appear to be in fine fettle, at least on average. That said, we expect lower business investment growth in the period ahead, particularly as uncertainty lingers about the impact of drought. At the same time, lower overall growth has generated new spare capacity and the weaker exchange rate has increased the costs of imported investment equipment.

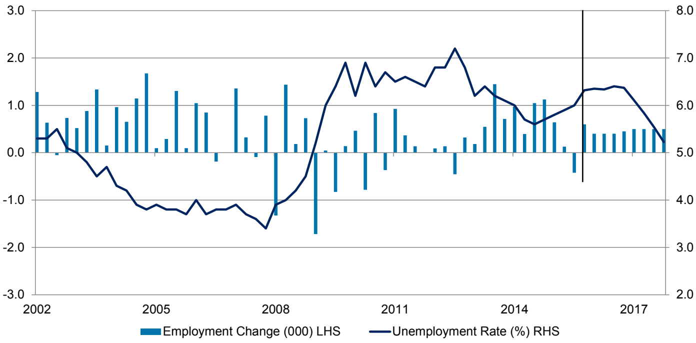
UNEMPLOYMENT RATE HEADING HIGHER, WAGES SUBDUED

Until recently the story of the New Zealand labour market has been one of strong demand for labour being largely met by strong growth in supply. Employment growth came in at 3.6% in calendar year 2014. At the same time, the labour force expanded 3.2% through a mix of rising participation and strong net inward migration. The unemployment rate reached a low of 5.6% in September 2014.

Since the start of 2015, employment growth has slowed while net migration has continued to rise. That has seen a rise in the unemployment rate to 6.0% in September 2015. A move even higher in the unemployment rate was only averted by a surprisingly large (and therefore questionable) decline in the participation rate in the September quarter.

We think the pull back in (mostly part-time) employment in the September quarter was in large part due to the tumble in business confidence over the same period, leading to businesses being more cautious about implementing their hiring and investment plans.

NEW ZEALAND LABOUR MARKET



Source: Statistics New Zealand and AMP Capital

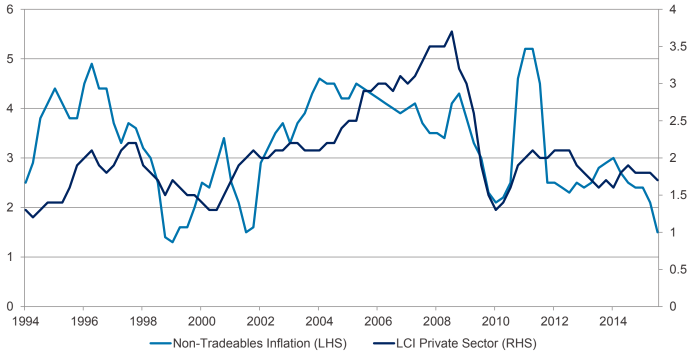
Looking ahead, we think employment will bounce back somewhat in the December quarter although we expect the annual rate of growth to settle at around the 1.0–1.5% per annum level in the near term. While still positive, this is significantly lower than the growth we have experienced recently. Along with continued growth in the labour supply, we expect the unemployment rate to continue to nudge higher, peaking at 6.4% in mid-2016.

Further out, as economic growth recovers we expect employment growth to also recover. At the same time, net migration is also expected to head lower. We believe this will result in the resumption of the downward trend in the unemployment rate which we expect will head back towards 5% during 2017.

THE INCREASED SLACK IN THE LABOUR MARKET, AS EVIDENCED BY THE RECENT RISE IN THE UNEMPLOYMENT RATE, HAS KEPT WAGE GROWTH SUBDUED.

In fact, increases in unit labour costs have drifted slightly lower as the year has progressed. Unit labour costs are an important indicator in our assessment of the strength (or lack thereof) of underlying inflationary pressures in the economy. As we've stated before, this has been the big surprise for us through this cycle. With the unemployment rate now heading higher, at least in the near term, we see little scope for increased wage inflation in the period ahead.

INFLATION AND THE LABOUR COST INDEX
Annual % change



Source: Statistics New Zealand

EXCHANGE RATE AND EXTERNAL SECTOR

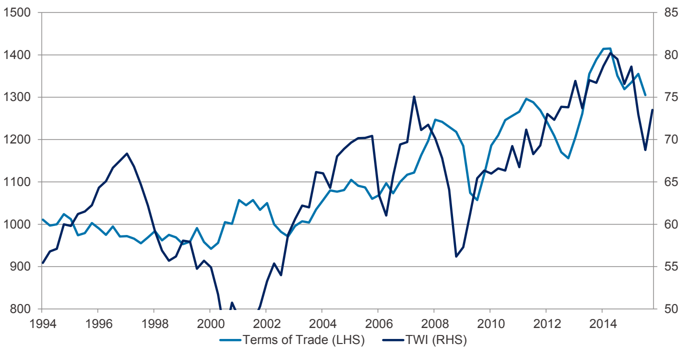
The external sector has been facing a number of headwinds over the last few years, some of which became less so during 2015 (the exchange rate), while others became more of a burden (soft global growth and weak commodity prices).

Trading partner growth softened during 2015 most notably in our two largest trading partners, Australia and China. Average trading partner growth slowed from 3.7% in 2014 to an estimated 3.5% in 2015. We expect a modest pick-up to around 3.7% in 2016, still short of its longer run average of closer to 4.0%.

Weakness in dairy prices has been the big story of the last two years, with its full impact still to be felt by rural New Zealand and the economy generally. The Global Dairy Trade auction index looks like finishing the year off its lows, but still down around 7% for calendar year 2015, which of course follows the decline of 48% over 2014.

But it hasn't all been bad news on the commodity price front as meat, horticulture and seafood prices have all held up well. This has helped limit the overall decline in export prices over the year. At the same time, import prices have remained low as global inflation has been low and oil prices have fallen. This has in turn limited the decline in the terms of trade which, while lower, is still holding up at relatively high levels despite the weakness in the price of our main export commodity.

NEW ZEALAND TERMS OF TRADE AND THE TWI
Index



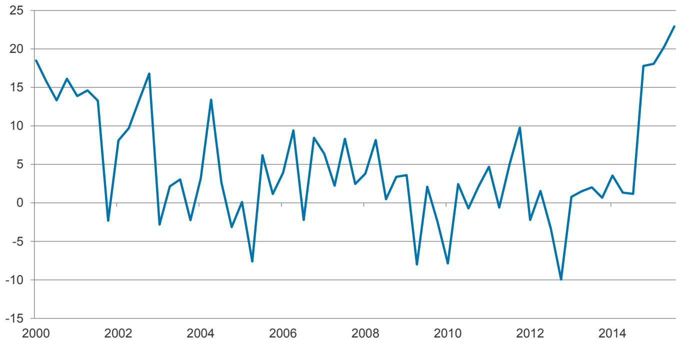
Source: Statistics New Zealand, RBNZ

We expect demand and supply factors in the dairy sector to rebalance in favour of higher prices as 2016 progresses. But we expect the same to happen to oil prices. Prices of these two commodities will likely be the prime determinants of the path for the terms of trade. With one a positive and one a negative the path for the overall index is unclear, though we are biased towards expecting some recovery.

The trade-weighted New Zealand dollar (NZD) ended the year lower, though off its lows for the year. The NZD remains overvalued against a number of key trading partners currencies including the Australian dollar, the euro and the yen, the latter two due to quantitative easing by their respective central banks.

The lower exchange rate will be supportive of the export sector generally. We are already seeing this reflected in service exports where tourism flows are providing a key support to growth as we head into summer.

NEW ZEALAND EXPORTS OF SERVICES
Annual % change



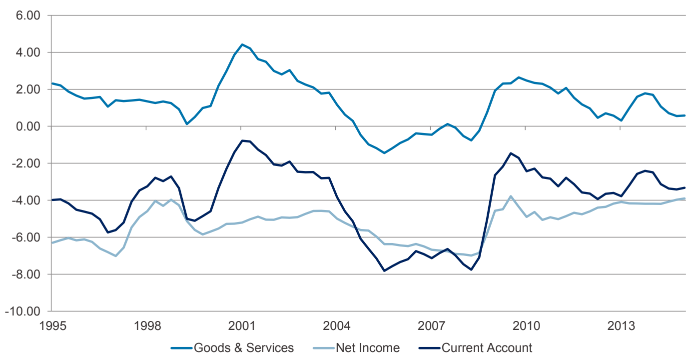
Source: Statistics New Zealand and AMP Capital

REDUCED IMBALANCES SHOW WE'RE IN PRETTY GOOD SHAPE

Aside from cyclical considerations, we are also keeping an eye on our internal and external imbalances for signs of our structural well-being. The two key imbalances – the current account of the Balance of Payments and the Government's fiscal balance – both indicate New Zealand is in pretty good shape.

While a current account deficit tells we are not saving enough to fund our various investment needs, the most recent read on our position compares favourably with history. The deficit of 3.3% of GDP in the year to September compares with a historical average of 3.7%. The deficit is holding in better than we thought it would at this stage of the cycle, helped most recently by the strong tourism sector boosting service export earnings. We continue to believe the deficit will increase from here, but we continue to pare back the extent to which we think it deteriorates. Also, continued better-than-expected deficit out-turns has led to continued improvement to our ratio of net external debt to GDP, which at 56.1% is low by historical standards and is on a downward trajectory.

CURRENT ACCOUNT BALANCE
Year to date: percent of GDP



Source: Statistics New Zealand

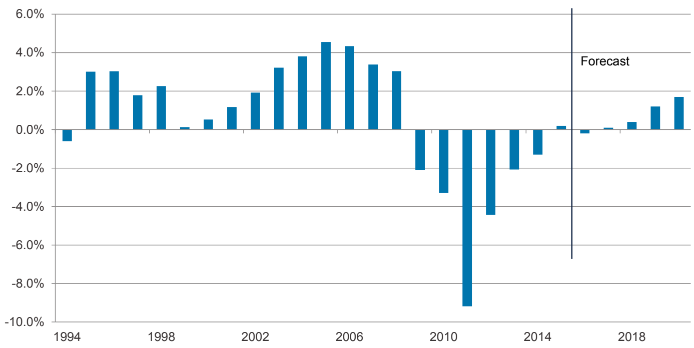
The Government's accounts are also in pretty good shape. The elusive surplus in the operating balance was achieved in the 2015 fiscal year (FY). This is a more than creditable turnaround following the deep deficits resulting from the GFC and the Canterbury earthquakes.

The surplus may well prove short-lived. The Treasury's latest projections sees a return to a small deficit in the current financial year, then a return to rising surpluses from FY 2017.

THE LOWER OPERATING BALANCE FORECASTS ARE LARGELY THE RESULT OF LOWER FORECAST GROWTH IN NOMINAL GDP.

Exactly when the Government moved back into surplus was more a game of political rhetoric than anything more meaningful. The important consideration for financial markets and rating agencies is the trend. We have seen, and will likely continue to see, a continued trend improvement in the Crown's accounts. Also the forecast peak in the ratio net public debt to GDP of 27.7% in FY 2017 must be the envy of many of the mature developed economies we tend to compare ourselves to.

FISCAL BALANCE
Operating balance excluding gains and losses



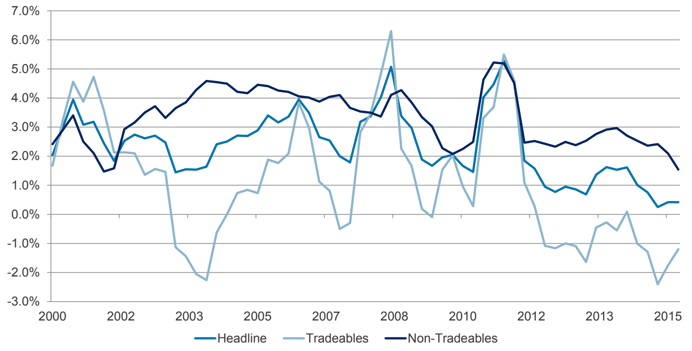
Source: NZ Treasury

INFLATION AND MONETARY POLICY

The lack of inflation in the domestic economy was made even more surprising recently with the upward revision to GDP growth. Statistics New Zealand had previously estimated annual average growth for calendar year 2014 at 3.4% but this has now been revised up to 3.7%. Yet from 3.0% in the year to March 2014, non-tradeables (domestic) inflation has been on a steady downward trajectory. Indeed, the annual rate stood at 1.5% in September 2015, its lowest level in 14 years.

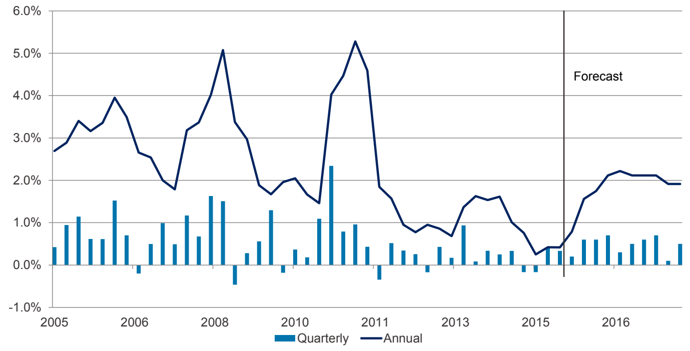
As we've discussed as the year has progressed, much of the lack of core inflation can be sheeted home to the labour market. With much of the increased demand for labour being met by increased supply, wage pressure has remained subdued which has flowed through to a benign inflation environment. Private sector unit labour costs (as measured by the Labour Cost Index) reached a high for this cycle of 1.9% in September 2014 and have since ticked lower.

TRADEABLE VS. NON-TRADEABLE INFLATION
Annual % change



Source: Statistics New Zealand

NEW ZEALAND INFLATION
% change



Source: Statistics New Zealand and AMP Capital

LACK OF GENERALISED INFLATIONARY PRESSURE AND RECENTLY WEAKER GROWTH WHICH HAS OPENED UP NEW SPARE CAPACITY HAS LED TO THE RBNZ REVERSING ALL OF 2014'S INTEREST RATE HIKES. THE OFFICIAL CASH RATE IS NOW BACK DOWN TO THE HISTORICAL LOW OF 2.5%.

We expect inflation to move higher over 2016, although this is largely due to low numbers from a year ago dropping out of the annual calculation and the pass-through of the lower exchange rate into retail prices. The extent to which retailers can pass higher prices on to consumers remains to be seen given the lack of pricing power in the highly competitive retail sector.

At the same time, we expect wage inflation to remain subdued, especially given the lower growth in employment and the expected rise in the unemployment rate. We may see pockets of wage pressure (eg the construction sector in Auckland), but we don't expect those pressures to become generalised.

That lack of underlying inflationary pressure will justify the Reserve Bank's recent interest rate cuts. At the December Monetary Policy Statement the Bank flagged interest rate cuts were done, although comments in the press release kept the door open for further cuts should economic conditions warrant it.

We agree the bias is still towards lower interest rates but will stop short of forecasting that for now. It's certainly the case that if the Bank is to do anything soon it will be another interest rate reduction, but that will depend on the emerging flow of data, the exchange rate...and the weather.

CONTACT US

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