insightpaper

NEW ZEALAND INSIGHTS

DECEMBER 2016

A HOME-GROWN POLITICAL SURPRISE

Little did we know when we first started speculating on political risk around the world in 2016 that the biggest political surprise (at least for us Kiwis) would come from Wellington. As I write the December issue of New Zealand Insights I've got one eye on Bill English's first press conference as New Zealand's 39th Prime Minister.

By virtue of a strong lead in the polls, the National Party is heading into election year as favourite to secure the Treasury benches for a fourth term, a feat last achieved by Sir Keith Holyoake's National Party which won four successive elections between 1960 and 1969 (under the old first-past-the-post electoral system).

The change of leader adds a new level of interest to next year's election campaign. That said, National will enjoy the benefits of the strong economy, low unemployment, low interest rates and, while nominal wage growth has been subdued, strong real wage growth by virtue of low inflation.

After a lot of hard work by the Government, the fiscal cycle is finally turning in its favour with Budget surpluses approaching 3.0% of GDP in 2021, a significant turnaround from the deficit of 9.0% of GDP in 2011. This provides the Government with a whole raft of fiscal choices when it comes to the election-year Budget in May, even allowing for the estimated $2-3 billion repair bill following the Kaikoura earthquake.

BEVAN GRAHAM
NZ Chief Economist

But the National-led Government appears vulnerable on housing, particularly the availability of affordable housing. The not-unrelated issue of immigration, an issue of heightened global anxiety, is likely to be to the fore during the election campaign also.

Regional economic development, an issue that provided considerable traction for New Zealand First leader Winston Peters in his 2015 Northland by-election victory, is also likely to be a hot topic for debate during the election campaign. And inequality, the global political issue du jour, can be expected to feature here too. That is likely to manifest itself as a rigorous debate about what the Government chooses to signal around the disbursement of the rising budget and what other choices the opposition parties would prefer to make.

The good news is that both the main political parties that are likely to form the nucleus of the next Government support the foundations of New Zealand's macro-economic stability. Regardless of outcome, we expect little change in the framework of monetary policy nor the commitment to prudent fiscal management, though the detail of fiscal policy may look different under different governments.

The same set of factors, both positive and negative, are likely to be the driving forces in the economy for the rest of 2016 and into early 2017. This is expected to see growth hold at around the 3.5% level over the next few quarters.

We think this period of growth will be the peak in the cycle. That said, we don't expect growth will be a lot weaker next year. While net migration appears to be peaking, we expect net inflows to remain strong from a historical perspective. Dairy prices are also recovering, with global auction prices up 30% in the last few weeks. But the dairy price outlook remains highly uncertain and it remains to be seen whether the recent improvement can be sustained. In the meantime, we expect annual average growth of 3.1% in 2017, followed by 2.6% in 2018.

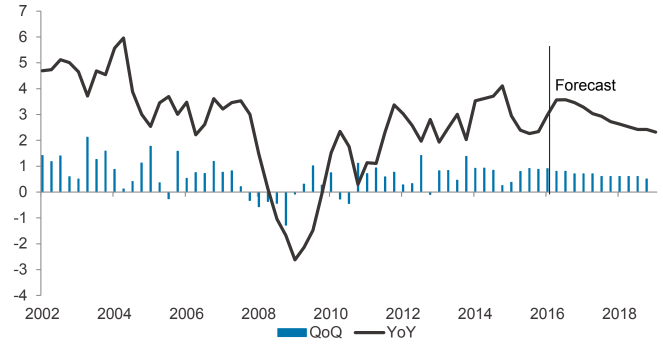
GROWTH LOOKING (MORE) SOLID

Despite the headwinds of weak dairy commodity prices and the strong exchange rate, the New Zealand economy has continued to perform well. GDP growth hit an annual rate of 3.6% in the year to June 2016 as the positives of stronger ex-dairy commodity prices, population growth, tourism inflows and record low interest rates have underpinned solid activity and more than offset the negatives.

We expect growth to slow in the period ahead, though not to the extent nor as quickly as we thought previously. Wholesale milk prices are recovering, and expect the growth impetus from both population gains and residential construction to remain stronger than we anticipated in our last report.

We expect annual average growth of 3.4% in 2016 to be followed by 3.0% in 2017 and 2.5% in 2018. Household consumption continues to be the biggest contributor to growth as low interest rates, strong gains in labour income (jobs plus wages), rising house prices and strong population gains all serve to boost consumer spending. Strong and rising tourism inflows are also supporting the retail sector. Bring on the 2017 Lions tour!

NEW ZEALAND GDP
% change



Source: Statistics NZ and AMP Capital

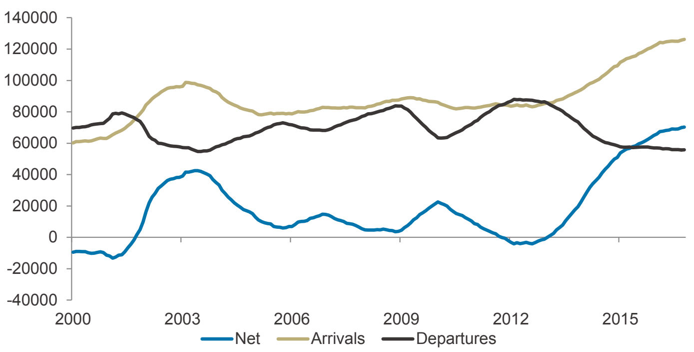
While the recent 40% uplift in wholesale dairy prices is great news, it remains to be seen whether the improvement is sustainable. The improvement is off the back of reductions in supply, though this seems to be more due to short-term (weather) factors than any structural (permanent) reductions.

Furthermore, while the wholesale price recovery has seen an increase in the Fonterra payout for the season being revised up to $6.00 per kg of milk solids, we don't expect this to flow directly into higher farm spending or investment. Recent low prices have seen farmers take on more debt. The more recent boost to prices therefore appears more likely to end up being used to get debt back down to more manageable levels and overdrafts in check, rather than for a spend-up.

NET MIGRATION STILL A KEY SUPPORT

Net migration seems to have got a second wind. In the middle of 2016 it looked like net migration was peaking, but by October we had achieved a new record high of just over 70,000. Population growth now stands at 2.4%, its highest level since 1974.

NZ PERMANENT AND LONG-TERM MIGRATION
Number, year to date



Source: Statistics New Zealand

Recent policy changes are likely to reduce inflows of migrants in the various visa categories, while tighter enforcement of entry requirements for those on student visas will also see net migration slow. But it's the flow of people across the Tasman that remains the biggest swing factor in net migration flows. And that is directly related to the relative performance of New Zealand and Australian economy or, more precisely, the relative performance of the respective labour markets. On that front the New Zealand economy still has the advantage.

The New Zealand economy, and with that the New Zealand labour market, is performing more strongly than Australia. That is likely to see people in New Zealand who may have been anticipating a move to Australia delay their departure for better times across the Tasman. At the same time, those who had already made the move to greener pastures are now seeing a brighter shade of green back in New Zealand.

I would be surprised if the net migration level is able to maintain an annual total of 70,000, but neither do we expect the number to fall away sharply.

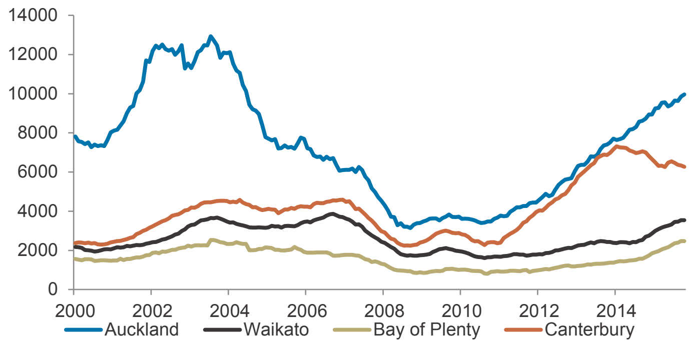
CONSTRUCTION BOOMING

The recent history of the New Zealand housing market has been one of a strong market fuelled by population growth, ultra-low interest rates and an inability for supply to keep up with demand. It's still the same story.

An annual total of just short of 10,000 dwelling permits issued in Auckland for the year to September 2016 is significantly higher than the recent low of 3,400 issued in the year to mid-2011, but still falls short of the estimated 13,000 per annum needed to close the gap.

Auckland's new Unitary Plan is a step in the right direction, but the bigger question is whether the construction sector can run much faster than it already is. Resources are being freed up in Canterbury as the residential construction re-build winds down and non-residential activity peaks, but it's optimistic to assume all that expertise will simply pack their bags and head to Auckland, especially when there's plenty of work to be done in cheaper cities to live in such as Tauranga and Hamilton.

RESIDENTIAL BUILDING CONSENTS
Number, year to date



Source: Statistics New Zealand

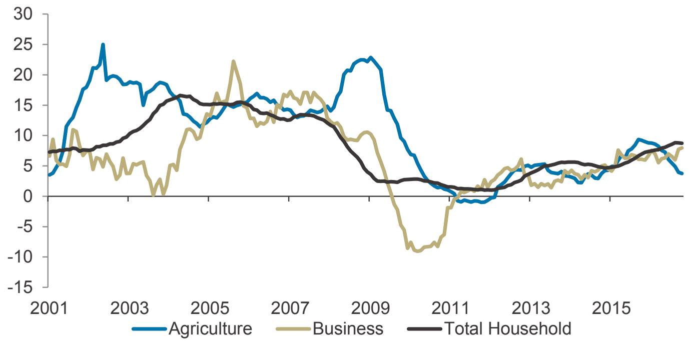
So long as demand continues to out-strip supply, the most basic law of economics tells us that prices will continue to rise. The cautionary note for house buyers is that at some point, the supply demand dynamic will flip back the other way, and we would expect to see some softening in house prices at that time. If you are an aspiring first home buyer, patience may prove a valuable commodity.

Macro-prudential policies have taken the wind out of the sails of the market at various times, albeit temporarily. The most recent round of measures saw a widening of restrictions on investor lending to areas outside Auckland. House price increases seem to be moderating as we head into the end of the year, but it remains to be seen whether this is a seasonal downturn or something more permanent.

STRONGER CREDIT GROWTH

Credit growth has been expanding strongly and is now at its fastest pace since just before the Global Financial Crisis. This growth is strongest in the household sector which shouldn't come as too much of a surprise given the combined strength of the housing market, the labour market and the economy generally. And of course ultra-low interest rates are also a factor.

SECTORAL CREDIT GROWTH
Annual % Change



Source: RBNZ

That said, borrowers are already beginning to face higher borrowing costs even with the Official Cash Rate (OCR) likely to remain on hold for the foreseeable future. Strong credit growth requires strong growth in deposits, which is proving challenging in the low-interest rate environment. That challenge is amplified as banks continue to grow the proportion of funds sourced domestically rather than from potentially more volatile global markets. Indeed, the Reserve Bank of New Zealand (RBNZ) signalled bank funding pressures as one of the medium-term risks to the financial system in its latest financial stability report.

TIME FOR BUSINESS INVESTMENT TO KICK IN

One area where we wouldn't mind seeing some strength in credit growth is in the business sector.

One of the great conundrums for many developed economies has been the weakness in productivity growth since the Great Recession. Our take on this is that it has all been part of an elongated business cycle in which firms have been resourcing the growth in demand for their goods and services with labour. Following a recession labour is typically plentiful and wage growth is subdued.

However, as the cycle matures labour becomes less available, skills shortages emerge and wages start to rise. It's at this point we would expect firms to look increasingly towards investment in plant and equipment to resource the next phase of their growth. Both the United States and New Zealand are closest to this point in the cycle.

NEW ZEALAND BUSINESS CONFIDENCE
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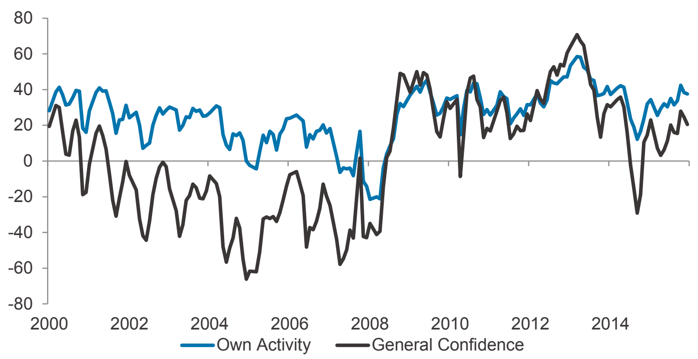


Source: ANZ Bank

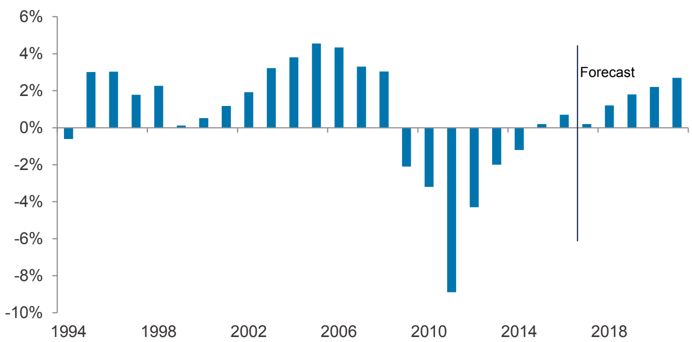
Solid business sentiment supports some uplift in investment in the period ahead. This will go some way towards solving the great productivity paradox. Productivity tends to be weakest when labour is favoured over capital but then benefits in times of greater capital investment. Problem solved? Only time will tell.

FISCAL CHOICES

Sound management of expenditure combined with strong economic growth have combined to generate a significant turnaround in the Crown's accounts. It was only in 2011 that New Zealand ran a budget deficit of 9% of GDP. We now have a set of accounts that are the envy of much of the developed world.

Fiscal surpluses are rising towards 3% of GDP by 2021 and net debt is projected to be below 20% at the same time. It's this set of enviable circumstances that are providing the Government with its much vaunted range of fiscal choices for May's election-year Budget. Those choices include debt repayment, higher spending, tax reductions and the resumption of contributions to the New Zealand Superannuation Fund.

FISCAL BALANCE
Operating Balance Excluding Gains and Losses



Source: NZ Treasury

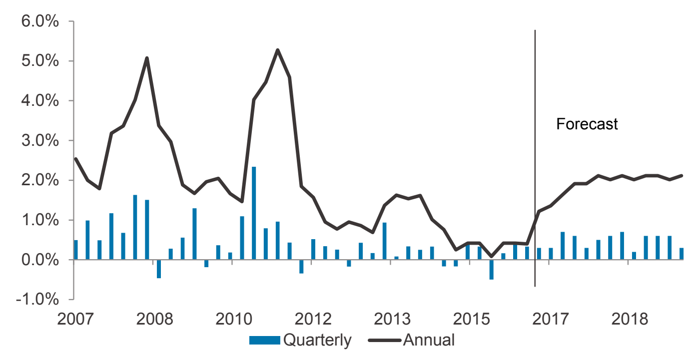
The National-led Government has, over the last few years, become more centre than centre-right. Last year's increase in benefit payments caught the traditional parties of the left somewhat flat-footed in their response to Budget 2016.

That leaves us with an expectation that the choices the Government takes in Budget 2017 might not be the sorts of things you would traditionally expect from the right. Tax cuts, for example, are likely to be lower down the priority list than many might expect.

INFLATION HEADING HIGHER...

Inflation is at the low point in the cycle and is expected to head higher from next year. Annual inflation came in at 0.4% in the year to September, but with a big negative -0.5% dropping out of the annual calculation in December, annual CPI inflation is expected to be back to around 1.0%, the bottom of the RBNZ's target band, by the end of 2016.

NEW ZEALAND INFLATION
% change



Source: Statistics New Zealand and AMP Capital

Getting inflation back to 2%, the mid-point of the target band, is expected to be a more arduous process. While strong growth and the continued absorption of spare capacity will help, we don't expect inflation to be back to 2% until mid-2018.

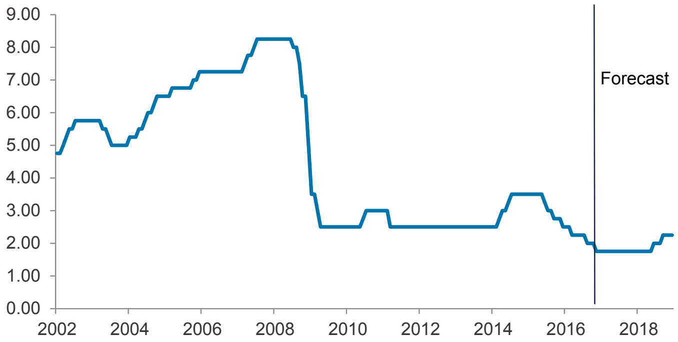
The absorption of spare capacity is most obvious in the fall in the unemployment rate which is now under 5% and heading towards full employment. We are at the point in the cycle where we expect skills shortages to have a more noticeable impact on wage growth and some strengthening of underlying inflationary pressures.

...SO NO FURTHER INTEREST RATE CUTS

The RBNZ delivered the well-flagged and highly anticipated 0.25% cut to the OCR, taking it to a fresh all-time low of 1.75%. The Bank maintained what we would call an 'informal' bias to ease by stating they could cut interest rates further, but there was no 'formal' cut built into their interest rate projections.

Absent a turn for the worse in either or both of the global or domestic economies, we expect 1.75% will prove to be the bottom of the OCR cycle. Above trend growth, rising credit growth and the improving global economic environment all support this being the low point in the cycle.

NZ OFFICIAL CASH RATE



Source: RBNZ and AMP Capital

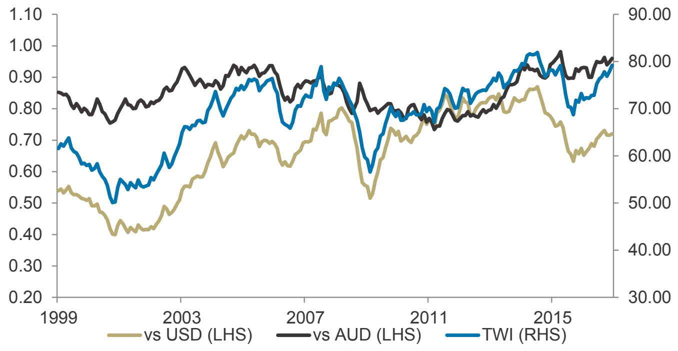
But neither do we anticipate a quick reversal of the interest rate cycle. As has become de rigueur for central bankers, we expect the RBNZ will be prepared to let inflation run hot for a while to ensure the sustainability of its return to the mid-point of the band and to expedite a fast-as-possible repair to damaged inflation expectations.

We expect the OCR will be on hold for all of 2017, with interest rate hikes only starting to be anticipated as we head into 2018.

STILL PLENTY TO SUPPORT THE NEW ZEALAND DOLLAR

The New Zealand dollar (NZD) remains well supported by an economy that is performing well, interest rates that despite recent cuts by the RBNZ are still high by global standards, and more recently by the sharp rise in wholesale dairy prices. All of these factors can be expected to continue to support the currency into 2017.

THE NEW ZEALAND DOLLAR



Source: RBNZ

Against the US dollar (USD), much will depend on the pace of rate hikes by the US Federal Reserve (the Fed) and the path of the USD. The Fed delivered their much anticipated second hike of the cycle in mid-December and revised up the number of expected hikes in 2017 from two to three.

Even adding another hike for next year, we still believe the risks to US interest rates are to the upside, especially if we see an aggressive easing in US fiscal policy under a Trump Presidency. That also means upside risk to the USD, and with that the potential for some downside in the NZD.

Against the Australian dollar it's a different matter. The relative New Zealand/Australia economic performance and monetary policy cycle remain in favour of a strong NZD versus the AUD for some time yet. Indeed, our Sydney-based team sees scope for a further interest rate cut in Australia next year whereas it's increasingly the case that we have seen the lows in New Zealand interest rates.

CONTACT US

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