insightpaper

AMP CAPITAL

NEW ZEALAND INSIGHTS

SEPTEMBER 2015

The New Zealand economy has just come through its weakest six month period since the first half of 2013. The good news is we have seen a significant easing in financial conditions which will support growth in the near term and generate a modest pick-up in activity towards the end of the forecast period.

Since our last report, the negatives for the economy have outweighed the positive. Dairy prices fell sharply before the more recent recovery (albeit on lower volumes), the residential component of the Christchurch reconstruction appears to be peaking, business and consumer confidence have fallen further and the global economic outlook has become somewhat darker. This has brought with it a fair degree of market volatility, which has not helped sentiment.

Offsetting the negatives for the economy are the fact that population growth remains strong as net inward migration continues to rise, and Auckland is replacing Christchurch as the centre of growth for residential construction.

BEVAN GRAHAM

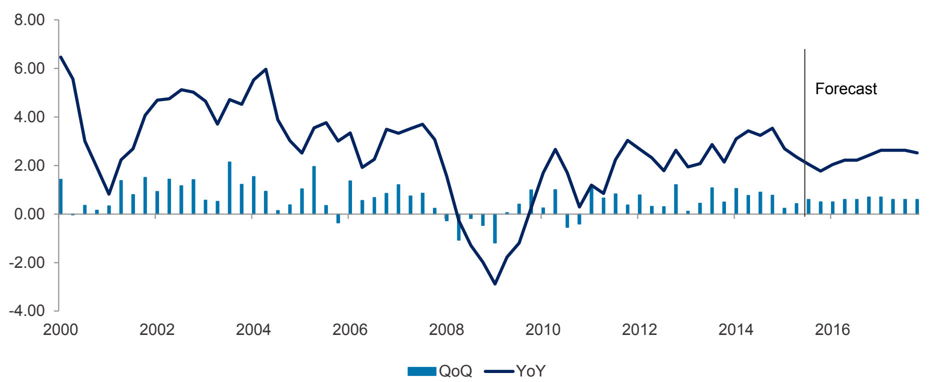
AMP Chief Economist

At the same time, service exports (tourism) are strong, the Reserve Bank of New Zealand (RBNZ) is cutting interest rates and appears likely to cut them further, and the trade-weighted exchange rate is around 15% lower than the peak in April, helping deliver a significant easing in overall financial conditions.

With the economy currently going through a weak patch, we have lowered our growth forecasts and now expect GDP growth of 2.2% in calendar year 2015. We expect 2016 to also come in at 2.2% but we see some modest upside in 2017 to 2.5%. That sounds weak, and it certainly is relative to our recent past, but by developed world post-Great Recession standards we think this still represents a solid performance.

As always there is an abundance of risks, but the two that stand out most are to the downside: global growth could disappoint in the period ahead and there is the risk of a summer drought. The good news is there is scope for monetary policy to respond if those risks materialize.

NEW ZEALAND GDP
% Change



Source: Statistics NZ and AMP Capital

CONSUMERS LESS CHIPPER

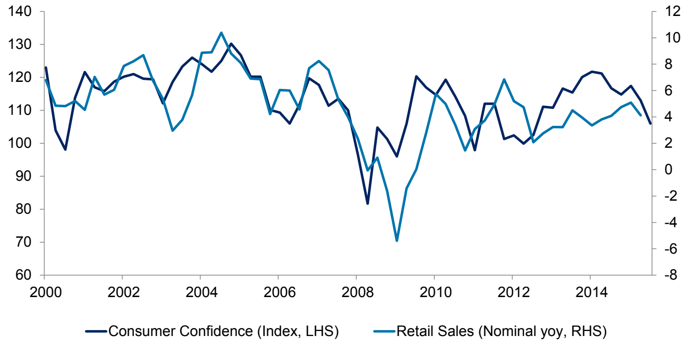
Growth in consumer spending has been relatively healthy recently, largely thanks to the sharp drop in petrol prices, rising employment and robust population growth on the back of strong net inward migration. Healthy tourism flows have also helped retail sales.

Low fuel prices and strong population gains will continue to support consumption in the period ahead, although growth in household incomes can be expected to slow as employment growth moderates and as lower dairy incomes impact on rural New Zealand.

ON THE PLUS SIDE, THE WEALTH EFFECT OF HIGHER HOUSE PRICES WILL HAVE A POSITIVE IMPACT ON CONSUMER ACTIVITY, PARTICULARLY IN AUCKLAND, AS WILL LOWER INTEREST RATES.

The Westpac-McDermott Miller consumer confidence index stood at 106.0 (100 = neutral) in September, well down from the peak of 121.7 in early 2014, but still in optimistic territory. Overall, we expect some moderation in consumption growth ahead but certainly not a collapse.

NEW ZEALAND RETAIL SPENDING

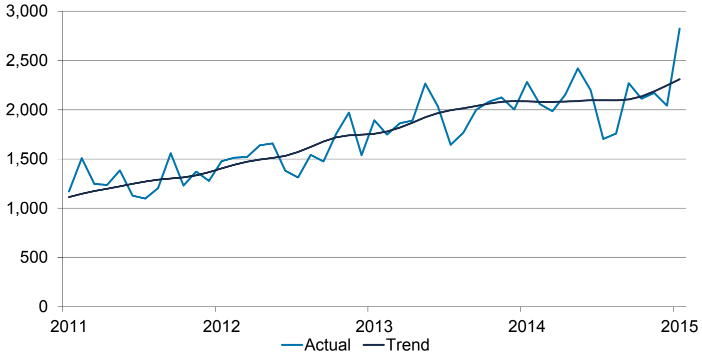


Source: Statistics New Zealand, Westpac-McDermott Miller

RESIDENTIAL CONSTRUCTION – PASSING THE BATON

It appears Canterbury residential rebuild activity has peaked. While that means it won't provide the same upward impetus to growth, it's unlikely to provide a meaningful drag on growth for a while as activity remains at a high level. At the same time, however, activity in the Auckland residential construction market is strengthening and will provide fresh impetus to growth.

NEW ZEALAND DWELLING PERMITS
Number/month



Source: Statistics New Zealand

Sharply rising house prices in Auckland are problematic but remain a function of supply and demand dynamics in that market. The Government is using a range of measures to ameliorate the risk to the financial system of unsustainably high house prices. Work is being done to address supply issues but these will take time to have an impact. In the meantime, the RBNZ has tweaked its Loan to Value Ratio (LVR) rules and the Government announced a number of measures in the 2015 Budget to try and address the imbalance in the meantime.

WE CONTINUE TO BELIEVE AUCKLAND HOUSE PRICES ARE NOT A BUBBLE, AS THIS SUGGESTS AN INEVITABLE CATASTROPHIC BURST OF THE BUBBLE AT SOME POINT.

But buyers need to be aware that current supply and demand dynamics will eventually turn as net migration inevitably slows, and possibly reverses, and as a greater supply of housing in Auckland eventuates, the combination of which could see average prices fall.

BUSINESS SECTOR IN GOOD SHAPE, IF NOT GOOD HEART

Business confidence has been falling, indicating the business sector is not in as good heart as it was just a few months ago. Lower export commodity prices and concerns about the state of the global economy (more precisely Australia and China) have taken their toll.

HOWEVER, WE BELIEVE THE NEW ZEALAND BUSINESS COMMUNITY REMAINS IN SUFFICIENTLY GOOD SHAPE TO WEATHER MUCH OF WHAT GETS THROWN AT IT.

The New Zealand Institute of Economic Research's quarterly business confidence index peaked at +53 (0 = neutral) at the end of 2013 and has since dropped back to +5 as at June 2015. The earlier strong level of confidence along with the low cost of capital and the strong exchange rate, which kept the cost of imported capital equipment low, contributed to a relatively robust pickup in business investment.

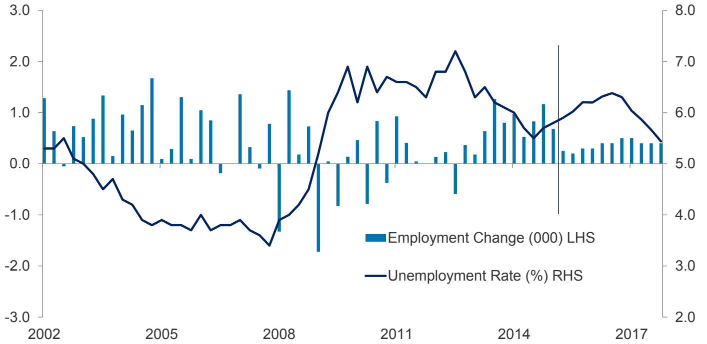
Along with the recent increase in labour supply, the recovery in business investment has been a contributing factor to rising potential (non-inflationary) GDP growth and resultant low domestic inflationary pressures.

While interest rates are falling again, business confidence is well off its highs and the recent decline in the exchange rate is increasing the cost of imported goods. Further, with GDP growth slowing spare capacity may open up in some businesses, reducing the urgency for new plant and equipment. Looking ahead, we expect growth in business investment to slow but to remain positive.

THE LABOUR MARKET AND NET MIGRATION

After peaking at 3.6% in the year to December 2014, employment growth has since slowed to 3.0% in the year to June. Given the weaker near term growth environment, we expect growth to remain positive but decline further to around 1.0% by early 2016.

NEW ZEALAND LABOUR MARKET



Source: Statistics New Zealand and AMP Capital

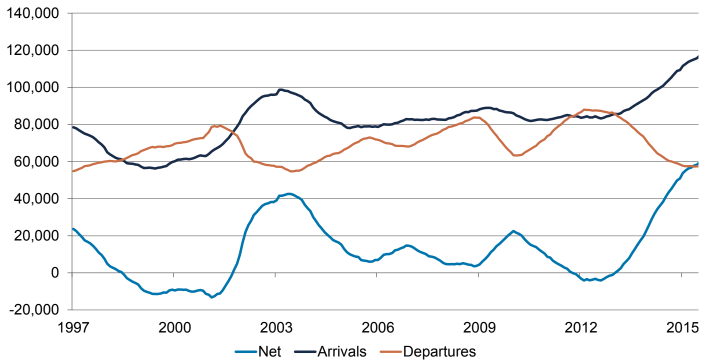
Despite the recent strong growth in employment the unemployment rate has remained elevated, and in fact rose in the last two quarters to currently stand at 5.9%. Rising unemployment has been a function of the significant growth in the labour force. That has in turn been the combined effect of strong net inward migration and a record high participation rate. The latter is a sign of a well-functioning labour market and is in stark contrast to countries such as the United States where the recent decline in the participation rate suggests there is still work to be done before the US labour market is fully repaired.

LABOUR SUPPLY GROWTH HAS KEPT WAGE AND UNIT LABOUR COST INCREASES SUBDUED.

Annual increases in the Labour Cost Index, a measure of unit labour costs, have not yet breached 2%, the level that would be consistent with 2% inflation. And neither does it look like doing so any time soon.

While employment growth is now slowing, net inward migration continues to reach new highs. Year-to-August permanent and long term migration net inflows reached 60,000. That's 1.3% population growth, though more for Auckland, given that's where a large number of migrants choose to settle.

NZ PERMANENT AND LONG TERM MIGRATION
Number, year to date



Source: Statistics New Zealand

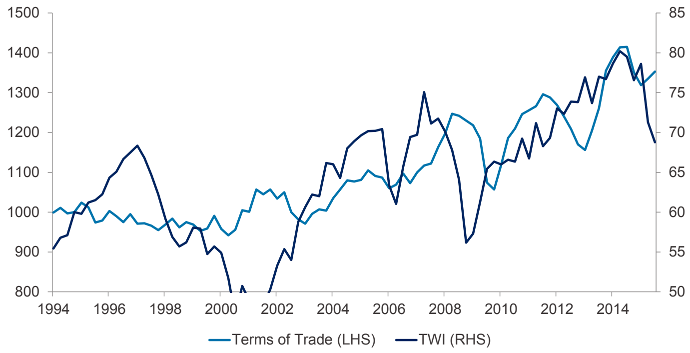
The combination of still rising supply and slowing employment growth means further upside the for the unemployment rate. We now see unemployment rising to 6.4% by early 2016 before heading lower again as growth picks up and net migration slows.

EXTERNAL SECTOR AND THE EXCHANGE RATE

It has been a roller-coaster ride for dairy prices since our last report. In June prices were coming back off the mini drought-induced bounce in prices we saw in the first quarter of the year. Between June and early August the decline accelerated. At that point the peak to trough decline was a whopping 65%.

Subsequently we have seen a sharp recovery in prices. In the three auctions since the low point in August prices have risen a cumulative 48%. Some of that improvement reflects lower volumes being offered at auction, but longer-dated futures prices have also improved which probably reflects Fonterra signaling lower production this year and the growing risks of an El Nino weather event.

NZ TERMS OF TRADE AND THE TWI
Index



Source: Statistics New Zealand, RBNZ

Our near term forecasts for the terms of trade have been on the same ride as dairy prices. At one point we were looking at a peak to trough decline of around 20% which we have since pulled back to around 8-10%. So we are back to the story of a modest decline in the terms of trade which we see remaining at close to historical highs.

At the same time, the current account deficit is holding in better than we thought, helped in part by positive (deficit reducing) historical revisions. The annual deficit for the year to June came in at 3.5% of GDP, down a touch from the 3.4% for the year to June. The surprise for us was the improvement in the investment balance reflecting higher earnings from New Zealand's offshore direct investments.

CURRENT ACCOUNT BALANCE
Year to date: Percent of GDP

Source: Statistics New Zealand

Better recent numbers aside, we continue to expect a further deterioration in the deficit from here, although we are paring back that degree of deterioration. While exports are still yet to reflect the full impact of the decline in dairy prices, the recent decline in the exchange rate is a positive for the export sector more generally, especially as global growth picks up next year. On the imports side of the equation, higher prices will have an impact on import values but may result in some degree of import substitution. Volumes will be lower in the near term due to lower business investment and consumer spending.

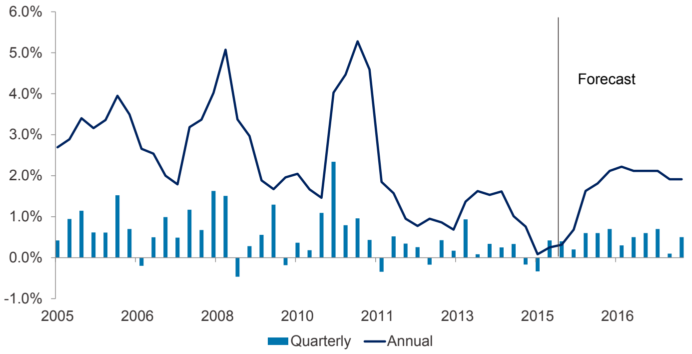
Previously we had the current account deficit deteriorating to around 6% of GDP during 2016. We have now pared that back to around 5% of GDP.

INFLATION: SETTING MONETARY POLICY ISN'T GETTING ANY EASIER

Inflation has remained low with latest data coming in at the end low end of expectations, though in line with RBNZ forecasts. Overall it is the low rate of domestic inflationary pressures that has been the biggest surprise, with non-tradeable inflation now at 2.0%, its lowest level since 2001. The biggest impact there continues to be the significant boost given to the ability of the economy to grow without generating inflation growth from labour supply growth and the recovery in business investment.

We believe headline inflation will be back to the midpoint of the RBNZ's target band by mid-2016, but this will be mostly exchange rate related. Exactly how the transmission of the weaker currency into inflation plays out is yet to be determined. The retail sector is highly competitive so just how much exchange rate impact is passed through to retail price and in what timeframe is open to conjecture.

NEW ZEALAND INFLATION
% Change



Source: Statistics New Zealand and AMP Capital

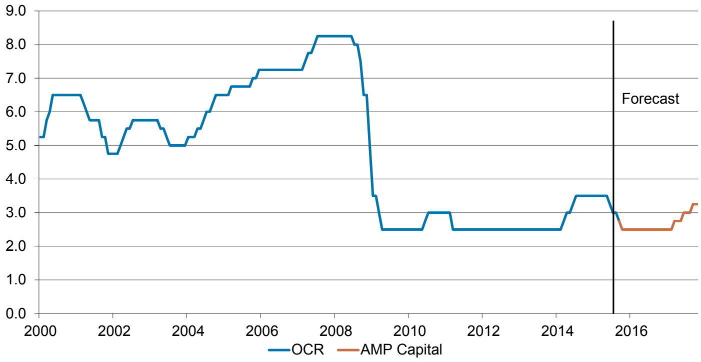
Continued persistently low inflation outcomes combined with the more recent deterioration in the growth outlook has provided scope for the RBNZ to reduce the official cash rate (OCR). The RBNZ has cut the OCR from 3.5% to 2.75% in three consecutive 25 basis points (bps) reductions since June.

> WE BELIEVE THERE IS SCOPE FOR ONE FURTHER 25 BPS CUT THIS SIDE OF CHRISTMAS WHICH WILL TAKE THE OCR BACK TO THE HISTORICAL LOW OF 2.5%.

At this point, we believe the need for more aggressive OCR cuts will be negated by the recent fall in the exchange rate. However, should downside risks such as lower global growth and/or a drought occur, then interest rates will most likely be reduced further.

Further out, as growth begins to recover we think interest rates will need to head higher through 2017. That's because by that stage we believe potential growth will be lower as net migration slows.

NZ OFFICIAL CASH RATE



Source: RBNZ and AMP Capital

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