insightpaper

NEW ZEALAND INSIGHTS

MARCH 2016

The outlook for the New Zealand economy is the extent to which a number of positives for the economy are offset by a number of negative factors. On balance we think another year of modest GDP growth is in store. And with inflation almost disappearing without trace, the RBNZ is cutting interest rates again, with further cuts on the way.

BEVAN GRAHAM
NZ Chief Economist

POPULATION GROWTH AND STRONG TOURISM FLOWS SUPPORT RETAIL SPENDING...

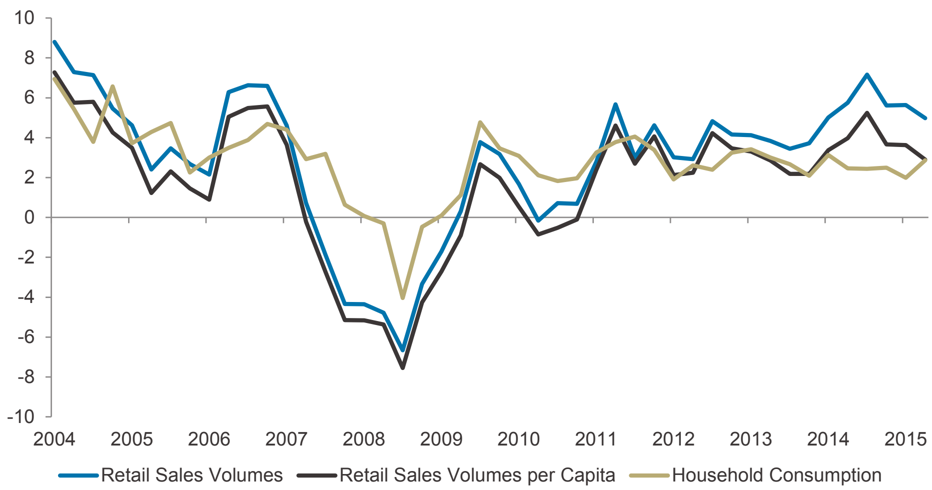
Retail spending remains strong and is a key support for solid underlying growth in GDP. However, this has little to do with growth in household spending. The key contributors to the recent strong spending growth are population growth via net migration and the current high level of tourism flows.

Net migration inflows continue to hit new peaks on a monthly basis, with the annual rate of gain topping 67,000 in the year to February. This represents population growth of 1.5% or a little more than the population of Nelson. Continued setting of new annual records defies our expectation of the last six months that inflows would peak soon.

Tourism flows are strong which is also supporting retail spending. Visitor numbers reached a record three million in calendar year 2015, and there are no signs of that strong activity letting up any time soon.

That means retail spending is not as strong as it looks at first glance. Retail spending volumes were up 5.0% over calendar year 2015, but drops back to 2.9% on a per capita basis. Taking tourism spending out of the mix, real household consumption was up 2.9%, but only 0.8% on a per capita basis.

NEW ZEALAND RETAIL SPENDING
ANNUAL % change



Source: Statistics New Zealand and AMP Capital

There are a number of reasons for that weakness at the household level. While consumer confidence is in positive territory, it has bounced around along with sentiment about the global economy. And while net migration flows have been a significant boost to population growth, it has increased the supply of labour, which has kept nominal wage growth in check. Lower export prices are also impacting negatively on incomes, especially in rural centres. All of these have served to partially offset the benefits of the wealth effect of strong house price gains (in some areas), modest jobs growth, the effective 'tax cut' from lower petrol prices and low interest rates.

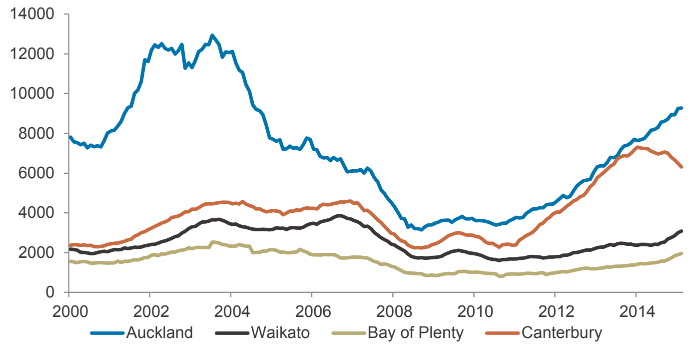
Looking ahead, we expect consumer spending to remain positive but modest in the near term but to pick up when commodity prices recover and as net migration flows (eventually) peak. At that point we expect to see some pick-up in growth in labour incomes through jobs and higher wage growth.

... AND RESIDENTIAL CONSTRUCTION REMAINS STRONG

Residential construction remains a key support for the economy but the centre of growth has shifted north. The Canterbury residential rebuild peaked late last year, and will eventually become a drag on growth as this part of the rebuild winds down.

At the same time, building activity in Auckland has picked up and is providing new impetus to growth. That is being driven by population growth from the high proportion of migrants who choose to settle in our largest city and as Auckland catches up from a number of years of under-investment in housing stock. We expect solid growth in residential construction in the period ahead.

RESIDENTIAL BUILDING CONSENTS
Year-to-date



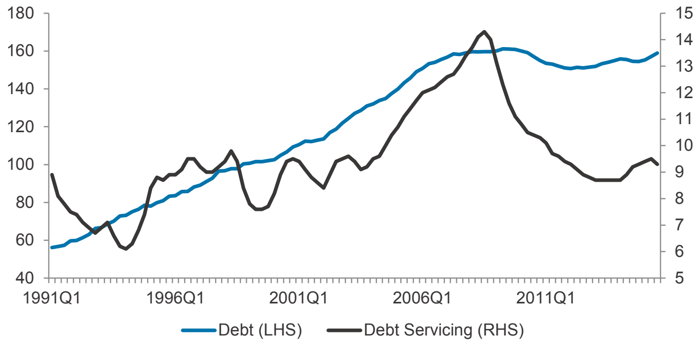
Source: Statistics New Zealand

High growth in house prices, particularly in Auckland, has moderated following the introduction of new rules around investor lending that were introduced in the final quarter of 2015. Whether this proves sustained remains uncertain and only time will tell.

That still leaves Auckland house price unsustainably high and vulnerable to a correction. However, we see nothing on the horizon that could cause a correction, such as a rapid increase in interest rates or a recession that results in significant job losses and unplanned house sales.

That's not to say that house prices can't fall in Auckland. The most likely catalyst for price weakness seems likely to be a reversal of the recent phenomenon of demand outstripping supply. It is not inconceivable that as supply continues to increase, and as net migration peaks and eventually moves lower, we could see supply outstripping demand. That's something to be wary of, especially as New Zealand's household debt levels are on the rise again.

HOUSEHOLD DEBT AND DEBT SERVICING
As a % of disposable income



Source: RBNZ

BUSINESS CONFIDENCE WAXES AND WANES

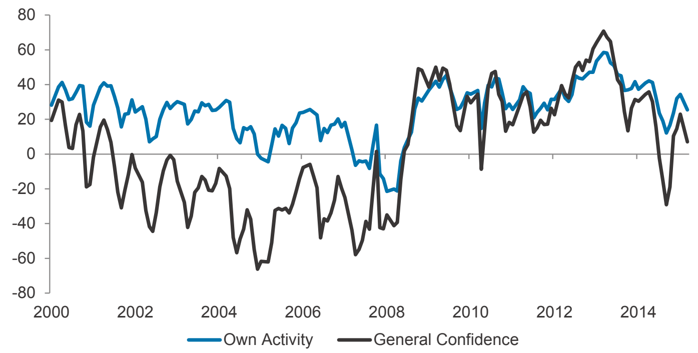
Business confidence took a big dive in the middle of last year as concerns about the global economy, particularly China, reverberated around the world. Confidence then recovered into the end of the year, only to be hit again early in 2016 as we saw renewed fears about the global economy and its financial wellbeing.

THROUGH THIS PERIOD FIRMS' EXPECTATIONS ABOUT THE OUTLOOK FOR THEIR OWN BUSINESSES WERE LESS VOLATILE AND MORE OPTIMISTIC ON AVERAGE.

It's this indicator we rely on more than general confidence to gauge the mood of businesses, as it is most directly aligned to their hiring and investment intentions and indeed the overall outlook for the GDP growth.

The current level of 'Own Activity' optimism seems to us to be consistent with growth that is lower than we saw at the peak of the cycle, but is still consistent with modest employment gains, a pickup in business investment and continued modest GDP growth.

NEW ZEALAND BUSINESS CONFIDENCE
Index



Source: ANZ Bank

DAIRY IS THE BIG HEADWIND (STILL)

In our December issue one of the big potential near-term negatives for the economy was the prospect of a summer drought. While it is certainly dry in some parts of the country, fears of a nationwide hit to agricultural and pastoral production has not eventuated. As drought and output fears mounted we saw some degree of recovery in dairy prices late last year, but as drought fears have receded, so too have prices.

GLOBAL DAIRY TRADE AUCTION
Index

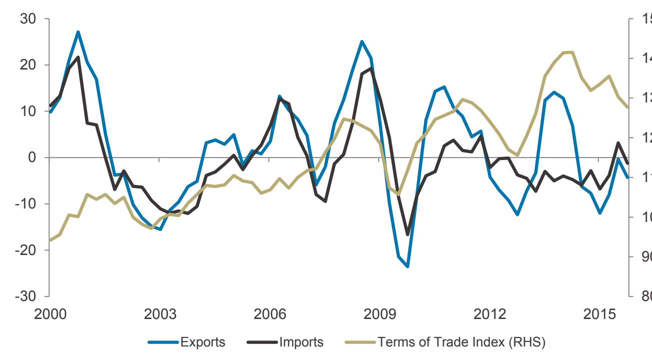
Source: Global Dairy Trade

Low dairy prices are the biggest negative for the economy right now. When dairy prices started their slide in 2013 our judgement was that farmers would cope with one or two years of a low (below break-even) payout. We are now staring down the barrel of a fourth year with no immediate prospect of recovery. This will further dampen rural spending and see some business failures, particularly those with high debt levels.

The dairy story, like the Auckland housing market, is a story of supply and demand. Demand from the key market of China is currently low while the global supply of milk is growing strongly, especially in Europe and the United States. There will be no recovery in prices until the demand/supply imbalance works its way through – and it's impossible to put a timeframe on that.

However, it's not all bad on the export price front. While dairy prices are languishing, prices of other key commodity exports, including forestry, beef and wool, are all holding up relatively well. Add that to the fact that import prices in general remain low in the midst of global deflationary pressures, and prices of our commodity imports (eg oil) are weak, New Zealand's Terms of Trade index has held up relatively well, thus far. Sure the index is down 9.8% from the local peak in mid 2014. That's still a significant hit to our national income, but not as bad as we though it was going to be this time last year.

MERCHANDISE TRADE PRICES
Annual % change



Source: Statistics New Zealand and AMP Capital

The terms of trade will likely fall further in the months ahead as the latest falls in dairy prices are captured along with the recent rise in oil prices. Further out we expect some recovery and for the terms of trade to rise as global growth improves and supply demand imbalances in critical markets are eventually worked through.

GLOBAL GROWTH A DOWNSIDE RISK...AND THE IMPACT ON THE NZD

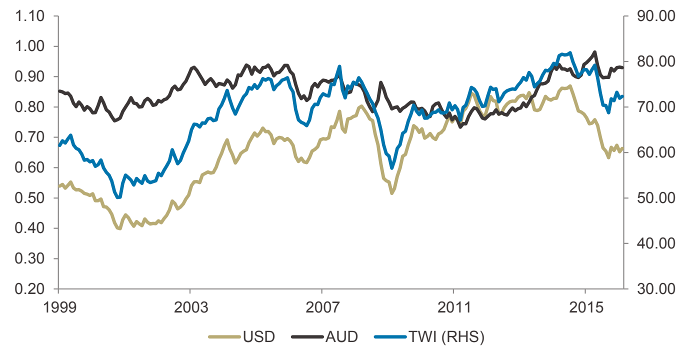
At the start of the year our expectation was we would see global growth of around 3.4% in 2016, up from 3.0% in 2015. As a result of the turmoil in markets at the start of the year, we have revised that back to 3.1%, with the biggest downward revision being to US growth.

That means we can expect no new impetus from global growth this year, but neither do we at this point see it become a negative factor. However, the risks are biased to the downside, including in our key export partners such as China.

The changed growth outlook in the large developed economies has seen a monetary policy response. This was the year in which monetary policy divergence would result from the Bank of Japan (BoJ) and the European Central Bank (ECB) on hold, and with the US Federal Reserve (the Fed) raising interest rates. What a difference three months makes. We are still seeing divergence but with the BoJ and ECB easing further, while the Fed is now likely on hold until the second half of the year.

The New Zealand dollar (NZD) is currently sitting around our fair-value estimate of US0.68 cents, with a number of factors pulling in different directions. The changed interest rate outlook in the United States has seen a reversal of the recent strength in the US dollar, and with that some renewed strength in the NZD.

THE NEW ZEALAND DOLLAR



Source: RBNZ

However, the renewed weakness in dairy prices and the resumption of interest rate cuts from the Reserve Bank of New Zealand (RBNZ) suggests the NZD should be lower. While the Reserve Bank has no influence on the USD, the balance of forces suggests further weakness for the NZD in the period ahead, especially in the second half of the year when the Fed resumes interest rate increases.

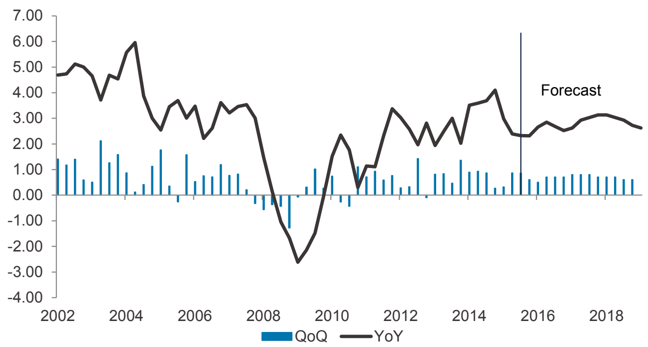
The recent surprise cut to New Zealand's Official Cash Rate (OCR) saw some weakness in the NZD against the Australian dollar (AUD). This is where the RBNZ could arguably have more influence on an exchange rate where relative monetary policy matters more. With the RBNZ likely to cut interest rates further, a further decline in the NZD versus the AUD is likely. That outlook could be upset if the Reserve Bank of Australia were to resume cutting interest rates.

NEW ZEALAND ECONOMY TO DO OKAY IN 2016 – ON BALANCE

The New Zealand economy was growing strongly again at the end of 2015, following a weak patch in the first half of the year as dry weather and low commodity prices hit rural incomes and oil exploration ground to a halt in the face of the falling price of oil. But by the second half of the year the economy was bouncing back, posting growth of 0.9% in each of the September and December quarters. That strong performance was part solid underlying growth but also part catch up from the soft start to 2015. Annual average growth came in at respectable 2.4% in calendar year 2015.

Into 2016 we see the positives of population growth, tourism, construction, low import commodity prices and record low interest rates being partially offset by lower export commodity prices and a benign global growth environment, to deliver another year of respectable growth of 2.6% in 2016. We expect that will be followed by growth of 2.9% in 2017 as global growth and export commodity prices recover.

NEW ZEALAND GDP
% change



Source: Statistics New Zealand and AMP Capital

LABOUR MARKET VOLATILE

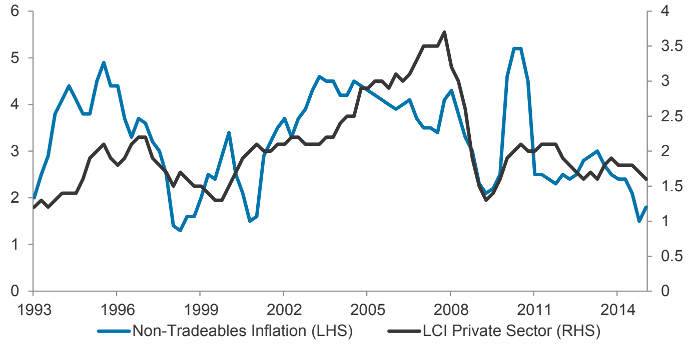
Labour market data at the end of last year showed a significant drop in the unemployment rate from 6.0% in September to 5.3% in December. On the surface that suggests a considerable reduction in the amount of slack in the labour market over a three month period and something the RBNZ should be concerned about.

IT'S NOT THAT THE LABOUR MARKET IS VOLATILE – IT'S THE DATA. WITH SO MANY MOVING PARTS AND LIKELY MEASUREMENT ERRORS THAT ARE INHERENT IN ALL SURVEYS, IT'S SOMETIMES HARD TO GET A HANDLE ON EXACTLY WHERE THE LABOUR MARKET IS.

The way we think about this is the unemployment rate of 6.0% in September last year probably overstated the weakness in the labour market, while the reading of 5.3% in December more than likely overstates its strength. Somewhere in the middle is probably more correct.

One thing we know for sure is that there is still some slack in the labour market. That's because wage growth remains benign and unit labour costs are drifting lower. That continues to be a function of the strong growth in the supply of labour via net migration inflows and a rising participation rate, at a time when employment growth has also been strong. This has been the primary reason for low domestic inflationary pressures.

INFLATION AND THE LABOUR COST INDEX
Annual % change



Source: Statistics New Zealand

We believe employment growth is currently running at around 1% per annum and that the next read on the unemployment rate will find a balance somewhere between the two most recent readings. Looking ahead, as GDP growth picks up into 2017 we expect employment growth will also recover, and it's at that point we will start to see some upward pressure on inflation from the labour market.

INFLATION NON-EXISTENT

Headline inflation is currently sitting at 0.1% for the year to December. This is not only well below the RBNZ's target of 2%, but also below the bottom end of the target range of 1-3% where it has been ensconced since the end of 2014.

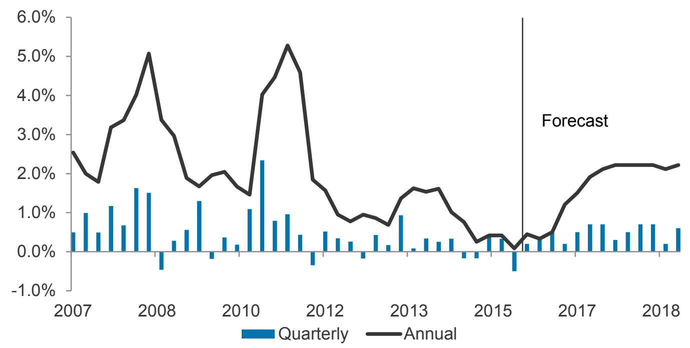
There are a number of factors at play. The first is the low price of oil and the flow through to retail petrol prices. Theoretically, the RBNZ should look through price changes in volatile commodity prices. However, with oil now low for so long here has been a flow through into more generalised disinflationary pressures.

Of course inflation is low everywhere – most major developed and some emerging central banks are struggling with low inflation. That's because many of the disinflationary forces are global, as growth struggles to move back to its historical trend and as all commodity prices remain low.

Some of the reason is also domestic. Competition, especially in the important retail sector has remained intense which means the expected flow through to retail prices of the lower NZD hasn't eventuated. And of course there is also the impact of low wages.

Our current inflation forecasts only start flirting with 1% at the end of the year and not reaching the 2% target until late 2017.

NEW ZEALAND INFLATION
% change



Source: Statistics New Zealand and AMP Capital

RBNZ CUTS … MORE COMING

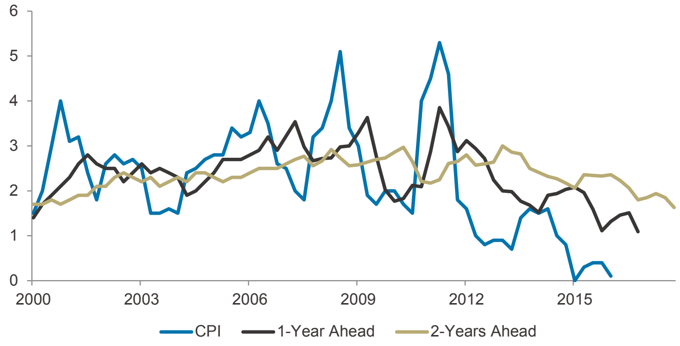
The question for the Reserve Bank as it went into its March meeting was the extent to which they thought further cuts to interest rates would help them achieve their inflation target, especially in light of the global nature of the disinflationary forces at play, without boosting housing market activity and undermining financial stability.

IN THE END, THE RBNZ OBVIOUSLY DECIDED THAT LOWER INTEREST RATES WOULD HELP AS THEY CUT THE OCR TO NEW RECORD LOW OF 2.25%.

Global growth uncertainty, declining terms of trade, the recent renewed strength in the NZD high currency, and of course low inflation itself, all played a role in that decision.

The final straw appeared to be the recent drop in inflation expectations. Expectations matter in that if survey respondents think inflation will remain below target that will influence things such as wage setting behaviour and ultimately make it harder for the central bank to achieve its target.

INFLATION EXPECTATIONS
Annual % change



Source: Reserve Bank of New Zealand

We did think that if the RBNZ cut again they wouldn't stop at one. Indeed, they flagged another 0.25% cut is on the way in either April or June. And they may not stop there. Given the importance the RBNZ is placing on inflation expectations, they could keep cutting until expectations at least stabilise. In that case, an OCR of below 2% is entirely possible.

CONTACT US

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