> INVESTMENT STRATEGY & ECONOMICS

AMP CAPITAL

New Zealand Insights

MARCH 2015

HIGHLIGHTS

- One of the key developments of 2014 was the divergence in growth among the key developed economies. In New Zealand the outlook is for growth to remain solid at just ahead of potential. Page 2.
- Business confidence is off its highs but remains at relatively strong levels. Business investment will remain a key contributor to growth in the period ahead. Page 3.
- Lower fuel prices continue to impact on the headline inflation rate and current forecasts show the annual rate remaining below 1% throughout 2015. Page 4
- Further reductions in the unemployment rate will likely lead to higher wage inflation next year. Page 5
- We don't believe the RBNZ need to lift rates this year, but the next move is still likely to be up, sometime in 2016/17. Page 6
- Global interest rates are expected to remain low for some time. This should support the broad New Zealand equity market as it is relatively high yielding. Page 7

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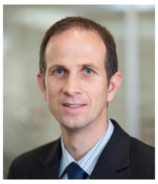

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New Zealand Outlook

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Growth looking stronger for longer

One of the key developments of 2014 was the divergence in growth among the key developed economies, with growth in the United States and the United Kingdom easily outpacing that of the Eurozone and Japan. New Zealand was in the fast growth club last year, membership of which we expect will be maintained over the next two years.

As always there are pluses and minuses to the growth outlook, as well as the occasional revision to the starting point for our forecasts. Recent revisions to historical GDP growth paint a picture of somewhat less robust growth than originally reported during 2014. Annual average GDP had been originally reported at 3.5% for the year to June 2014 but revisions knocked that back to just under three percent.

The only good news about that was it helped provide at least part of the answer to the puzzle of persistently low inflation in the face of growth that had been initially reported as well above its non-inflationary potential. So part of the answer is that growth hasn't been as strong as we initially thought it was.

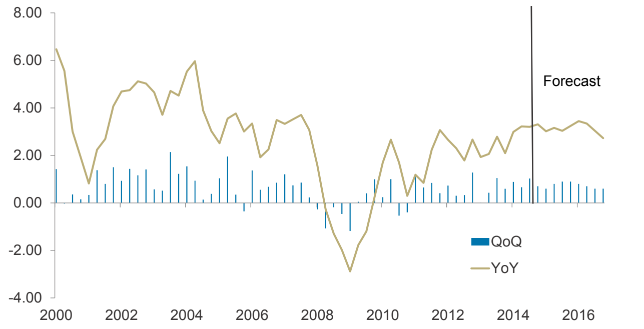
THE OUTLOOK IS FOR GROWTH TO REMAIN SOLID AT JUST AHEAD OF POTENTIAL. BUT IT LOOKS SET TO REMAIN A STORY OF TWO HALVES, WITH STRONG DOMESTIC ACTIVITY WHILE THE EXTERNAL SECTOR CONTINUES TO FACE HEADWINDS.

The pluses will continue to be residential construction (particularly in Christchurch and Auckland), population growth via net migration, still relatively low interest rates, and strong business investment on the back of robust confidence and the low cost of capital. Other pluses are strong consumption growth underpinned by strong employment growth and higher real incomes as headline inflation approaches zero and, further out, accelerating average trading partner growth.

The minuses will be the still strong New Zealand dollar (NZD), especially against those currencies where central banks are easing monetary policy such as the Eurozone, Japan and Australia, fiscal drag as the Government continues to keep fiscal conditions tight in pursuit of fiscal balance, the drought and lower dairy prices.

That mix of factors has the New Zealand economy set to maintain growth of around 3% per annum for the next two years. Compared to our previous forecasts that means we see 3% growth being maintained for longer as interest rates remain on hold for a period of time and we see a more muted than expected decline in the terms of trade. We expect annual average growth of 3.1% in 2015 followed by 3.2% in 2016. The cycle then turns down further out as interest rates rise further, we pass the peak in the Canterbury rebuild and the migration cycle turns.

New Zealand GDP % change



Source: Statistics New Zealand and AMP Capital

The economy is working

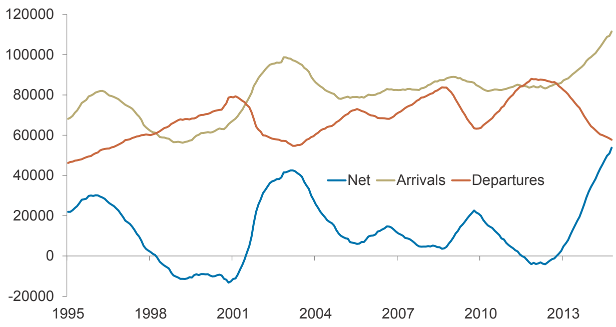
Annual employment growth was 3.5% in calendar year 2014. The strength of the labour market is further underlined by the fact the growth has been driven by full-time jobs with growth of 3.8% over the year. Close to a third of the new jobs over the year were in the construction sector.

The unemployment rate ticked higher at the end of the year to 5.7% but remained lower than it was at the start of the year. We are not reading anything negative into the move higher. The growth in the jobs is coinciding with strong growth in the labour force as strong net inward migration boosts the working age population.

Net migration reached a fresh year-to-date peak of 53,797 in January 2015, up from 50,922 in the year to December 2014. The total appears likely to head higher over the next few months with a peak of 60,000 not unreasonable.

THE NET INFLOW CONTINUES TO REFLECT NEW ZEALAND'S STRONG RELATIVE ECONOMIC AND LABOUR MARKET PERFORMANCE, ESPECIALLY COMPARED WITH AUSTRALIA.

New Zealand permanent and long term migration
Number, year to date



Source: Statistics New Zealand

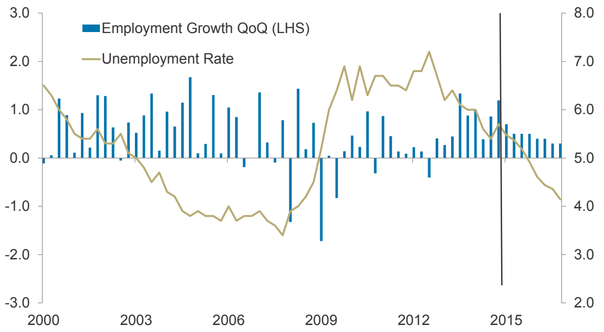
At the same time the participation rate is rising, itself a sign of a healthy well-functioning labour market. The participation rate is now at 69.7%, its highest level in the history of the Household Labour Force Survey.

Wage inflation remains benign with the Labour Cost Index (wages adjusted for gains in productivity) for all salary and wage earners up 1.8% over the year. This has been another contributing factor to surprising low inflation outcomes recently. It's the direct result of strong employment growth currently being met by the rising supply of labour.

WE EXPECT EMPLOYMENT GROWTH TO REMAIN STRONG OVER 2015 GIVEN STRONG GROWTH IN THE ECONOMY AND POSITIVE EMPLOYMENT INTENTIONS.

That will lead to a further trend decline in the unemployment rate which we see just under 5% by the end of 2015. As the unemployment rate moves lower we expect upside wage pressures to emerge.

New Zealand labour market



Source: Statistics NZ and AMP Capital

Household spending well oiled

Retail sales volumes recorded a whopping 1.7% increase in the final quarter of 2014, the eleventh consecutive quarterly increase. The annual rate of growth reached 5.5% at the end of the year. Strong population growth, strong employment growth, modest wage increases, low interest rates, robust consumer confidence and, more recently, lower petrol prices are all conspiring to support strong growth in household spending.

All of those factors will continue to support consumption growth in the period ahead. Indeed, in the near term we expect higher private consumption on the back of declines in fuel prices to provide some offset to GDP growth from the impact of the drought. Consumer durables also look set to grow more strongly as residential construction remains strong. We expect growth in private consumption to peak later this year at around 4.5% before heading back towards 3% in 2016.

One thing to keep an eye on is levels of consumer credit. High consumer confidence and low interest rates can be a dangerous combination, although latest credit data from the Reserve Bank isn't flashing red yet.

Housing's second wind

The housing market got a second wind at the end of last year. It seems reasonable to assume that part of that was related to the September election and uncertainty about the tax treatment of residential property. With that uncertainty out of the way an element of catch-up activity ensued.

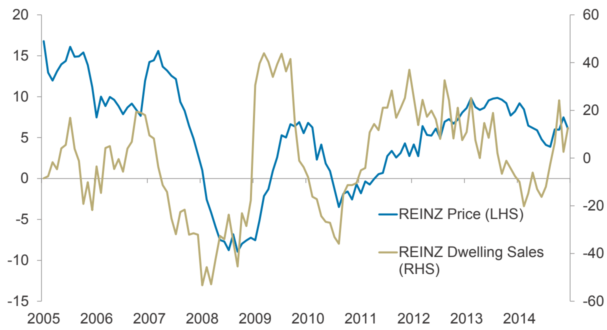
RESIDENTIAL BUILDING ACTIVITY REACHED A SEVEN YEAR HIGH IN THE DECEMBER QUARTER OF LAST YEAR.

Activity remains strongest in those areas where the supply/demand imbalance is greatest. Construction activity is strong in Christchurch where the earthquake reconstruction effort is ramping up and in Auckland where population growth is strongest. While Christchurch reconstruction will likely peak soon, strong demand in Auckland along with efforts to unlock supply will continue to see string residential construction underpin GDP growth for some time yet.

Activity in the existing home market has been a bit volatile over the last few months. Data from the Real Estate Institute of New Zealand shows the number of sales up strongly straight after the election, a slump in January followed by a recovery in February. Looking through the volatility, sales are up 13% between September 2014 and February 2015, a healthy level of growth.

House prices are up 6.1% over the year to February with the strongest gains centered in Auckland where the supply/demand imbalance is greatest. That's not a problem that is going to be resolved anytime soon, so we wouldn't be surprised to see a further increase in the rate of house price appreciation this year. In the absence of an ability to raise interest rates, the Reserve Bank of New Zealand (RBNZ) may rely on greater use of its macroprudential tool-kit to take some heat out of the market.

New Zealand housing market



Source: REINZ

Business investment

Regular readers will recall one of the important factors we were watching for from an inflation perspective this cycle was the extent to which businesses would resource higher demand for their goods and services from capital (investment) rather than an over-reliance on labour as we saw in the previous cycle.

As it has turned out, business investment has been strong over the last couple of years with growth in plant and machinery up 4.7% in 2013 and an estimated 7.0% in 2014. That's the result of strong business confidence levels and the relatively low cost of capital.

HIGHER INVESTMENT HAS INCREASED THE ECONOMY'S POTENTIAL TO GROW WITHOUT GENERATING INFLATION.

That has in turn reduced pressure on the labour market. In previous cycles with a higher cost of capital businesses have relied more heavily on labour which has led to strong jobs growth but also skills shortages, upward pressure on wages and inflation. This cycle we are seeing a better balance between capital and labour.

Business confidence is off its highs but remains at relatively strong levels. Our expectation is that business investment will remain a key contributor to growth (and potential growth) in the period ahead.

External sector and the exchange rate

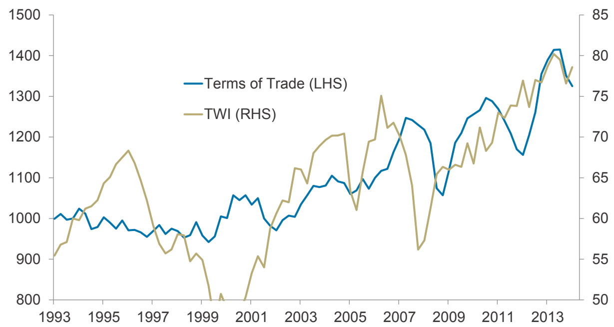
After reaching its highest level in 40 years in the middle of last year, the terms of trade have now declined 6.4%. Dairy prices have been the main contributor to the decline, however the overall index has been holding up better than expected. That's thanks to firm prices for many of our other important export commodities including meat, aluminium and forestry.

Weaker oil prices have also been a key offset, keeping increases in overall import prices subdued despite the weaker exchange rate. Prices have been rising for transport equipment and mechanical machinery. Higher machinery prices may be a reason to temper our expectations of business investment in the period ahead.

Since December oil prices have recovered and dairy prices are also higher, although the latter won't be captured in the terms of trade until the June quarter. Right now it appears the worst of the decline in the terms of trade is behind us, which will likely see the index stabilise at what is still a historically high level.

So while the NZD remains high, especially on a trade-weighted basis, the high terms of trade will continue to provide support.

New Zealand terms of trade and the TWI Index



Source: Statistics New Zealand, RBNZ

We see further downside for the NZD versus the US dollar (USD), but that's a USD strength story as the US Federal Reserve gets closer to raising interest rates. The NZD dollar looks set to remain high against the euro, the yen and the Australian dollar as central banks in the Eurozone and Japan pursue quantitative easing and the Reserve Bank of Australia maintains an easing bias in the face of below trend growth. That means the Trade Weighted Index (TWI) looks set to remain high by historical levels.

THE STRONG TWI WILL REMAIN A HEADWIND FOR EXPORT VOLUME GROWTH.

Drought conditions will also have a near term negative impact on dairy export volumes. On a more positive note, we see average trading partner growth trending higher over time. On balance, we see export volumes expanding at around 3.0% per annum over the next three years.

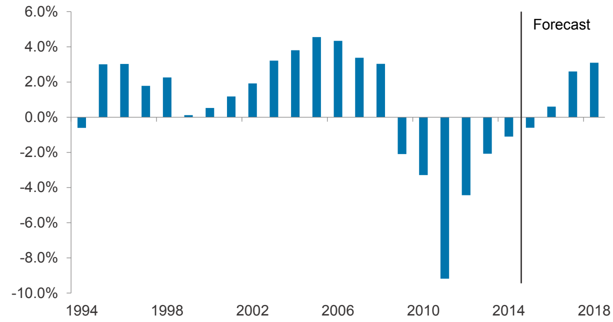
On the import side of the equation, we expect stronger growth as the growth in the economy overall remains biased towards the domestic sectors. Strong business investment and household spending will likely see import volumes expand at an average 4.0% per annum over the next three years.

Over that projection period we expect a gradual deterioration in the current account deficit from the current low of 2.6% of GDP to 6.0% of GDP in 2017.

Fiscal outlook

Fiscal policy looks set to remain a drag on economic growth for the foreseeable future. The Government remains committed to achieving fiscal surplus, although the Half Year Economic and Fiscal Update (HYEFU) shifted the goalposts with latest Treasury forecasts showing the first surplus in 2016/17, one year later than forecast in last year's Budget. That was off the back of the persistent shortfall in the tax-take over 2014 which saw the Government delay $1 billion in new policy initiatives until 2017.

Fiscal balance
Operating balance excluding gains and losses



Source: NZ Treasury

Whether surplus is achieved this year or next is of no great economic importance, although missing the target will cause some political embarrassment and challenging questions in the House.

WHAT'S MORE IMPORTANT IS THE TREND IN THE OPERATING BALANCE, WHICH IS ON A CLEAR IMPROVEMENT AND THE RATIO OF NET DEBT TO GDP WILL SOON PEAK.

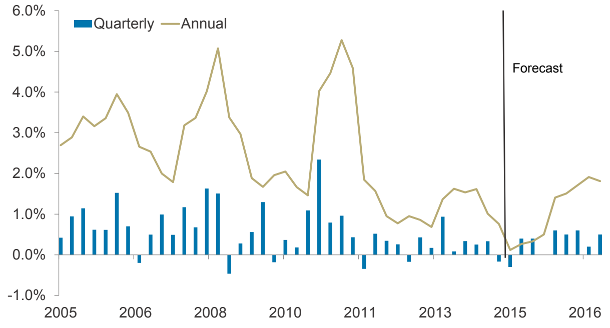
In short, New Zealand's Crown accounts are in pretty decent shape. That would be welcome news for any country, but especially for a small, open and vulnerable South Pacific nation such as ourselves.

In terms of the impact of the Government's fiscal stance on GDP growth, the Half Year Economic and Fiscal Update (HYEFU) shows the fiscal impulse remaining negative over the forecast horizon.

Inflation and monetary policy

The annual rate of inflation fell to 0.8% in the year to December 2014, back under the bottom end of the RBNZ's 1-3% target band. It will head lower in March as lower fuel prices continue to impact on the headline inflation rate and our current forecasts show the annual rate remaining below 1% throughout 2015.

New Zealand inflation % change



Source: Statistics New Zealand and AMP Capital

Inflation had already been tracking lower than expected even before lower petrol prices added a fresh layer of disinflationary pressure. While the downward revision to GDP helped explain some of the lack of inflation, other important factors are at play. Low global inflation and the recent strength in the exchange rate are still flowing through to lower prices of tradeable goods, strong business investment has added to the economy's potential to grow without generating inflation, and recent strong net inward migration has added to the supply of labour and which is in turn helping keep wage pressures in check.

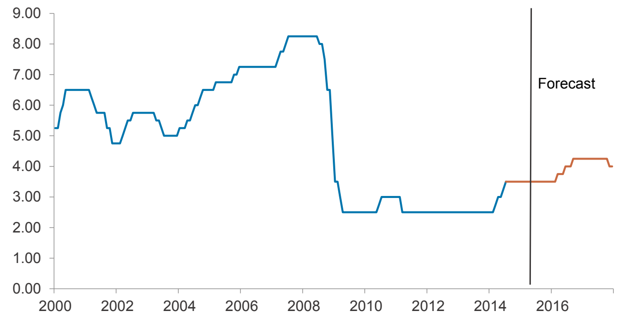
WHILE LOWER THAN TARGET INFLATION MAY BE CAUSING THE RBNZ SOME DISCOMFORT, THERE IS NOT MUCH THEY CAN DO ABOUT IT.

They can't cut interest rates given the strength in the housing market and signs of rising capacity pressures, even though that is ot yet reflected in consumer prices.

Nor should they do anything about it. The dip lower on the back of weaker oil price will prove transitory. The RBNZ should look through that in the same way they should look through price shocks to the upside as will happen once oil prices begin to rise again.

In the meantime the RBNZ has adopted a neutral stance. The March Monetary Policy Statement was accompanied by no change to the Official Cash Rate at 3.5% and showed a projected interest rate track that is now completely flat, reinforcing its neutral stance. That said, the interest rate projections are one year shorter than normal, lopping off the year in which we thought they would show a further modest increase in interest rates.

New Zealand Official Cash Rate



Source: RBNZ and AMP Capital

However it remains our expectation that we will still need higher interest rates from current levels. Growth, while off its peak, is still expected to remain ahead of potential. Key measures of capacity continue to tighten, in particular further reductions in the unemployment rate will likely lead to higher wage inflation next year. But right now the RBNZ is ahead of the curve with higher interest rates a story for next year.

New Zealand Fixed Income

GRANT HASSELL

Head of NZ Fixed Income

WARREN POTTER

Senior Portfolio Manager,
NZ Fixed Income

Global fixed income markets continued to look at the weaker growth outlook, low inflation and Euro quantitative easing as a reason to push bonds yields lower. Within the last three months there have been around 20 central bank easings, with the most dramatic being the releasing by the Swiss of the currency peg to the euro. These actions have given investors confidence that rates aren't likely to move higher, but without question the risks are becoming skewed with rates approaching 0%. In fact, nearly US$2 billion of developed world debt has a negative yield.

US yields fell from 2.15% at the end of 2014 to a low of 1.64% at the end of January. Global fixed income investors got a return of over 2% due to this capital gain, with a full year's yield delivered in one month. Not surprisingly, yields retraced in February and are set to trade around the 2% mark for a while. Our view is that growth in the US is building and will slowly become evident through the rest of 2015. The Fed will get themselves deliberating 'behind the curve' by raising rates later than they ought to in order to allow the growth to take hold. After many false starts, it is better to be certain before taking any action.

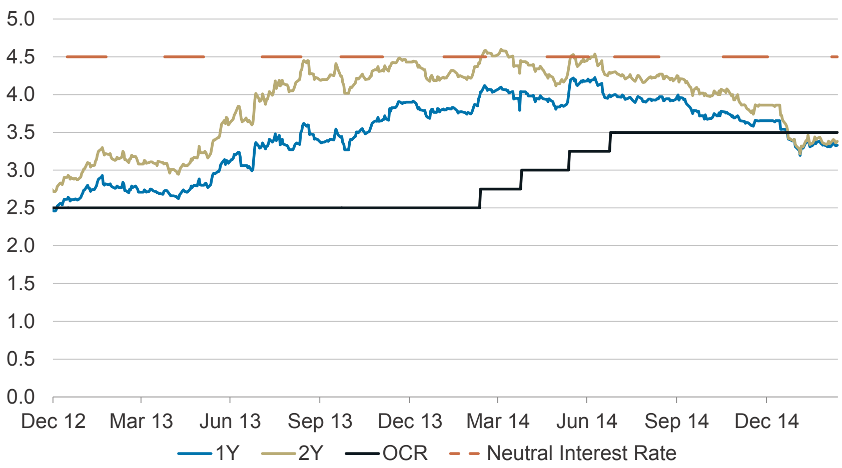
Inflation pressures will slowly return and bond yields will rise back to around 2.5% by the end of 2015.

In New Zealand, long term rates will follow upward moves in US yields. We have a year-end expectation that US 10 year yields will be around 2.6% (fair value by our model). New Zealand 10 year rates, which are currently at 3.4%, should reach 3.8% by year end.

More interesting will be the way the RBNZ manages it ways through the rest of 2015. We don't believe that they need to lift rates this year, but the next move is still likely to be up, sometime in 2016/17. The housing market remains robust and dairy prices appear to have stabilised. All things being equal, they would look to raise rates again soon. However, faced with a struggling Australian economy and a weaker Asia, remaining neutral is preferred.

- Short duration positioning. The cost of holding this position (cost of carry) is minimal and unmatched globally where steeper curves are the norm.
- Yield curve steepening position, with an overweight to short term bonds and underweight to long term bonds. A rise in yields is likely to be led by the long end on the back of higher US bond yields.
- Overweight to credit to preserve portfolio running yield. While spreads are already narrow, conditions persist to allow them to remain this way for the foreseeable future.
- Overweight inflation linked bonds. Inflation expectations are very low and these should protect from any unexpected inflationary bounce.

Market expectations of the OCR in one and two years' time

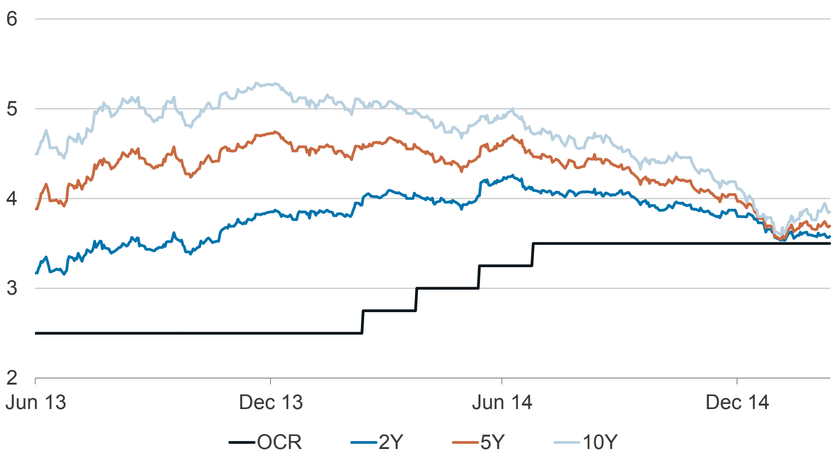


Source: Bloomberg, AMP Capital

You can clearly see the change in expectations from the market. From having hikes priced through 2013 and 2014, the market is now suggesting cuts. We do not agree with this.

With this change in expectation, the yield curve has flattened dramatically. All benchmark rates are now within a 0.4% range. We do not expect this to continue and look for the curve to steepen, led by higher long term rates.

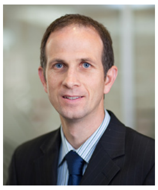
New Zealand benchmark rates



Source: Bloomberg, AMP Capital

New Zealand Equities

MICHAEL PRICE
Co-Head Fundamental Australian Equities



DAN MEAD
Investment Research Manager

The February/March reporting season has just wrapped up in New Zealand and on the whole can be classified as solid.

Going into the reporting season domestic equity valuations were high relative to history, and expectations for companies to deliver strong earnings growth were also high. However, profit margins came under pressure as positive sales growth did not necessarily translate into positive earnings growth. Of the NZX 50 companies that reported, 37 announced positive sales growth, with only 25 announcing positive earnings growth.

One of the major take outs of the latest reporting season was the market's focus and reaction to companies' capital management and dividend payout polices.

In a low interest rate environment investors have sought alternative investments to gain a yield higher than record low bond yields. This has seen an increased dividend payout in recent years, which conversely means reduced capital available to invest in growth opportunities.

Contact Energy's earning announcement was a good example of the market's focus on capital management. Contact Energy reported earnings in line with expectations, but instead of increasing dividends it announced it was considering investing in offshore geothermal. This saw Contact's share price plunge 9% on the day of the announcement, clearly not pleasing investors.

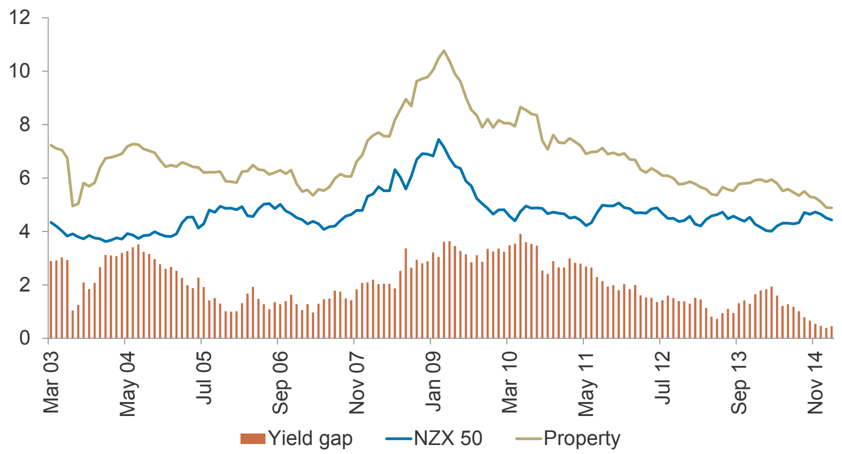
The market's high dividend payout ratio suggests that companies have been listening to the market. High yielding shares have performed extremely well, with the major domestic beneficiary being listed property. The NZ Property Index generated an excess return of 6.2% above the NZX 50 Index over the 2014 calendar year.

The hunt for yield is likely to continue given global interest rates are expected to remain low for some time. However, the beneficiaries locally may be less obvious going forward. The dividend yield differential between the New Zealand property market and the broader NZX 50 Index has narrowed significantly in recent years. Investors' appetite for high yielding investments has seen the share prices for New Zealand listed property push higher, which in turn has pushed their yields lower. This means there is now little separating the yield of listed property and the broader market.

	Sales growth			Earnings growth		
Industry	Positive	Flat	Negative	Positive	Flat	Negative
All securities	**37**	**1**	**8**	**25**	**2**	**18**
Oil and gas	2					2
Basic materials	1		1	2		
Industrials	5		2	5		2
Health care	5	1		4	1	
Consumer services	7			4		3
Telecommunications			2			2
Utilities	6			2	1	3
Financials	10		3	8		5
Technology	1					1

Source: Bloomberg

Dividend yield



Source: Bloomberg, AMP Capital

Another consequence of rising share prices of domestic listed property is that share prices for the majority of property stocks are now trading well above the underlying asset values. The growing divergence between price and asset backing can entice companies to raise capital.

Looking ahead, global interest rates are expected to remain low for some time. This should support the broad New Zealand equity market as it is relatively high yielding, although the recent run of double digit returns may be a stretch. In saying this, markets are forward looking and interest rate hikes will come. This is likely to see investors shift their focus at some point from dividends and payout ratios to growth opportunities.

Contact us

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