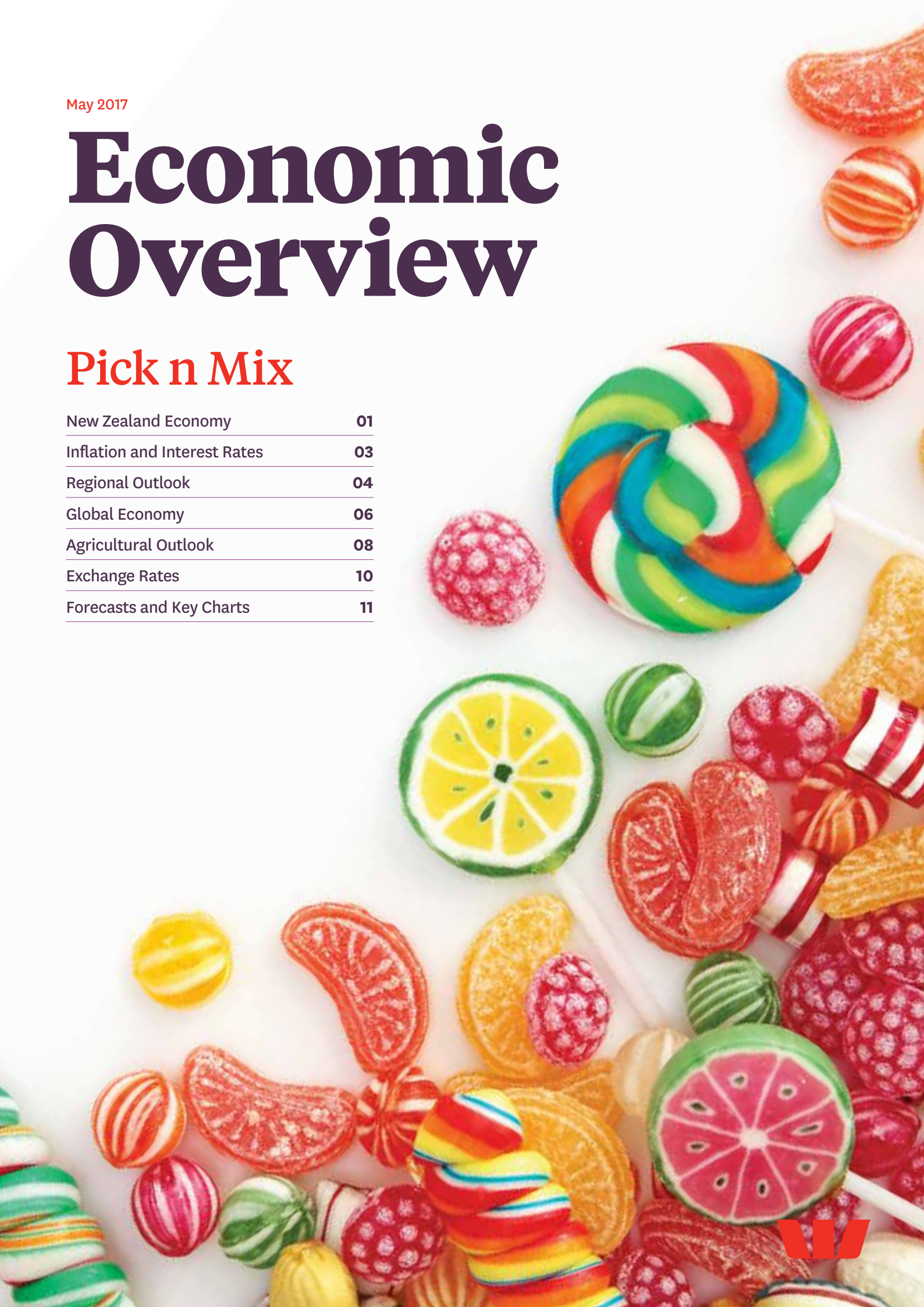


May 2017

# Economic Overview

## Pick n Mix

New Zealand Economy	01
Inflation and Interest Rates	03
Regional Outlook	04
Global Economy	06
Agricultural Outlook	08
Exchange Rates	10
Forecasts and Key Charts	11





# May 2017 Economic Overview

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## Note from Michael

On the face of it, our latest forecasts suggest more of the same for the New Zealand economy: growth of around 3% a year, supported by strong population growth and low interest rates. However, there are some subtle but important changes happening in the mix of activity.

The housing market has cooled significantly in recent months – and this time we think that the slowdown will stick. Interest rates have risen from their lows, and globally the pressure is for them to push higher. Since housing accounts for a large chunk of New Zealanders' wealth, we expect to see some impact on household spending patterns.

But at the same time, exports and the government are ready to step up. The rebound in world dairy prices will help to revive the economic performance of many rural regions. And even setting aside the potential for election-year promises, already-announced plans for infrastructure spending will provide a meaningful boost to activity in the coming years.

We remain of the view that the New Zealand economy is not at risk of overheating, notwithstanding the growing pressures in the construction sector. The pace of growth that we're expecting over the next few years is consistent with only a gradual reduction in the country's spare capacity. So while inflation looks to be past its lows, the Reserve Bank is under no pressure to raise rates to head off the risk of an overshoot in inflation.

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# New Zealand Economy

## Mixing it up

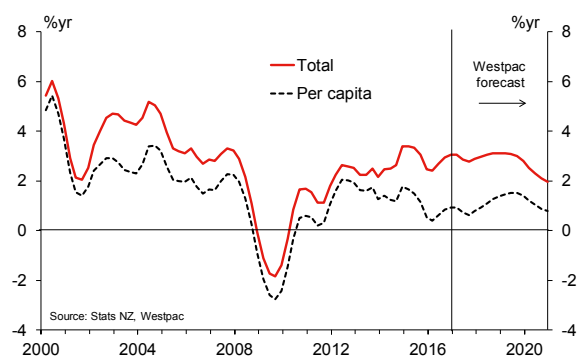
The New Zealand economy is set to continue growing at around 3% per annum over the next couple of years. However, the drivers of growth are changing. Softening housing market activity will dampen household spending. But at the same time, we're seeing a pick-up in investment, including increases in home building and infrastructure spending, as well as a recovery in rural regions.

Some of the gloss has come off New Zealand's economic story in recent months. GDP growth surprised to the downside in late 2016. And as we've moved in to 2017 confidence has eased, the housing market has continued to slow, and poor weather has resulted in significant disruptions in some regions.

But while economic conditions may have softened in recent months, we're still in reasonable shape. Economic activity expanded by an estimated 3% in the year to March. And while much of that growth did come on the back of very strong population growth, increases in output and employment have still been strong enough to push the unemployment rate back below 5%.

We expect that economic growth will continue ticking along at around 3% per annum for the next couple of years. In addition to population growth, a range of drivers are propelling the economy along. These include a large pipeline of construction work, boosts to demand from improved export commodity prices and growing tourism exports, as well as continued stimulatory monetary policy. Reinforcing those factors, fiscal policy is set to adopt a more expansionary stance.

Figure 1: Total and per-capita annual GDP growth



The economy is still facing some challenges. Notably, the slowdown in the housing market is expected to become more pronounced, and this will be a drag on household spending. In addition, although the economy as a whole doesn't appear to be at risk of overheating, capacity pressures have emerged in the construction sector.

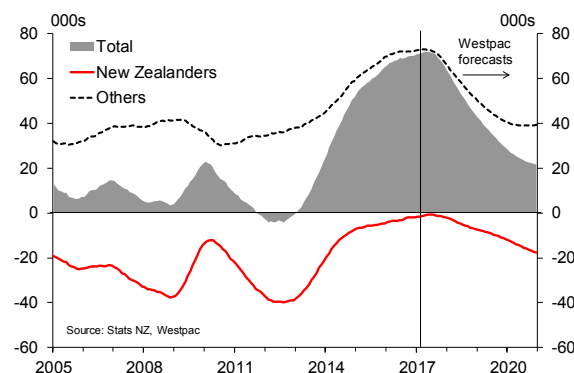
Some of the current drivers of growth will fade over the coming years: Post-earthquake reconstruction spending

in Canterbury is winding down; migration will eventually ease back to more normal levels; and borrowing rates will gradually push higher over time. This will see growth easing back to below trend rates towards the end of the decade.

## Everyone wants to live here

A key driver of economic activity in recent years has been strong population growth on the back of record net migration. Our relatively positive economic conditions have seen large numbers of new arrivals, including those on work and residency visas. We've also seen higher than usual numbers of New Zealanders choosing to stay onshore or come back from overseas (particularly from Australia). In fact, the net outflow of New Zealanders has dropped to its lowest level since 1984.

Figure 2: Net migration, annual



Population growth is boosting retail and services spending, masking what's been quite muted growth in activity on a per capita basis. It's also adding to housing and infrastructure needs. But migration isn't just affecting demand. With inflows weighted towards those of working age, migration has added to our productive capacity and is helping to address skill shortages in areas like construction.

Net migration and population growth are expected to ease back over the next few years as global economic conditions slowly improve. The recent tightening of New Zealand residency requirements, as well as potential changes in immigration policy following the election, will reinforce this slowdown. But while policy changes may stem inflows, it's still looking like the eventual wind back in net migration

will be quite gradual. In fact, with more New Zealanders choosing to remain onshore, we've revised up our forecasts for population growth. A key reason for this change is that Australia, the main destination for New Zealanders moving offshore, is looking a lot less welcoming. Policy changes mean that tertiary study in Australia will become much more expensive for New Zealanders. On top of this, levies on foreign workers and softening conditions in sectors like construction will limit New Zealanders' employment options across the Tasman.

## Construction ramping up

Construction is set to remain a key driver of growth and employment, with a large pipeline of work planned over the coming years. Much of this is centred on Auckland, where around a decade of strong building is required to address the existing shortfall of housing and keep up with surging population growth. Residential construction has also been increasing strongly in areas such as Northland, Taranaki, Manawatu and Wellington. On top of this, there is a large amount of non-residential work planned nationwide, including a substantial amount of infrastructure spending.

In addition to the above work streams, reconstruction activity following the Canterbury and Kaikoura earthquakes will continue for several more years. However, in the case of the Canterbury rebuild, planned spending is well advanced and has started to gradually wind down.

While there is a large amount of work planned, the construction sector is encountering some growing pains. Building costs have been rising, with capacity in the sector already stretched and construction firms reporting increased difficulty finding suitable staff. In addition, increases in borrowing rates and tighter bank lending standards for property developers will provide some brake on how quickly building activity ramps up. Combined, these conditions mean that the existing housing shortage will be eroded only gradually.

## Housing market momentum fading

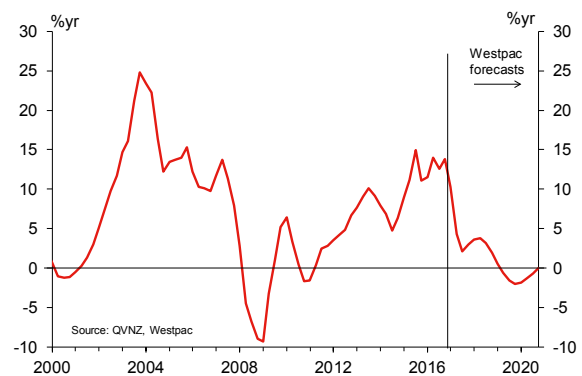
One of the most significant changes in the economic landscape in recent months has been the slowdown in the housing market. Since mid-2016, house sales have fallen by around 20%. At the same time, much of momentum in house prices has evaporated, with Auckland prices effectively flat since last August and a slowdown in previous hotspots such as Hamilton and Tauranga.

The tightening of loan-to-value restrictions for investors last July has no doubt played a role in slowing the housing market. More significantly, however, mortgage rates have risen since late last year. Borrowing rates are likely to continue gradually rising over the coming year in response to increases in domestic and offshore funding costs for local banks. This will further sap the strength of the housing market, with annual house price inflation expected to slow to around 3% by the end of 2017.

We've been forecasting a slowdown in the housing market for some time, and have highlighted the importance this has for demand in the economy more generally. New Zealanders hold a large proportion of their wealth

in housing assets, and the combination of low borrowing rates and strong house price inflation in recent years gave household spending a powerful shot in the arm. Now, with borrowing rates pushing higher and momentum in the housing market fading, household spending appetites are also likely to soften. This will dampen GDP growth over the coming year.

Figure 3: House price growth



## Improved outlook for exports

In addition to the domestic drivers of growth, we're also seeing firmer conditions in export sectors. As discussed in the *Agricultural Outlook* section, prices for some of our key exports (especially dairy) have increased, signalling a boost to agricultural incomes.

Tourism has also been a bright spot, with a record number of international visitors over the past year. This has added to demand in a range of areas like hospitality and accommodation, with increases in spending spread across the country. Although arrivals have flattened off in recent months, the outlook for tourism remains positive, with events like the upcoming Lions tour expected to give demand an extra boost.

## Make New Zealand great again

Strengthening economic activity and a focus on debt consolidation has seen an improvement in the government's coffers in recent years. And with a general election in September, fiscal policy is set to adopt a more expansionary stance. The incumbent National-led government has already announced a sizeable increase in infrastructure spending, and has hinted that an adjustment in tax thresholds is on the cards. It's likely that we'll see additional new spending announced when this year's Budget is released. Importantly, it looks like fiscal stimulus will avoid its usual pro-cyclicality, with spending set to increase as some of the private sector drivers of growth wane.

The precise details of fiscal policy over the next few years will of course depend on the makeup of government after September. One area where we could see major policy changes is housing, with changes in tax treatment of investment housing already mooted.

In addition to changes in spending, we could see large changes in migration policy, with the main opposition parties suggesting significant curbs on inflows.

# Inflation and Interest Rates

## New orders

Inflation has picked up from its lows, even after adjusting for the temporary boost from higher food and fuel prices. For the Reserve Bank, the challenge has turned from lifting inflation back up the target range, to maintaining it there. The modest pace of growth suggests that the economy is not at great risk of overheating, and we believe that the OCR can remain on hold for some time.

New Zealand's inflation performance has turned around in a short space of time. After spending two years straight bobbing just above zero, the annual inflation rate rose to 1.3% in December, then 2.2% in March. The latest reading is the highest since September 2011.

The sharp lift in the annual inflation rate is partly the result of temporary factors and base effects. Some fruit and vegetable prices have spiked higher this year, as poor weather has either wiped out crops or delayed harvesting. But today's weather won't affect next year's prices, and as prices revert to normal levels we expect a sharp, albeit temporary, drop in the annual inflation rate in early 2018.

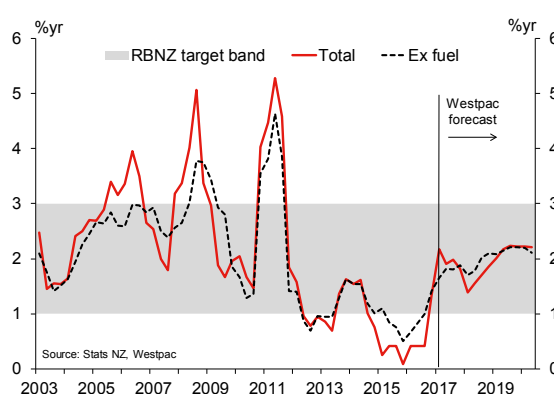
The other factor was that the March quarter represented the peak impact of the rebound in fuel prices. World oil prices had fallen to unsustainably low levels by early 2016, but by early 2017 they had rebounded by about 80%. It's very unlikely that this rate of increase will be repeated – at current prices most US oil fields are profitable, and a great deal of production has since come back online.

The volatile food and fuel components aren't the entire story, though. Measures of underlying inflation have been lifting gradually from their lows over the last year. There are tentative signs that businesses are regaining some pricing power, in terms of both imported and locally-produced items. This suggests that monetary policy is having its intended effect: the Reserve Bank began to lower the OCR in June 2015, and interest rates typically have their greatest impact on inflation with a lag of 1-2 years.

With inflation close to the 2% midpoint of the RBNZ's target range – and surveyed expectations reaching similar levels – the risk of a persistent undershoot of the inflation target has now passed. The challenge for the RBNZ has turned from lifting inflation towards the target, to maintaining it there. Over a long enough timeframe, low interest rates will eventually see inflation pressures build up and threaten the upper end of the target range. So the question for the RBNZ is at what point it should act to head off this risk.

We're still of the view that the New Zealand economy is not at great risk of overheating. Per-capita growth remains modest compared to past cycles. We still see some slack in labour market, with the unemployment rate lingering around 5% and wage growth remaining subdued. Our growth forecasts are consistent with this slack being reduced over time, but at a gradual pace.

Figure 4: Inflation forecast



Moreover, there are signs that the modest, market-driven rise in longer-term rates since last year has already had a cooling effect. In particular, house price inflation has slowed dramatically in recent months. Admittedly it's hard to distinguish between the impact of higher mortgage rates and the tightening of loan-to-value restrictions last year, but our research suggests that interest rates are the more likely of the two to have a sustained impact on house price gains.

Consequently, we believe that monetary policy can afford to move slowly. We expect the RBNZ to delay OCR hikes until early 2019, and then to proceed gradually as it assesses the impact of higher rates on activity and house values.

### Financial market forecasts (end of quarter)

	CPI inflation	OCR	90-day bill	2 year swap	5 year swap
Jun-17	1.9	1.75	2.00	2.50	3.10
Sep-17	2.0	1.75	2.00	2.50	3.20
Dec-17	1.8	1.75	2.00	2.60	3.30
Mar-18	1.4	1.75	2.00	2.70	3.40
Jun-18	1.5	1.75	2.00	2.80	3.50
Sep-18	1.7	1.75	2.00	2.90	3.55
Dec-18	1.9	1.75	2.15	2.90	3.60
Mar-19	2.0	2.00	2.40	2.90	3.60
Jun-19	2.2	2.25	2.50	2.85	3.55
Sep-19	2.2	2.25	2.50	2.80	3.50

# Regional Outlook

## The dairy divide

Most regions have shared in the country's economic upturn over the last couple of years, but there has been a notable underperformance among the more dairy-intensive regions. With farmgate milk prices back to around average levels, we expect to see a more even growth performance across the regions in the coming years.

New Zealand's economic growth over the last couple of years has been fairly widely shared across the regions. Building activity is heating up across much of the country, especially in the North Island. House price gains, and their associated effects on household spending, have spread well beyond Auckland. Tourist spending is up across the board. And most regions are experiencing stronger population growth, courtesy of fewer New Zealanders heading overseas.

Still, there have been some notable distinctions across the regions, perhaps most apparent in the jobs market. The Household Labour Force Survey tells some of the tale; however, sampling error is a significant issue for the survey, even more so when broken down by region.

As a complement to the official labour force statistics, we have looked at the share of the working-age population who are receiving the jobseekers' benefit (Figure 5). This is only part of the picture, as there are many people who are looking for work but do not receive this benefit. But it is a complete record rather than a sample, so it provides a clearer picture of how joblessness is changing, particularly over the short term.

There's another useful feature of this series: only citizens or permanent residents are eligible to receive the benefit. So these figures can help to shed some light on whether migrants are pushing New Zealanders out of the jobs market.

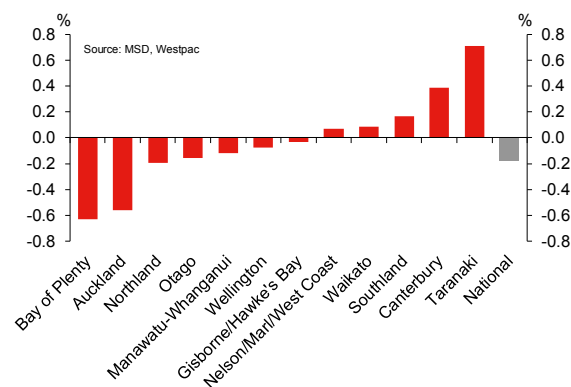
The results are striking. The biggest declines in benefit rates have been in the regions with the strongest population growth: Auckland, which receives the majority of overseas migrants, and the Bay of Plenty, which attracts many New Zealanders either returning from overseas or moving within the country. This suggests that people are largely moving to where the jobs are.

In contrast, there is a common theme among the regions where benefit rates have increased over the last two years: they all have relatively large exposures to dairying. Two seasons of extremely low farmgate milk prices appear to have had an insidious, drawn-out effect on spending and job creation in those regions. (The two worst performers, Taranaki and Canterbury, have their own region-specific issues, as we'll discuss shortly.)

On the positive side, with milk prices back to around average this season, and expected to be a bit above

average next season, we should see the benefits of growth shared more evenly between the main centres and the rural regions over the next couple of years.

Figure 5: Change in jobseeker benefit rates, 2014-2016



## Auckland

Auckland has stood out as a relatively weak performer in our recent surveys of consumer and regional confidence, despite the region's strong economic performance. Dissatisfaction with the city's unaffordable housing and clogged roads may be a factor here. Strong population growth has left the city with an estimated shortfall of more than 35,000 homes, and increasing strain on its infrastructure. The building sector is already encountering capacity constraints, but the need for a further lift in activity is simply unavoidable. With the Unitary Plan passing its last legal hurdle in February, building consents have picked up again in the last few months. However, rising building costs and low housing affordability will be challenges for some time.

## Bay of Plenty

The Bay of Plenty was the most upbeat region a year ago, but it has since dropped back to the middle of the pack. Still, the region is benefiting from ongoing strength in the horticulture sector (led by kiwifruit), growing tourist numbers, and a construction boom to match the rapidly growing population. Prior to the latest LVR restrictions, Tauranga had overtaken Auckland as the city with the fastest house price gains, but the pace has slowed sharply since.

## Canterbury

Planned earthquake reconstruction is well advanced and the level of activity is now declining. Reconstruction work has been rotating towards commercial activity, while residential construction has been winding back. As the housing stock has been restored, conditions in the housing market have changed markedly: house prices have levelled off, and rents have fallen since 2015. Unemployment rose to 4.3% in the March quarter – still one of the lowest rates in the country, but up from around 3% during the height of the rebuild. There is still a sense of vibrancy in Christchurch as commercial completions rise and businesses move back into the central city, and the region should benefit from growing tourist numbers and the recovery in dairy sector incomes.

## Gisborne/Hawke's Bay

The Gisborne and Hawke's Bay regions are currently benefiting from strong prices across a number of primary industries, including sheep and beef farming, horticulture and forestry. While these regions haven't seen the same degree of population growth as other parts of the country, rising construction and a belated upturn in house prices have still been supporting activity.

## Nelson/Marlborough/West Coast

Industry exposures vary substantially across these regions, but wine, fruit growing and forestry are all important employers and have generally been faring well. The top of the South Island has also benefitted from the surge in visitor numbers in recent years. The West Coast will benefit from the recovery in dairy prices, but otherwise the region's economic prospects remain subdued. It's notable that this is the only region in the country that has not seen an upturn in house prices in recent years.

## Northland

Economic confidence in the Northland region has improved markedly over the past year. High log prices, growing tourist numbers and rising house prices have supported the economy, and the recovery in dairy prices will provide a further boost. Northland is also benefiting from population growth and its links to the strong Auckland economy. House prices have risen 22% in the last year, the biggest gains of any region.

## Otago

Economic confidence declined in Otago in the early part of this year, but it remains above its long-term average. Central Otago is benefitting from a strong horticulture sector, and the Queenstown-Lakes district remains a tourist hotspot, although this is one region where capacity could prove to be a constraint on future growth.

## Southland

In the last year, Southlanders have swung from being the most pessimistic to the most optimistic about their region's economic prospects. Given the importance of dairying in the region, the improved outlook for dairy incomes will

likely bolster growth and employment prospects in the region. Sheep and beef farmers are also benefiting from improved export prices.

## Taranaki/Manawatu-Whanganui

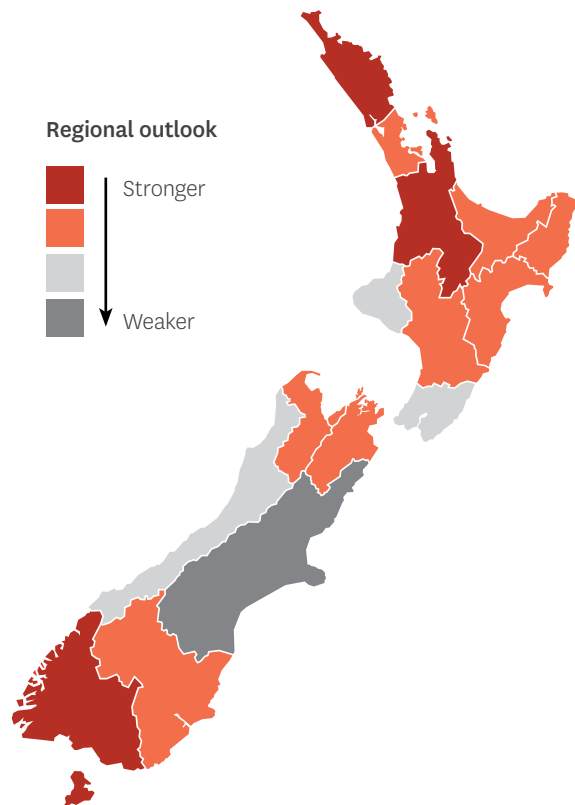
In recent years Taranaki has faced the double whammy of low dairy prices and a plunge in oil prices, which wiped out the incentives for oil exploration. Both prices have rebounded to some degree, although world oil prices are probably still too low to make exploration viable in New Zealand (and we don't expect them to rise from here). Higher dairy, sheepmeat and beef prices are all positive for the Manawatu-Whanganui region.

## Waikato

The recovery in farmgate milk prices will no doubt be a boon for the country's largest dairying region. But as part of the 'golden triangle' along with Auckland and the Bay of Plenty, the Waikato is benefiting from gains across a broader range of industries. The region is also experiencing strong population growth, though unlike Auckland it is building fast enough to meet demand.

## Wellington

The Wellington region has relatively little exposure to agriculture, so it tends to be a middle-of-the-road performer through both commodity price downturns and upturns. An emerging shortage of housing in the region – albeit nowhere near to the same extent as in Auckland – has no doubt contributed to an 18% rise in house prices in the last year. While building activity in the region has been rising, it will take some time to address the challenges in the Capital's housing market.



# Global Economy

## Resilient

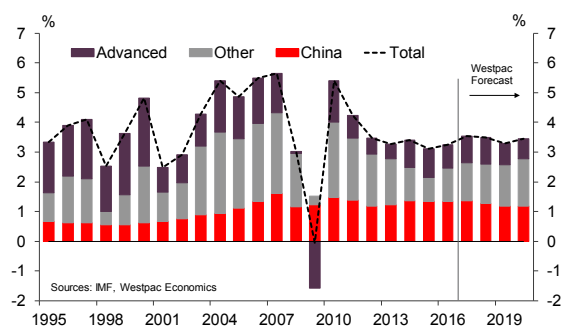
Global activity and inflation are looking a little firmer. However, demand in many economies is still being propped up by supportive monetary policy. In contrast to central banks in other regions, the Fed is expected to continue gradually increasing the funds rate as US activity continues to strengthen. However, there are questions around the stance of US fiscal policy.

Activity has been picking up in many countries in early 2017, and we expect that the global economy will grow by 3.5% over the course of this year. While that's still a relatively moderate pace, it's a step up from the modest rates that we've seen in recent years.

Demand in many economies continues to be underpinned by accommodative monetary policy. Although we are seeing some firming in global inflation, we expect central banks in most regions will keep official interest rates low for some time to support demand. The exception is the US, where the Fed is expected to gradually tighten policy in response to firming economic activity and labour market conditions.

The wild card for the global economic environment continues to be the stance of US government policy under the Trump presidency. There are questions around the timing and extent of fiscal stimulus, as well as the stance of policy in areas such as trade.

Figure 6: Contributions to global growth (annual)



## Targets and Bands

Global inflation has picked up from its lows over the past year. In part, this has been due to earlier rises in prices of volatile items, including food and fuel, the impact of which has already started to wane. Core inflation has also been firming, though in most regions it remains below policy targets. With the notable exception of the Fed, central banks are generally expected to keep policy rates on hold for some time yet.

Prices for internationally-traded manufactured goods remain subdued. The prices for many such goods fell

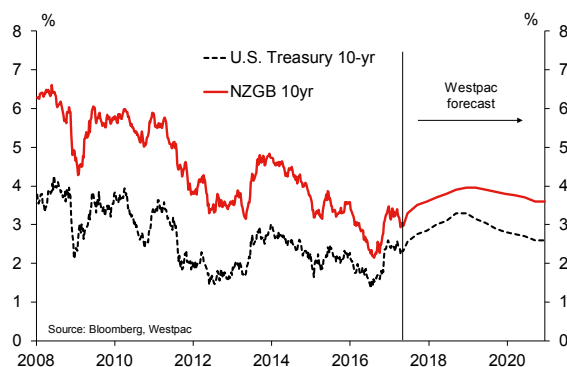
sharply during the financial crisis, particularly in the case of consumer goods from Asia. And while we may not be seeing outright declines anymore, strong competition and lingering capacity in the global economy are continuing to weigh on prices. We expect that softness in import prices will remain a drag on inflation in many regions, including New Zealand, over the coming years.

## Going for a hike

The US economy started 2017 on a soft note, with Q1 GDP growth coming out below expectations. However, it looks like this was a temporary slowdown, in part due to poor weather. Indicators are pointing to positive manufacturing sector conditions. Jobs in the US have continued to improve with non-farm payrolls growth remaining robust and the unemployment rate edging down.

US inflation has also firmed over the past year, though core inflation remains a bit under 2% and we expect this to continue. With that in mind, the FOMC is likely to keep rates at accommodative levels for some time yet. We expect monetary stimulus will be gradually rolled back as the US economy continues to strengthen. Our forecasts have rate hikes in both June and December of this year, with another three hikes pencilled in 2018.

Figure 7: Long-term interest rates



In addition, the Fed has mooted plans to begin unwinding its balance sheet. We expect this process to begin in early 2018. After large increases following the financial crisis, the eventual reduction in the Fed's balance sheet has the



potential to materially influence long-term interest rates over and above the impact of Fed funds rate changes. With the risk that a premature tightening in financial conditions could dampen growth in the US and more widely, we expect that the pace of the balance sheet unwind will be gradual and data-dependent.

## A hole in none

The key uncertainty around the outlook for the US is what the impact of the new President will be. The initial wave of optimism that followed his election has now dissipated as the administration has encountered numerous hurdles to its policy agenda. The implementation of major policy initiatives such as tax reform and infrastructure spending is at risk of being significantly delayed.

Since taking office, President Trump's focus has been on 'America First.' In practical terms, this means a shift to a more protectionist stance for US trade policy, as well as changes to the regulatory environment to support US business and employment. With the US still the world's largest consumer, the risk of a wave of protectionist sentiment adds to the already sluggish global trade environment.

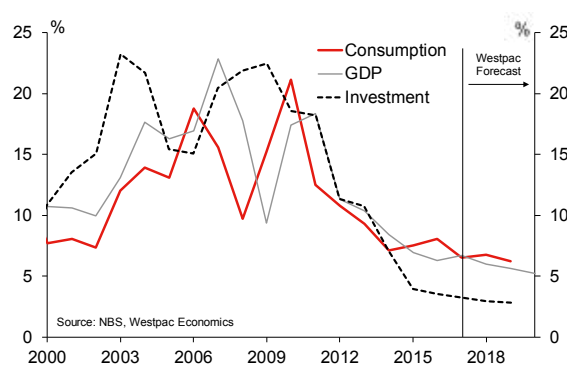
## China

We expect China's economy to grow by 6.6% over 2017, slowing to 6.0% in 2018. The drivers of growth in the Chinese economy continue to shift. The government is strategically pulling back from the infrastructure spending that has underpinned growth in recent years. Additionally, the growing risks associated with high corporate leverage have prompted President Xi to declare a crackdown on the financial risks from credit-driven growth, which will weigh on private sector investment. The National Congress in November could see a further push towards rebalancing and reform.

As investment has slowed, consumption has been picking up at a moderate pace, driven by improving credit availability and housing market developments. The trend

in China is that consumption is rapidly becoming a critical part of economic growth, supported by the rising middle-class, jobs in urban areas and the relative rise in disposable incomes. The changing mix of China's growth generally bodes well for exporters of consumer products such as New Zealand, and less so for exporters of industrial commodities such as Australia.

Figure 8: Chinese GDP growth components



## Across the ditch

After stumbling in 2016, the Australian economy has been on firmer ground in 2017. The drag from declines in the terms of trade and the mining downturn are fading. Additionally, activity has been supported by improved global conditions, a lower Australian dollar, lower interest rates, and increases in public spending. However, weakness in wage growth continues to dampen demand.

We expect growth to fall below trend in 2018, driven by a downturn in residential building. Increased government spending on infrastructure may provide some offset, but we still expect the unemployment rate to climb to 6.2%. This weakening in the Australian labour market, along with recent policy changes, will continue to discourage migration to Australia by New Zealand citizens.

## Economic forecasts (calendar years)

Real GDP % yr	2013	2014	2015	2016f	2017f	2018f
New Zealand	2.2	3.4	2.5	3.1	2.9	3.1
Australia	2.1	2.8	2.4	2.5	2.5	2.7
China	7.7	7.3	6.9	6.7	6.6	6.0
United States	1.5	2.4	2.6	1.6	2.1	2.4
Japan	1.4	0.0	0.5	0.6	1.1	1.0
East Asia ex China	4.2	4.1	3.7	3.7	3.8	3.8
India	6.6	7.2	7.3	7.2	7.3	7.4
Euro zone	-0.3	0.9	1.6	1.7	1.1	1.4
United Kingdom	2.2	2.9	2.2	2.0	1.8	1.6
<b>NZ trading partners</b>	<b>3.5</b>	<b>3.9</b>	<b>3.6</b>	<b>3.3</b>	<b>3.4</b>	<b>3.3</b>
<b>World</b>	<b>3.3</b>	<b>3.4</b>	<b>3.1</b>	<b>3.2</b>	<b>3.5</b>	<b>3.5</b>

Forecasts finalised 19 May 2017

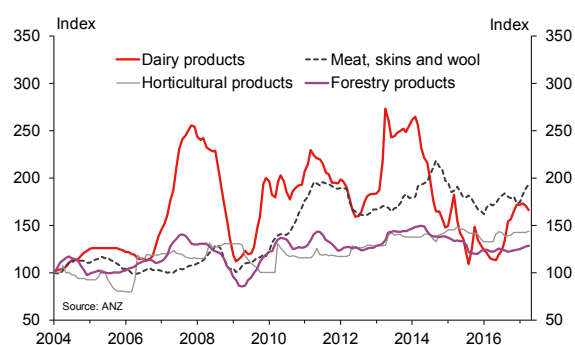
# Agricultural Outlook

## Rising tide

The tide has been rising for New Zealand's export commodities. A pick-up in global growth has supported demand, with tight supply in some markets further boosting prices. While some of those supply-induced gains are expected to unwind, it's a moderate outlook for prices overall. That said, the risk of a more protectionist trade environment continues to cloud the outlook for commodities demand.

New Zealand's export commodity prices are in a good space. World prices for key exports have risen or held their ground this year, taking the aggregate commodity price index over 20% higher than a year earlier. While dairy prices have seen the largest improvement over the year, price gains have been widespread, including for meat, forestry and horticulture products. A 6% depreciation in the New Zealand dollar since January has provided a further kicker for prices at the farm (or orchard) gate, although the extent of currency relief depends on where key markets are located. Despite the recent depreciation, exporters to Europe (particularly the UK) and Australia continue to face historically high New Zealand dollar cross rates.

**Figure 9: New Zealand export commodity prices (world terms)**



The positive trend for New Zealand's commodity basket has bucked the broader trend in global commodities. In May, broad-based commodity indices fell to the lowest levels this year, to be roughly unchanged from a year earlier. Those indices tend to be dominated by hard commodities (such as metals and oil) compared to our food-focused export basket, which means quite specific demand and supply dynamics can be at play. Certainly, in meat and dairy markets, tightening supply, including from New Zealand, looks to have played a key role in bolstering prices over the past year.

The demand side of the broader commodity complex remains murky. Firmer global growth this year, including renewed momentum in the Chinese economy, is supporting commodity demand and prices, although we're sceptical whether that momentum can be sustained heading into 2018. And while the immediate risk of the US slapping large tariffs on imports from China and Mexico has diminished (reducing the risk of a tit-for-tat trade war), there's still significant uncertainty about the global trade environment.

Indeed, recent disputes between the US and Canada about trade of lumber and milk products sparked fears that the US could bring in a broader range of protectionist measures, including New Zealand exports to the US. New Zealand already faces heavy protectionism in the US market, but it's a useful reminder of where New Zealand stands. We're a big producer and exporter of food, in a world where agriculture is still heavily protected in most countries.

### Commodity price monitor

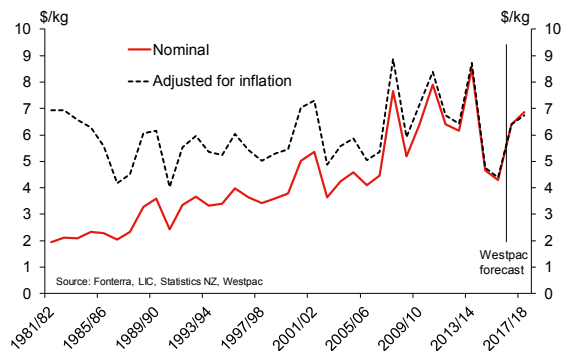
Sector	Trend	Current level <sup>1</sup>	Next 6 months
Forestry	Strong Chinese demand is underpinning log prices, but prices are likely to ease heading into 2018 as growth in China's property sector slows. Supply from North America has been rising.	High	➔
Wool	Synthetic substitutes remain attractive while oil prices remain low.	Average	➔
Dairy	World prices are expected to pull back as milk production continues to rise.	Average	➡
Lamb	Tight supply and improved demand have boosted prices. Brexit continues to cloud the outlook for European demand.	Above Average	➡
Beef	Demand from the US and Asia has strengthened. But that's likely to be offset by rising supply, led by the US, and increased competition in Asia as more countries gain market access.	High	➡
Horticulture	Benefiting from strong demand and product innovation. Further improvement expected.	Above average	➡

<sup>1</sup> NZD prices adjusted for inflation, deviation from 10 year average.

## Steadying the ship

After a rocky ride in recent years, dairy farmers will be breathing a little easier with a season of better cash flows (nearly) under their belts. Indeed, the farmgate milk price of \$6/kgMS expected for the 2016/17 season is a far cry from the previous season's \$3.90 that drove cash flows firmly into the red. For the 2017/18 season (beginning June), we're forecasting a milk price of \$6.50/kgMS – just above the average of the past decade. That will further shore up sentiment within the sector and should flow through into a broader improvement in spending in dairy-intensive regions.

**Figure 10: Farmgate milk payout (including dividends)**



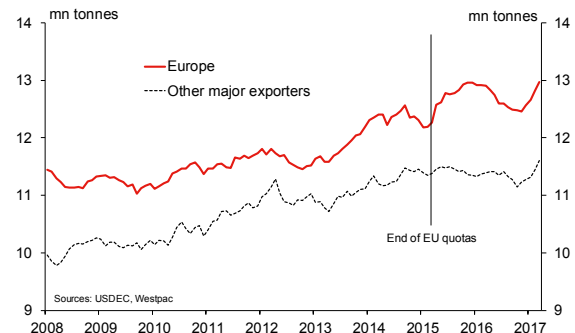
The recovery at the farmgate mirrors the movement in world dairy prices, which have risen over 50% in the past year. That's in no small part due to reduced supply from key dairy exporters, especially New Zealand and Europe. But improving farmgate prices and low feed costs have seen supply change course in recent months. Further growth in supply is expected to weigh on world prices later this year. Our \$6.50 milk price forecast for the 2017/18 season allows for some pullback in world prices.

Locally, the production season was a game of two halves, as plentiful summer rainfall provided the foundation for a strong rebound in production. That saw the first half shortfall of 3.7% pared back to 1.3% by March. And while there were some concerns that severe storms in March and April would hamper milk production, they hit at the tail end of the season and shouldn't have a sustained impact on production. We're expecting a positive trend for milk production when the new season ramps up in spring. The recovery in margins should see some farmers increase cow numbers (which has been borne out by low numbers of culled cows so far this year), and provides scope for greater use of supplementary feed.

Further afield, the most notable development has been the change in course of European production. After adjusting for seasonal patterns, production has been rising since November, and by March had risen back to its 2015 peak. Improved farmgate returns are expected to see this positive trend continue. As a significant exporter of a large production base, swings in European production can result in large swings in the volume of product hitting global markets. Indeed, the rapid growth in production following the removal of the region's production quota system in April 2015 overwhelmed the market, driving prices down and resulting in significant stockpiling of skim

milk powder. In the US, steady growth in milk production looks set to continue.

**Figure 11: Global milk production, seasonally adjusted**



An improvement in global dairy demand has also chipped in to support prices. The recovery in import demand has been led by China as renewed momentum in economic growth has supported conditions for households, while China's dairy industry has struggled to expand milk production. Rising demand from countries such as Algeria and Mexico has also been encouraging.

By product, milkfat has been extremely sought after, boosted by Western consumers' push back towards natural food products and the growing Asian bakery and foodservices markets. That's pushed milkfat prices to record highs, while skim milk powder has become somewhat of an unwanted by-product, with prices extremely depressed. Whole milk powder prices (New Zealand's dominant dairy export) are in a moderate middle ground. A key risk is that milkfat demand can't keep up with rising European and US supply, weighing on the dairy price complex as a whole.

## Sailing ahead

The horticulture sector remains one of the standouts among New Zealand's commodity exporters, with kiwifruit and apple exporters at the fore. The sector continues to reap the rewards of productivity growth and product innovation that's been successful delivering higher-quality, higher-priced products into key markets, especially in Asia.

World prices for beef and lamb have strengthened in recent months to be well up on a year ago, particularly for lamb. Higher prices reflect improved demand in key markets, but the biggest boost has come from constrained supply from New Zealand and Australia. As such, recent price gains are expected to unwind over the coming year as supply improves. China has become an increasingly important market for meat exports over time, and the trial of chilled meat exports provides an opportunity to gain a foothold in the higher-value segment of the market. For beef exporters, that will help provide an edge in a market that's becoming increasingly competitive following the re-entry of Brazilian beef in 2015 and US beef in coming months. And for lamb exporters, it offers a non-European outlet for high-value cuts. That may be a useful hedge given unfavourable European exchange rates and lingering uncertainty about market access as the UK moves towards Brexit.

# Exchange Rates

## Step down

The New Zealand dollar has lost ground over the past few months, as financial markets pared back the expected timing of New Zealand cash rate hikes and conditions abroad improved. The New Zealand dollar is expected to largely tread water in coming months, before weakening against the US dollar in 2018. In contrast, the NZD/AUD is expected to push higher in 2018 as growth in Australia slows.

The New Zealand dollar has been on the back foot since our February *Overview*. Against the US dollar, the Kiwi has fallen from 73 cents in early February to around 69 cents currently. That hasn't reflected a US dollar trend, with the US dollar broadly tracking sideways. Instead, the New Zealand dollar has lost ground against all of the major crosses, depreciating nearly 6% on a trade-weighted basis to the lowest level in around a year.

That depreciation has been against a backdrop where domestic conditions have remained firm. Growth is tracking at an annual pace of around 3% and annual CPI inflation has jumped back above 2%. And while dairy prices fell sharply in March, they've more than recovered those losses. Importantly, the economy still doesn't look at risk of overheating. That means the Reserve Bank has time on its side before raising the OCR: we're not expecting the first rate hike until early 2019. And market expectations have been moving in our direction. Back in February, a rate hike was fully priced in by November this year, but that's now been pushed back to mid-2018. That re-pricing has been a key factor weighing on the New Zealand dollar.

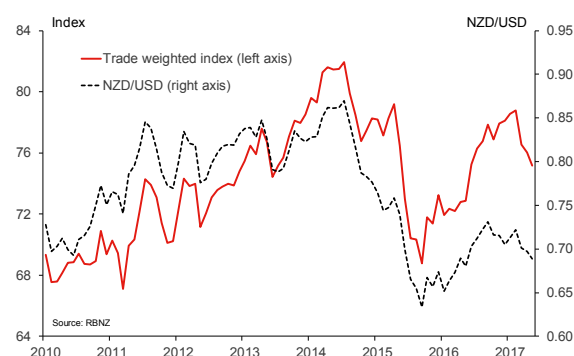
At the same time, conditions overseas have been improving. The US economy is growing at a moderate pace, and the Federal Reserve is continuing on the path of gradual policy tightening. We're expecting two more rate hikes this year and another two next year. But while this year's hikes are largely priced in, markets are more sceptical about the number of rate hikes next year. Consequently, the US dollar is expected to resume its upward trend over the next year as rate rises get priced in. This will drag the NZD/USD down to the low-60s by the end of 2018.

Across the Atlantic, the UK economy has continued to truck along despite Brexit-induced uncertainty. Growth in the euro area has also improved, and the risk of anti-establishment parties gaining power in the Netherlands and France has passed. Those factors have seen the pound and euro strengthen, although those moves have been off low bases. Ongoing challenges for the region's economies are expected to see the NZD/GBP and NZD/EUR cross rates remain high for some time yet.

The New Zealand dollar has also eased against its Aussie counterpart, trading in a range between 91 and 93 cents since March. Although policy interest rates in both countries are expected to remain unchanged this year and next, momentum should swing firmly in favour of the

New Zealand dollar in 2018 due to diverging commodity price and growth trends. Australia's commodity prices have been under pressure in recent months, led by iron ore. That downtrend is expected to intensify in 2018, while New Zealand's commodity prices are expected to be more stable. Similarly, growth in Australia is forecast to slow in 2018 due to a downturn in construction, while growth in New Zealand is expected to remain steady at around 3% per annum. Overall, the NZD/AUD is expected to head back to lofty heights above 95 cents.

Figure 12: New Zealand dollar



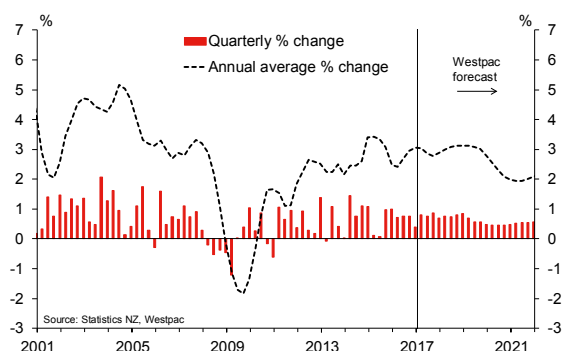
Exchange Rate Forecasts (end of quarter)

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI
Jun-17	0.68	0.93	0.65	0.56	75.5	75.2
Sep-17	0.68	0.93	0.65	0.57	76.2	75.6
Dec-17	0.68	0.93	0.66	0.57	77.5	76.2
Mar-18	0.67	0.93	0.66	0.57	77.7	75.7
Jun-18	0.66	0.96	0.65	0.56	77.2	75.8
Sep-18	0.65	0.96	0.65	0.55	76.7	75.2
Dec-18	0.63	0.97	0.64	0.53	74.3	73.8
Mar-19	0.64	0.96	0.65	0.54	75.5	74.6
Jun-19	0.64	0.93	0.66	0.53	76.8	74.1
Sep-19	0.64	0.91	0.67	0.53	76.8	73.8

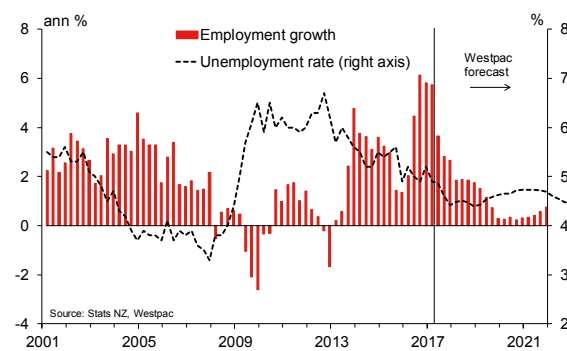
# Forecasts and key charts

	Quarterly % change				Annual average % change			
	2016	2017			Calendar years			
	Dec (a)	Mar	Jun	Sep	2016 (a)	2017	2018	2019
GDP (production)	0.4	0.8	0.8	0.9	3.1	2.9	3.1	2.8
Private consumption	0.4	1.1	0.6	0.8	4.3	3.6	3.4	3.0
Government consumption	1.1	0.5	0.5	0.5	2.3	2.7	2.0	2.1
Residential investment	0.1	-0.8	-0.5	2.4	11.0	2.3	6.9	-1.7
Business Investment	1.8	0.3	1.6	1.6	3.4	4.7	5.7	3.3
Stocks (% contribution)	1.9	0.2	-0.5	-0.3	0.2	0.7	-1.0	0.1
Exports	-3.8	1.1	2.3	1.5	1.6	1.1	3.8	2.4
Imports	1.9	1.2	0.2	0.7	4.2	4.8	2.6	2.1
Consumer price index	0.4	1.0	0.2	0.4	1.3	1.8	1.9	2.2
Employment change	0.7	1.2	0.4	0.5	5.8	2.7	1.8	0.3
Unemployment rate	5.2	4.9	4.9	4.6	5.2	4.4	4.4	4.6
Labour cost index (all sectors)	0.4	0.4	0.3	1.0	1.6	2.2	2.2	2.1
Current account balance (% of GDP)	-2.7	-2.7	-2.5	-2.3	-2.7	-2.4	-2.8	-3.2
Terms of trade	5.7	1.6	-0.2	-0.4	6.7	0.2	-1.2	-1.1
House price index	0.3	0.3	0.5	1.0	13.8	3.0	2.0	-2.0
90 day bank bill (end of period)	2.00	1.84	2.00	2.00	2.00	2.00	2.15	2.50
5 year swap (end of period)	2.65	3.00	3.10	3.20	2.65	3.30	3.60	3.50
TWI (end of period)	77.6	78.0	75.2	75.6	77.6	76.2	73.8	73.4
NZD/USD (end of period)	0.71	0.71	0.68	0.68	0.71	0.68	0.63	0.64
NZD/AUD (end of period)	0.95	0.94	0.93	0.93	0.95	0.93	0.97	0.90
NZD/EUR (end of period)	0.66	0.67	0.65	0.65	0.66	0.66	0.64	0.67
NZD/GBP (end of period)	0.57	0.57	0.56	0.57	0.57	0.57	0.53	0.52

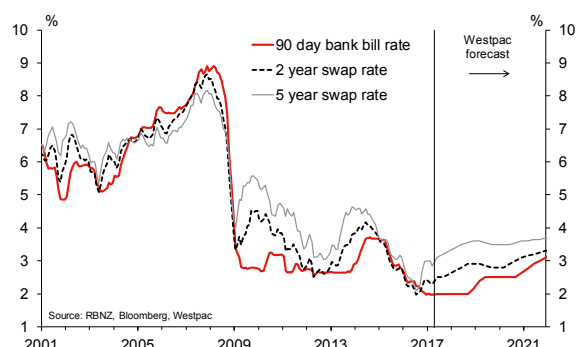
New Zealand GDP growth



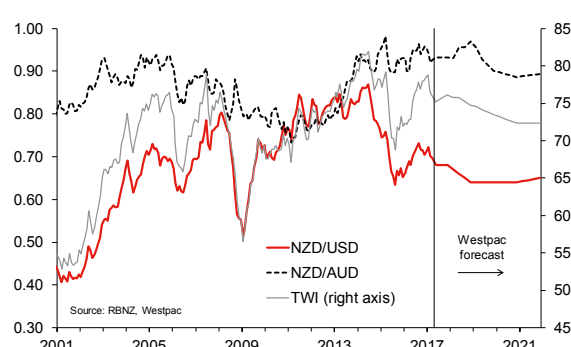
New Zealand employment and unemployment



90 day bank bill, 2 year and 5 year swap rates



NZD/USD, NZD/AUD and TWI



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