Quarterly Economic Forecast

August 2019

Failure to Launch?

- The economy looks like it will fail rebound significantly over the next year, with growth to lift only slightly.
- Ongoing domestic malaise remains the gravitational drag, though global headwinds are intensifying.
- Monetary policy might test its practical limits, which would bring quality Government action to the fore.

Our much talked about rebound in growth, to follow the recent soft patch, is starting to look increasingly more like a damp squib than one of Rocket Lab's examples of kiwi ingenuity. In part the shallow rebound is because early 2019 growth held up slightly better than expected – even if flattered by unsustainable jumps in construction and mining. But we see reduced scope for strong growth over the next few years, more around a 2.5% pace on average.

Let's be clear – NZ still has a lot propelling it along and we are using the word "growth", not "recession". Near-record Terms of Trade, courtesy of high export commodity prices, strong population growth, and even-lower interest rates will all keep up the momentum the economy. But there are continued domestic headwinds, and growing global ones.

Global prospects are for the slowest growth since the Global Financial Crisis, and the risks have risen sharply recently. Donald Trump has slammed further tariffs on China, reducing the chances of a ceasefire anytime soon. Meanwhile, newly-elected UK PM Boris Johnson is ordering "Exit" signs in bulk to illuminate his negotiating stance with the EU. The last thing the global economy needs is a bad hair day that a comb-over won't fix.

Domestically, businesses remain in a funk, with confidence still falling. The impact of margin squeeze is evident in intentions to invest and hire. And, yes, some government policy uncertainty lingers. All these domestic & global challenges, uncertainties, and nervousness mean businesses are wary about pushing the boat out. Employment has – encouragingly – held up for now, but businesses' capital spending is soggy outside of anything involving construction. But trading conditions are simply not as bad as surveys suggest. Businesses need to focus on the key levers of their performance that they can control. And the challenge is we need more investment to improve our becalmed productivity and deliver the strong economic and wage growth that is key to long-term prosperity.

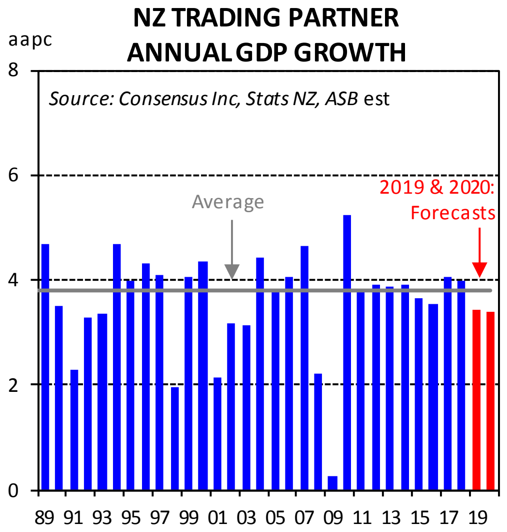
Monetary policy is doing its part – with a bang – to shore up growth, and there are early signs that the housing market is responding. We see the Official Cash Rate falling to 0.75%, with the risks it could go lower. But, the lower it goes the more its effectiveness will get called into question. And if there was a marked downturn for whatever reason, the RBNZ may end up resorting to the box of unconventional tools it is working on. But if things got to that point, the Government's role would take on more focus. The Government can and should prepare quality spending and investment plans. It could line up targeted welfare spending/tax cuts aimed at giving the economy a cyclical boost. The country is also crying out for infrastructure and policies that would jump-start productivity. With Government debt low and its borrowing costs even lower, the Government is well-placed to lend a hand, if needed.

But this talk is more around contingency planning. Meanwhile, let's not forget the sun is still rising every morning!

ASB Economics (649) 301 5659 nick.tuffley@asb.co.nz

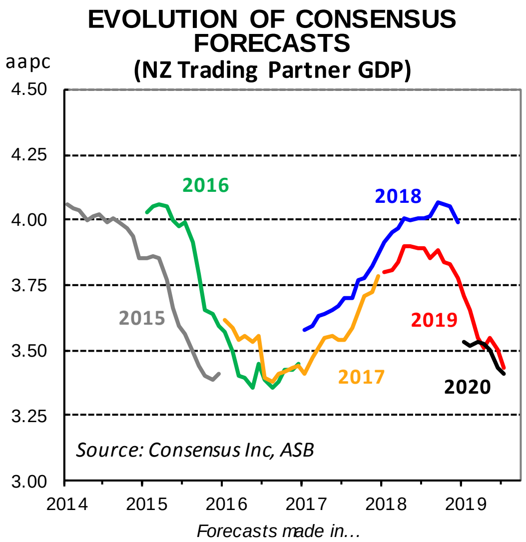
International Outlook – Trade War Fears Crystallising

The global growth slowdown has become even more entrenched in recent months. Trade war impacts are now more clearly showing up in hard data. Indeed, the latest round of global PMI data shows global manufacturing activity is in outright contraction. Service sector activity is so far holding in, but forecasts for NZ's trading partners nevertheless continue to be revised down.



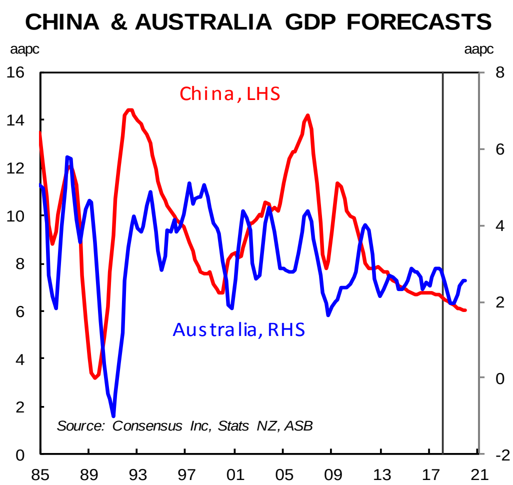
According to Consensus Economics forecasts, **trading partner growth is expected to print well below trend for the next two years**. 2019 growth is expected at 3.4% and the same is expected in 2020, with analysts having effectively revised away the small recovery in growth that had previously been expected next year. Risks are still to the downside in our view.

Growth forecasts for the Australian economy have continued to be pruned. The RBA has cut its cash rate twice reflecting, in part, concerns about the potential for weak domestic demand to spill over into the labour market. However, recent signs of a bottoming in the Sydney and Melbourne property markets help support analyst forecasts for a recovery in the Aussie economy next year.



In contrast, the slowdown in the Chinese economy looks set to resume. Authorities' stimulatory efforts haven't had a material effect on credit growth to date, and heading off the negative consequences of the trade war will become increasingly difficult. The headwinds from cooling external demand and trade tensions are expected to see GDP growth slow to 6.0% next year. But the risk of a deeper, trade war-related correction is rising rapidly.

The dark cloud of Brexit continues to hang over the UK, where it is now more clearly impacting activity, hiring, and investment plans. Moreover, with new Prime Minister Johnson now in the seat, the odds of a messy divorce have suddenly risen.

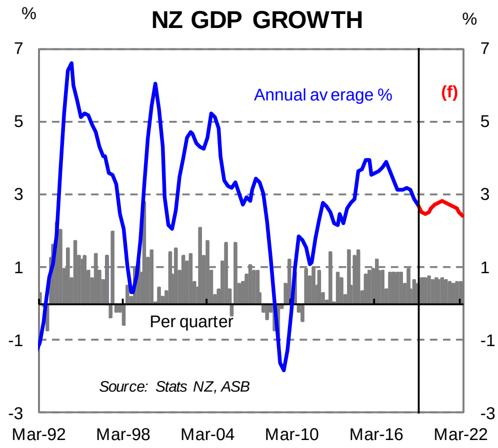


Central banks in Europe and the US will continue to act to support their economies. ECB President Draghi recently summed things up nicely noting "this outlook is getting worse and worse". The US economy, by contrast, is relatively solid with the Fed lowering rates more as an insurance policy than for disaster recovery.

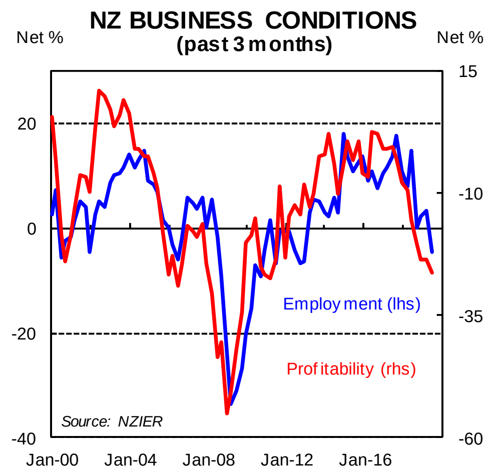
Despite the global gloom, **the NZ export sector is expected to continue to hold in relatively well**. Indeed, we expect NZ's Terms of Trade to hit fresh highs this year. Beef and lamb prices are leading the charge, with both set to hit new highs this season. Dairy production is expected to be similar to last season, but with higher milk prices. We expect a bullish farm-gate price $7.00 per kg of milk solids.

The two export sectors perhaps most at risk are forestry and tourism. Prices for the former have already tumbled. Higher global supply means we expect these lower prices to be sustained for at least the rest of 2019. The tourism boom is already showing signs of peaking, and the longer global growth remains below par the bigger the risk that overseas arrivals tail off faster than we currently expect.

The New Zealand Economy – under pressure



NZ economic growth has slowed since mid-2018 and is likely to remain subdued for the remainder of 2019. The economic slowdown has been particularly prominent in professional, scientific, technical, admin and support services (business services), retail trade and accommodation (particularly as international visitor arrival growth has slowed) and financial and insurance services. **We expect lower interest rates to support a recovery in economic demand over 2020.**



Business confidence has remained persistently weak over the past 18 months, with key measures of business activity pointing to economic conditions deteriorating in recent months. Businesses have reported a fall in profitability over the past year, as costs have increased but the ability to lift prices has been constrained. **Uncertainty around the economic outlook and waning demand have prompted firms to defer investment plans over the past year.** More recently, weak profitability has resulted in QSBO employment intentions turning negative for the first time since 2012. **Although the labour market has remained remarkably resilient to date, the recent fall in employment intentions highlights the risk that the labour market may start to soften over the coming year.** A weak labour market would lead to the economic downturn becoming more entrenched as households become risk averse and pull back on major household purchases.

A key puzzle over the recent economic cycle has been subdued price inflation relative to capacity measures, in particular relatively subdued wage growth despite the steady decline in the unemployment rate. The breakdown in the historical relationship between wage inflation and the unemployment rate has been evident in many countries following the Global Financial Crisis, including in Australia and the US. The Reserve Bank of Australia (RBA) recently concluded that there was greater slack in the labour market than previously thought, and this change in view was pivotal in its decision to lower its cash rate over June and July. **Recent ASB analysis suggests that, like Australia, there may be greater slack in the NZ labour market than previously believed.** Furthermore, with labour demand cooling as business confidence remains weak, the degree of slack in the labour market may start to increase going forward.

Recent declines in mortgage rates are likely to stimulate the housing market in coming months, and we expect nation-wide annual house price growth to nudge up to a modest 5-6%. Housing market trends have remained divergent across regional boundaries. The Auckland, Northland and Queenstown markets have underperformed the rest of the country, and have possibly been weighed down by the introduction of foreign buyer restrictions in late 2018. Elsewhere throughout the country the housing market has been buoyant, with house prices growing strongly in some regional centres.

NZ commodity exports continue to perform strongly, for the most part. Kiwifruit export sales have started the year strongly and orchard-gate returns are shaping up to be similar to last season's healthy levels. Both beef and lamb prices may test record highs over the spring, as Chinese consumers substitute to alternative forms of proteins as African swine fever impacts the Chinese pork supply. As already noted, we hold a relatively bullish milk price forecast. Bucking the positive commodity price trend, forestry prices have tumbled, ending a record-breaking run. Lifts in European and NZ supply have driven prices lower and, with a backdrop of muted global demand, forestry prices are likely to remain subdued. **Slowing global growth, in part due to escalating trade tensions, is likely to impact NZ's export performance over the coming year. However, we believe food export demand may buck the trend and hold up relatively well** (so long as the trade war economic impacts remain somewhat contained).

Interest Rates and Exchange Rates – Fresh OCR low beckons, but solid NZD outlook

New Zealand interest rates are hovering around record lows. Following a 25 basis point (bp) Official Cash Rate (OCR) cut in May, the Reserve Bank of New Zealand (RBNZ) surprised the market in August with a 50bp OCR cut with Governor Orr warning that "*it's easily within the realms of possibility that we might have to use negative interest rates.*" Central banks worldwide have cut policy interest rates, including the Reserve Bank of Australia's (RBA) 50bp of cuts over June and July, and the US Federal Open Market Committee's (FOMC) 25bp cut. **Despite lower short-term interest rates, yield curves in NZ and overseas have continued to flatten as still-low inflation, slowing global growth, and the negatively-skewed risk profile have pushed down long-term interest rates.** Ten-year government bond yields are sub 1% in NZ and Australia, close to 3-year lows in the US (circa 1.5%) and around multi-year lows in the UK and Germany. **The yield curve (2s-10s) briefly inverted in the US, highlighting risks to the global growth outlook.**

Given downside risks to the NZ and global growth outlook we expect the RBNZ to deliver a further 25bp OCR cut in November. We expect the OCR to plateau at 0.75% in November with **the risk the OCR trough is deeper. There is the risk the OCR is pushed below zero** (-0.35% is the OCR floor according to the NZ Treasury) and the RBNZ deploys non-conventional monetary stimulus. A sluggish domestic and global outlook, entrenched low inflation and remaining labour spare labour market capacity will enable a long period of very low policy interest rates. Proposed increases for bank capital requirements for locally-incorporated NZ banks are likely to keep the OCR lower than it otherwise would be. We expect gradual RBNZ hikes from early 2022, but a low OCR endpoint of just 2.25% by late 2024.

More policy support from overseas central banks will keep overseas short- and long-term interest rates historically low. We do not expect yield curves to steepen markedly and there is the risk that long-term yields fall further and curves flatten if downside global risks crystallise. We expect two further 25bp cuts to the RBA's 1% cash rate, in November and February. We also expect the Federal Reserve to "act as appropriate" and cut the Federal Funds rate by a further 75bp by 2020. Bank of England hikes are a long way off (and cuts may eventuate if a hard Brexit eventuates), the European Central Bank is expected to cut deposit rates in September, and we expect more stimulus from the People's Bank of China. **NZ and Australian longer-term yields are biased to hover at historical lows**, before eventually drifting higher as policy interest rate hikes are contemplated down the track.

Despite a lower NZ and global interest rate outlook, our currency outlook is little changed. We expect mid-2019 to be the low point for the NZD, which is expected to firm over the forecast horizon, given our persistently-high Terms of Trade, strong NZ fiscal position and continued investor interest in NZ assets. **The risk of a currency war and associated global slowdown biases the risks to commodity currencies (like the AUD, CAD and NZD) to the downside.** Consequently, risks to safe-haven currencies (Swiss France, Yen, and likely the USD) are to the upside.

With the Fed now part of the rate cut chorus, and with additional policy stimulus supporting growth prospects in China, the **USD is expected to weaken over the projection period**, with the NZD gradually strengthening to 0.73USD by the end of 2022. We expect the **NZD/AUD to remain supported** by the stronger outlook for our Terms of Trade, our (marginally) sounder nationwide housing market and consumer spending outlook. We see the NZD ending 2022 at around 97 Australian cents. **The Chinese yuan is expected to weaken**, to around 5.0 NZD by late 2022, with risks towards a stronger CNY profile if policy stimulus ignites the Chinese economy. Gradual NZD strengthening is expected against the yen, with the kiwi at around 80 yen by late 2022. We expect the NZD to broadly keep pace with the euro, with the NZD hovering around 60 euro cents over the projection period. UK Sterling is expected to remain volatile, but growing risks of a hard Brexit are likely to weigh on the GBP, with the NZD at around 56 pence by late 2022.

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Economic and Financial Forecasts

ASB economic forecasts		Dec-18	Mar-19 <<actual	Jun-19 forecast >>	Sep-19	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
NZ GDP real	**AA%**	**2.9**	**2.7**	**2.5**	**2.4**	**2.4**	**2.4**	**2.7**	**2.5**	**2.3**
private consumption	AA%	3.2	3.2	3.3	3.3	3.2	3.2	3.9	3.3	2.8
dwelling construction	AA%	2.6	3.5	5.1	7.3	8.8	8.8	-1.0	-6.2	-7.7
other investment	AA%	4.1	2.1	0.7	1.0	1.5	1.6	3.3	4.5	5.1
exports	AA%	3.1	3.5	3.6	4.2	4.6	3.7	2.7	2.3	2.1
imports	AA%	5.8	4.1	1.8	1.1	1.6	2.4	5.1	3.8	3.4
NZ GDP real	A%	2.5	2.5	2.3	2.4	2.5	2.6	2.8	2.3	2.4
NZ GDP real	Q%	0.6	0.6	0.7	0.5					
NZ CPI	**A%**	**1.9**	**1.5**	**1.7**	**1.3**	**1.4**	**1.7**	**1.7**	**1.9**	**1.9**
NZ house prices (QV index)	A%	2.8	1.4	0.9	2.4	3.4	4.4	1.9	1.0	2.6
NZ unemployment (sa%)	Qtr	4.3	4.2	3.9	4.1	4.1	4.3	4.2	4.0	4.0
NZ private sector wages (LCI)	A%	2.0	2.0	2.2	2.3	2.3	2.5	2.4	2.4	2.4

A% = percentage change since same quarter the previous year

AA% = percentage change for year ending quarter since the previous year

ASB interest rate forecasts (end of quarter)	Dec-18	Mar-19	Jun-19 <<actual	Sep-19 forecast >>	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
NZ cash rate target	1.75	1.75	1.50	1.00	0.75	0.75	0.75	1.00	1.50
NZ 90-day bank bill	1.97	1.85	1.65	1.20	0.95	0.95	0.95	1.20	1.70
NZ 2-year swap rate	1.97	1.63	1.35	0.95	0.85	0.85	0.85	1.20	1.70
NZ 10-year gov't stock	2.38	1.81	1.57	0.95	0.90	0.90	1.00	1.40	1.80

ASB foreign exchange forecasts (end of quarter)	Dec-18	Mar-19	Jun-19 <<actual	Sep-19 forecast >>	Dec-19	Mar-20	Mar-21	Mar-22	Mar-23
USD per NZD	0.67	0.68	0.67	0.64	0.68	0.69	0.72	0.73	0.73
GBP per NZD	0.53	0.52	0.53	0.50	0.53	0.53	0.55	0.56	0.56
AUD per NZD	0.95	0.96	0.96	0.94	0.94	0.95	0.96	0.97	0.97
JPY per NZD	74.1	75.2	72.1	71.0	74.1	74.5	77.8	78.8	80.3
EUR per NZD	0.59	0.60	0.59	0.57	0.58	0.58	0.59	0.59	0.60
CNY per NZD	4.61	4.57	4.60	4.45	4.69	4.75	4.90	4.96	4.96
TWI - 17 country	73.48	73.86	73.2	70.2	72.7	73.1	75.1	75.8	75.9

ASB Economics & Research			Phone
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659
Senior Economist	Mark Smith	mark.smith4@asb.co.nz	(649) 301 5657
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853
Senior Economist	Mike Jones	mike.jones@asb.co.nz	(649) 301 5661
Senior Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778
Senior Economist, Wealth	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5915
Data & Publication Manager	Judith Pinto	judith.pinto@asb.co.nz	(649) 301 5660

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