With a little help from my friends

- Economic momentum fading as construction activity peaks and dairy incomes decline - but support is on its way.
- RBNZ has begun reducing the OCR – we expect the OCR to fall to 2.5% by the end of 2015, with room for further cuts.
- NZD also lower, boosting export competiveness for the year ahead.

Last year's 'Rockstar' label for the economy has faded. The economy has cooled off and growth over 2015 will be modest compared to last year. Contributing to the slow-down is a combination of dry summer weather, weak dairy prices, and a levelling off in Canterbury construction activity. But, sticking with a music theme and paraphrasing Joe Cocker (and the Beatles), the economy is getting a little help from its usual friends: both the NZ dollar and interest rates are falling. Those falls will help prop up growth, particularly over 2016. Have a little faith in the economy: we expect calendar 2015 growth of 2%, rising to a healthy 2.9% in 2016 – hardly an economic meltdown.

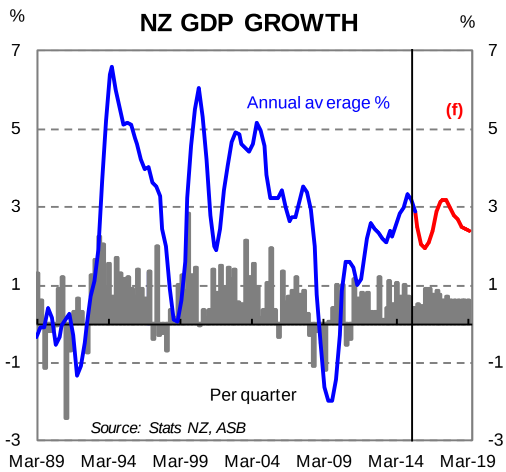
The big shift of the past few months has been further considerable weakness in dairy prices, coupled with a broader backdrop of benign inflation pressures. Consequently, the risk of Official Cash Rate cuts has turned into reality: the RBNZ cut the OCR by 25bp in both June and July to take the OCR to 3.0%. We expect further cuts over the next few months to take the OCR back down to 2.5%, its post-Financial Crisis and post-Canterbury Earthquake low. An even lower OCR is conceivable.

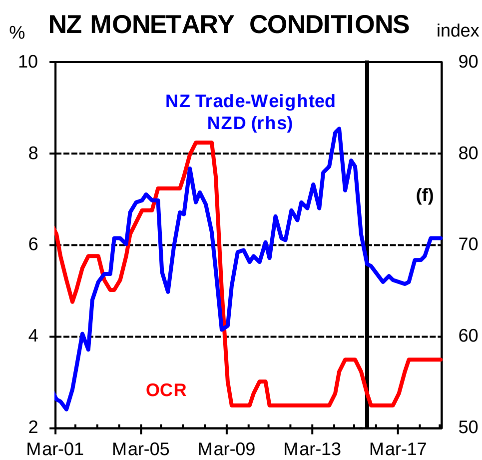
The continued weakness in dairy prices and increased likelihood that their recovery is more modest and distant alter the spending outlook for regions dependent on dairy incomes. The current dairy season ending May 2016 is shaping up to have a milk price that is around last season's $4.40/kg milk solid. However, dairy farmers' cashflows in this current season will be weaker than last season's and, consequently, farmers will be budgeting hard. Strong global dairy supply growth remains a headwind to a recovery in prices and confidence in the dairy sector is likely to remain weak for some time.

The rest of the world still has its risks, though Greece's near-successful effort at a self-inflicted euro exit has been more of a headline-rich sideshow than something likely to have a material impact on NZ. The recent retracement of over-heated Chinese share prices has heightened uncertainty over the outlook for the economy there. Closer to home, construction growth is slowing as the Canterbury rebuild levels off.

But to muse that there ain't no sunshine would be to miss the substantial array of positives for growth. The trade-weighted exchange rate has fallen 16% from its high a year ago, with much of the fall happening since April. Export industries across the board have become more competitive in a relatively short space of time as a result. Tourism, now vying to be our biggest foreign exchange earner, was already going from strength to strength before that NZD fall. Chinese consumers may not be buying a lot of our milk at present, but they are flocking to NZ in droves to look at cows (and other fauna and flora) in their natural habitat. The kiwifruit industry is also recovering from the blight of Psa, as another example.

Meanwhile, other domestic drivers will remain positive. Net migration flows will remain relatively strong over the next year, even if they should start gradually easing as Australia's economic recovery gains some ground and the net outflow of New Zealanders picks up. Consumer spending will be supported by that population growth and good employment growth. Cashflows for borrowers – including beleaguered dairy farmers – will be bolstered by falling interest rates, helping to support overall spending. There are undoubtedly parts of NZ that will feel pressure over the next year. But changes are occurring which will help over time.





International outlook

On balance, we continue to see gradual economic recovery from our major trading partners. Near-term wobbles and political risks have dominated some of the market focus of late, but this has generally masked gradual improvement in global growth, for the most part. In saying this, the IMF downgraded its forecasts for global growth in July. Part of this reflects 'temporary' weakness in the first quarter of the year. But the Chinese growth outlook was also downgraded, with rebalancing in the Chinese economy set to see growth decelerate to 6.8% over 2015.

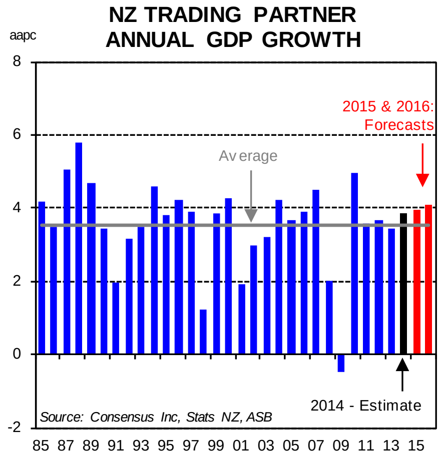
The Chinese equity market plunge grabbed attention of market watchers over July. However, given the relatively low level of participation in equity markets, there is likely to be limited direct impact on the Chinese economy and very little consequence for our exporters (for more discussion, see here). However, what has been of concern is the extent of slowdown in Chinese economic momentum over the first half of 2015. These concerns have been further intensified by wide-spread speculation that actual growth is actually substantially below the official estimates. The recent underperformance of growth has now grabbed the attention of officials. The pace of growth will become a greater priority, and we anticipate officials will provide the stimulus necessary to boost growth. However, given concerns around the composition of growth and risk of exacerbating imbalances, stimulus measures are likely to target specific industries rather than be broad-based.

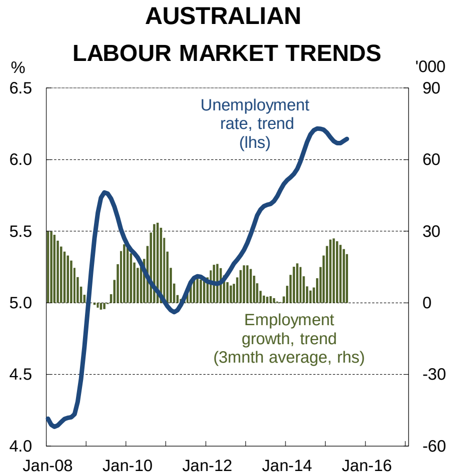
Australia continues to delicately manage its transition away from mining-investment led growth to a broad-based economic recovery. Like NZ, lower interest rates and the lower AUD should be supportive for Australia over 2015/16 and we are now seeing tentative signs of Australian labour demand improving. We expect the Reserve Bank of Australia (RBA) will continue to hold the cash rate at 2%. Reflecting recent improvements in the Australian labour market, the August RBA policy statement implied a move away from a soft easing bias to a more neutral stance. Comments also implied the RBA was more comfortable with the level of the AUD.

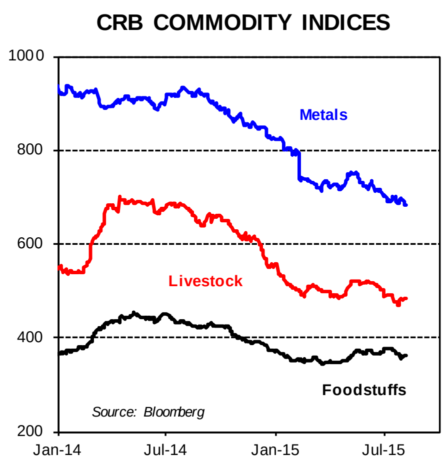
The US economy is also continuing to recover, with jobs growth and low interest rates supporting consumer spending and housing demand. However, the recovery remains reasonably fragile with business investment and exports still soft, in part reflecting the recent lift in the USD. The Federal Reserve is preparing to commence lifting interest rates later this year, although has strongly emphasised the timing and extent of rate hikes will remain data dependent. Jobs growth and inflation indicators are the key areas of focus. At the time of writing, the market saw a chance of the Fed starting rate hikes as soon as September, although we see the balance of risks as skewed toward a more cautious approach and a December lift off.

Eurozone developments have been overshadowed by the political drama resulting from Greece and its debt negotiations. The economic outlook for Greece has deteriorated markedly, largely a result of the damage to its banking sector caused by the uncertainty and political brinkmanship. Meanwhile, the remainder of the Eurozone has gradually improved, with recovery aided by lower interest rates, the lower Euro and low oil prices.

Global commodity prices remain low. The slump in oil prices over the second half of 2014 has been a key contributor to weak global inflation in 2015. However, weak commodity prices extend beyond oil. Coal and iron ore prices have fallen, reflecting high levels of investment increasing supply. Prices for precious metals have declined. Even agriculture prices have slumped, including USD prices for wheat, corn and soy. Commodity prices remain subdued and highlight the downside risks to global inflation.

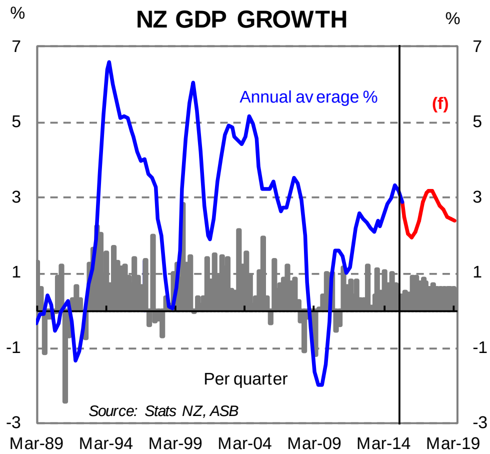




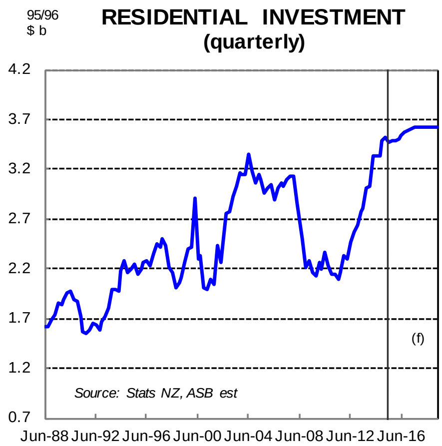


The New Zealand Economy

NZ economic growth over 2014 was supported by increased construction activity and strong population growth. However, over 2015, economic growth is set to slow from 3% annual average growth to just 2%. The slowdown in 2015 growth is a result of flatter construction activity and weaker demand from rural regions exposed to the dairy sector. Beyond 2015, we expect growth to recover back to 2.9%. The lower NZD will support growth from non-dairy exports while low interest rates will stimulate household demand. We expect inflation pressures to lift over the next two years, but remain muted by historical standards.

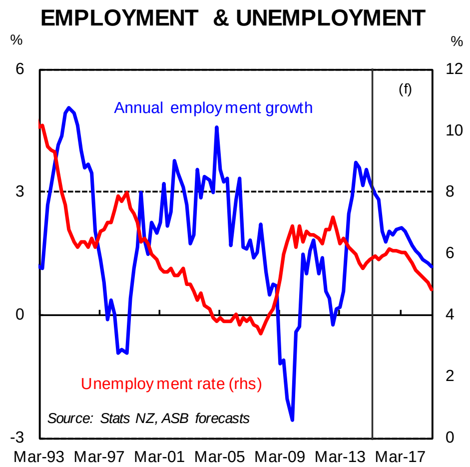


Dairy export growth is likely to remain slow as low dairy prices discourage production growth. While the current season will be challenging and a drag on the economy, we anticipate that slower production growth globally should eventually restore balance in global dairy markets and drive a recovery in prices over 2016. Meanwhile, **improving global demand and the lower NZD should help support growth for non-dairy exports.** Demand for other key commodity exports, including beef and kiwifruit, remains robust. Increased residential construction in Australia should also be beneficial for NZ manufacturing exporters.



Exports of Services are set to perform well over the next two years, with growth underpinned by strong tourist numbers, increased numbers of foreign students and the lower NZD. Tourist numbers have lifted strongly, on a steady upward trend over the past two years. Much of this has been driven by Chinese arrivals, and we expect this trend to continue.

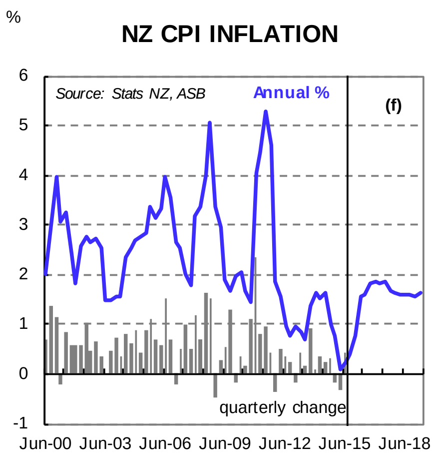
Consumer spending will remain supported by strong population growth, low interest rates and improving disposable incomes. However, confidence has become mixed, particularly areas of the country most exposed to the dairy sector**. Weaker dairy incomes will also lower investment demand** over 2015. Along with dairy sector weakness, lower business confidence and additional uncertainty on the economic outlook may also delay some investment projects in the near term. Fiscal settings will remain a drag on economic growth, as the focus remains on reducing net government debt.



Interest rates have fallen sharply over 2015. **Lower debt servicing costs will be a key support to consumer and investment demand over 2016.** We expect the housing market to remain tight in Auckland, while lower interest rates should modestly stimulate activity outside of Auckland and Canterbury over the coming year.

Construction activity is likely to peak in 2015, although remain at elevated levels. A small slowdown in Canterbury construction should be largely offset by increased building activity in Auckland.

The **unemployment rate is likely to remain around 6**% over the coming year, as strong net migration inflows continue to boost labour supply. Given recent trends in the labour market, we expect wage inflation pressures are likely to remain muted. Indeed, we may even see conditions in the labour market soften over the second half of 2015.

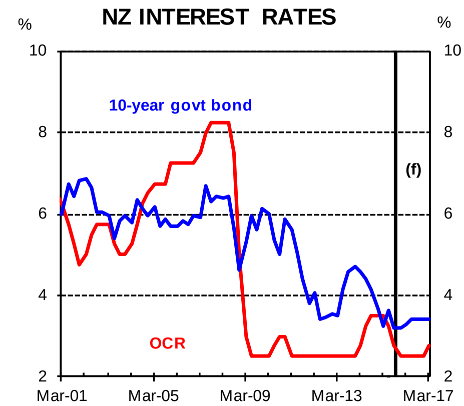


Broader inflation pressures remain very low. Imported inflation has remained subdued due to low global commodity prices and the high NZD. The recent drop in the NZD is expected to temporarily lift imported inflation over the next year. Meanwhile, domestic inflation pressures remain muted, due to ample capacity and strong competition. We expect domestic inflation pressures to remain broadly steady, given the relatively stable pace of recovery. Construction inflation has picked up but remains modest by comparison to historical cycles. **We expect medium-term inflation to settle at just under 2%.**

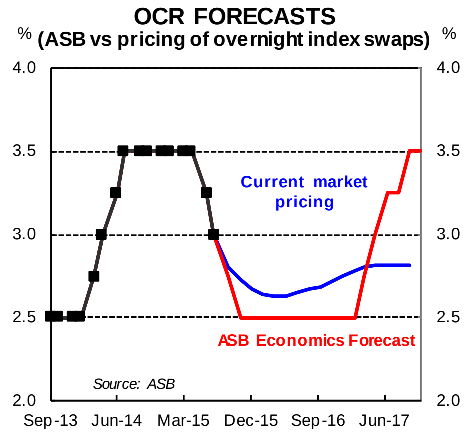
Interest Rates and Exchange Rates

We anticipate the Reserve Bank of New Zealand will cut the cash rate to 2.5% by October and the risks are skewed to the downside. Interest rates are likely to remain low, though we anticipate that while short-term rates will fall, longer-term interest rates may rise. Low interest rates and weaker dairy prices will weigh on the NZD.

Inflation pressures remain subdued and the 2015 growth outlook has deteriorated sharply in recent months. A key catalyst for the weaker growth outlook has been the realisation that the Canterbury rebuild has peaked earlier than expected and dairy prices falling sharply. Meanwhile, **inflation is currently close to zero** and, given the modest growth outlook, inflation is **less likely to return to the RNBZ's medium-term target** (1-3%) without further stimulus. **We see the RBNZ cutting the cash rate to at least 2.5%,** and at the time of writing risks to the interest rate and inflation outlook were skewed to the downside.

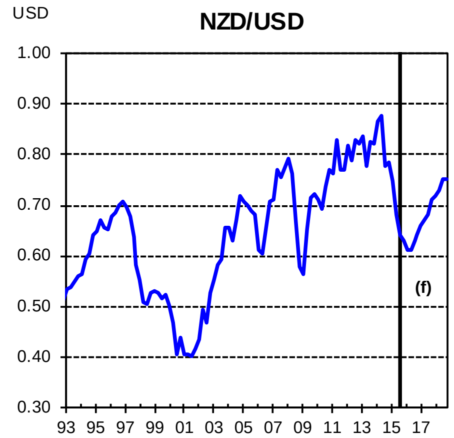


Further cash rate cuts will continue to **place downward pressure on short- to medium-term market interest rates**. Furthermore, as we see downside risk to the rate outlook there is scope for further declines in short- to medium-term interest rates later in 2015 or early 2016.



In contrast, we see upside risk to longer-term rates. Longer-term rates remain heavily influenced by offshore events. Global interest rates have remained very low over the first half of 2015, reflecting low global inflation pressures and stimulatory policy settings. Later this year, **we expect the Federal Reserve to commence lifting US interest rates** as the US economy continues to improve. Once this happens, we expect longer-term interest rates will drift higher.

We expect the **NZD/USD to continue to fall** toward a low of 0.61 as NZ dairy export prices remain weak, the RBNZ cuts rates and the Federal Reserve lifts rates (the latter providing support to the USD). The NZD/USD is likely to trough around the first half of 2016, before lifting gradually as NZ export prices recover over the next few years.



While the RBNZ is starting to ease rates, the **Reserve Bank of Australia's easing cycle has likely been completed**. The NZD/AUD is likely to remain around the high 0.80s over 2015 and 2016. However, in the **near term, concerns about Chinese growth and low commodity prices could see the NZD outperform the AUD**, and see the NZD/AUD move to the low 0.90s on occasion.

The **NZD/GBP** will gravitate to 0.40 over the next year: the Bank of England is inching towards lifting interest rates from zero, which will see the GBP outperform. We see scope for some limited **moderation of NZD/EUR** towards 0.58 this year. Eurozone growth is accelerating, and – fingers crossed – the Greek situation remains contained and some of the recent euro underperformance reverses. We expect **NZD/JPY to soften to 78-80.**

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Economic Forecasts

ASB economic forecasts		Dec-14	Mar-15 <<actual	Jun-15 forecast >>	Sep-15	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Mar-18
NZ GDP real	**AA%**	**3.3**	**3.2**	**2.9**	**2.5**	**2.0**	**1.9**	**2.1**	**2.4**	**2.9**	**3.1**	**2.8**
private consumption	AA%	3.2	3.7	3.8	3.4	3.0	2.6	2.6	2.9	3.3	3.6	3.5
dwelling construction	AA%	16.2	12.3	8.5	7.1	3.4	2.0	1.6	1.1	1.8	2.5	1.4
other investment	AA%	6.3	4.5	3.5	1.3	-0.3	-0.2	-0.6	0.4	1.7	2.5	5.1
exports	AA%	3.3	3.9	5.3	6.6	5.7	5.1	4.3	3.4	3.8	4.1	3.3
imports	AA%	7.9	7.5	6.4	6.0	4.4	3.0	2.2	2.0	2.4	3.0	4.0
NZ GDP real	A%	3.5	2.6	2.3	1.8	1.5	2.3	2.8	3.0	3.4	3.3	2.5
NZ GDP real	Q%	0.7	0.2	0.4								
NZ CPI	**A%**	**0.8**	**0.1**	**0.3**	**0.4**	**0.8**	**1.6**	**1.6**	**1.8**	**1.8**	**1.8**	**1.6**
NZ house prices (QV index)	A%	6.4	8.3	9.9	12.2	11.8	10.9	7.6	4.6	2.5	1.4	0.7
NZ unemployment (sa%)	Qtr	5.7	5.8	5.9	5.9	6.0	6.0	6.2	6.2	6.1	6.1	5.5
NZ private sector wages (LCI)	A%	1.8	1.8	1.8	1.9	1.8	2.1	2.0	2.0	2.1	2.1	2.2
NZ current account ($b)	Yr	-7.8	-8.6	-9.1	-10.1	-11.5	-12.7	-13.2	-13.4	-12.8	-12.1	-12.2
as a % of GDP	Yr	-3.3	-3.6	-3.8	-4.2	-4.8	-5.2	-5.4	-5.4	-5.1	-4.8	-4.6

A% = percentage change since same quarter the previous year

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

Financial Forecasts

ASB interest rate forecasts (end of quarter)	Dec-14	Mar-15	Jun-15 <<actual	Sep-15 forecast >>	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Mar-18
NZ cash rate target	3.50	3.50	3.25	2.75	2.50	2.50	2.50	2.50	2.50	2.75	3.50
NZ 90-day bank bill	3.67	3.63	3.26	2.8	2.6	2.6	2.7	2.7	2.8	3.1	3.6
NZ 3-year swap rate	3.91	3.59	3.21	3.1	3.0	3.0	3.2	3.3	3.4	3.6	3.9
NZ 10-year gov't stock	3.66	3.23	3.62	3.2	3.2	3.3	3.4	3.4	3.4	3.4	3.7

ASB foreign exchange forecasts (end of quarter)	Dec-14	Mar-15	Jun-15 <<actual	Sep-15 forecast >>	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Mar-18
USD per NZD	0.783	0.749	0.682	0.64	0.63	0.61	0.61	0.63	0.64	0.66	0.72
GBP per NZD	0.503	0.506	0.434	0.42	0.41	0.40	0.40	0.40	0.40	0.41	0.44
AUD per NZD	0.957	0.979	0.889	0.88	0.88	0.87	0.87	0.88	0.86	0.86	0.87
JPY per NZD	93.6	90.0	83.5	79	80	78	76	77	77	79	85
EUR per NZD	0.644	0.692	0.609	0.58	0.58	0.58	0.56	0.57	0.57	0.57	0.58
CNY per NZD	4.856	4.649	4.235	4.00	3.97	3.90	3.84	3.91	3.90	3.83	4.18
TWI - 17 country	79.3	78.6	71.3	68.0	67.7	66.7	65.9	66.6	66.1	65.9	68.3

ASB Economics & Research			Phone	Fax
Chief Economist	Nick Tuffley	nick.tuffley@asb.co.nz	(649) 301 5659	(649) 302 0992
Senior Economist	Jane Turner	jane.turner@asb.co.nz	(649) 301 5853	
Senior Economist	Chris Tennent-Brown	chris.tennent-brown@asb.co.nz	(649) 301 5660	
Rural Economist	Nathan Penny	nathan.penny@asb.co.nz	(649) 448 8778	
Economist	Kim Mundy	kim.mundy@asb.co.nz	(649) 301 5661	

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ASB Economics

ASB North Wharf, 12 Jellicoe Street, Auckland