BUSINESS NZ

PLANNING FORECAST

DECEMBER 2015

BusinessNZ

The economy – second half pick-up

Executive summary

Descriptions such as 'patchy growth' and 'uncertainty' characterised the state of the NZ economy mid-year with both business and consumer confidence taking a dive. This has changed somewhat since then with much higher confidence levels apparent despite some ongoing risks facing both the domestic and international economy. Recent feedback from BusinessNZ's Affiliated Industries Group (AIG) indicates optimism and increasing activity across a wide range of sectors, although this was not universal. Some sectors are continuing to face frustrations with existing regulatory frameworks.

The BNZ–BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show economic growth holding up well, while other forward looking indicators, such as the ANZ Truckometer (a measure of freight movements), are also steaming along quite well.

To be sure, the agricultural sector still faces some headwinds, particularly the dairy sector, in respect to milk prices which, while improving, are still somewhat off the pace if Fonterra is to deliver on its forecast payout for the 2015/16 year. Moreover, the El Nino weather pattern is already affecting some regions with drier than expected conditions for this time of year.

Other sectors of the economy are going from strength to strength, including both construction and tourism, while the continued strong growth in net migration is adding to demand.

In short, a number of factors are acting as positive drivers of future growth prospects for the NZ economy:

- Strong net migration inflows adding to the demand for goods and services
- Pent up demand for housing boding well for construction activity generally
- Continued earthquake strengthening of commercial buildings
- Continued strong growth in freight movement – a key forward indicator of economic growth
- Continued tourism growth on the back of a lower NZ dollar and the attraction of NZ as a safe destination
- Low inflationary environment with historically low interest rates likely to persist for some time
- An exchange rate at much more competitive levels for exporters - a theme which has come through in recent BNZ-BusinessNZ Performance of Manufacturing Index (PMI) comments
- Very transparent fiscal and monetary policy regimes by international standards, with a stable and predictable government.

Several key issues on the risk side of the equation are:

- The likely impact of El Nino on agricultural production over the 2015/16 summer period
- The ongoing threat of international terrorism and its effect on investment confidence
- High levels of household and agricultural debt posing a threat should asset prices burst (and/or interest rates rise significantly)
- Risk of government third term-itis with the danger of focusing on economically irrelevant issues rather than keeping a keen eye on the areas of reform required to make the boat go faster
- Incremental improvements in the regulatory space, including the latest largely process focused Resource Management Act proposals - positive but not a game changer.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 14 for the December 2015 quarter, up 10 on the previous quarter and up 4 on a year ago.

Business and consumer confidence have bounced back with both hiring and investment intentions rising.

The BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) show ongoing consistent expansion. For the month of November the PMI was 54.7 and the PSI 59.8 (its highest level since November 2007).

The construction and tourism sectors remain buoyant with strong migration inflows and pent-up demand for housing likely to drive construction for a number of years to come.

The agricultural sector remains a mixed bag. Despite recent rises, global dairy prices are still not at levels which can provide certainty that Fonterra's forecast payout for the current season will be met. Moreover, widely predicted El Nino effects are likely to be significant given already near drought conditions in some parts of the country. Some early destocking is already taking place which could affect overall capital stock levels next year.

Inflation is dead and buried for the present and one wonders what, if anything, can be achieved by way of boosting investment growth through any further interest rate reduction, given interest rates are already at historically low levels.

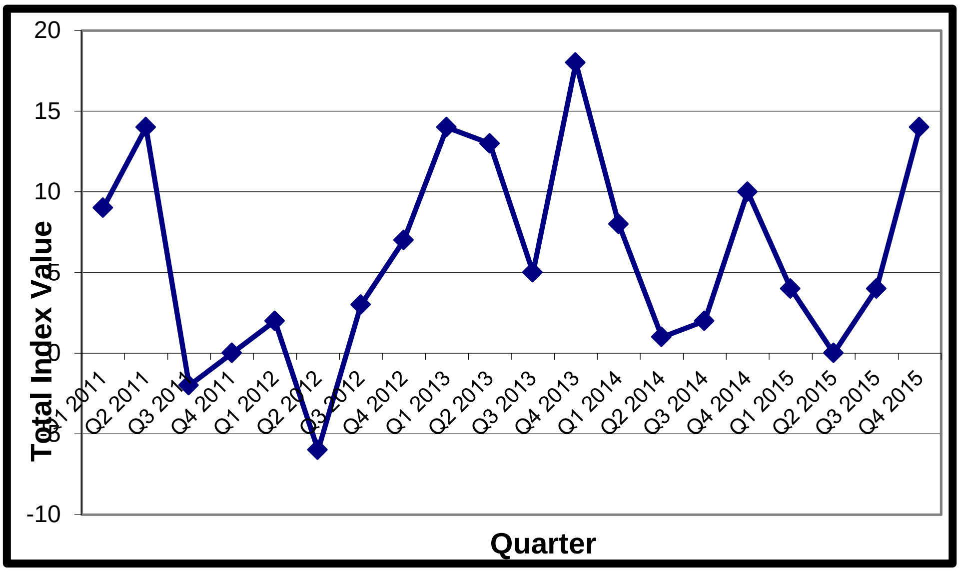
On the labour market front, high levels of inward migration and relatively high labour force participation rates are likely to keep the unemployment rate around 6 percent.

PART 1: THE NZ ECONOMY – WHERE ARE WE NOW?

BusinessNZ Economic Conditions Index (ECI)

The overall BusinessNZ Economic Conditions Index (a measure of the major economic indicators) sits at 14 for the December 2015 quarter, an improvement of 10 on the previous quarter and up 4 on a year ago.[1]

Overall Economic Conditions Index (ECI)



Source: BusinessNZ

Data in the ECI is broken into four key sub-groups:

- Economic growth/performance indicators
- Monetary policy/pricing indicators
- Business/consumer confidence indicators
- Labour market indicators

Of the ECI sub-groups:

Economic growth/performance indicators sit at 3 for the December 2015 quarter, down 2 on the previous quarter and the same as a year ago. The recent slide in the NZ dollar has helped dampen down the impact of lower international commodity prices.

Monetary policy/pricing indicators sit at 3 for the December 2015 quarter, down 1 on the last quarter and down 1 on a year ago. The significant drop in the NZ dollar mid-year has not translated into higher inflationary pressures to date since key international commodity prices (including oil) remain subdued.

Business/consumer confidence indicators sit at 5 for the December 2015 quarter, up 5 on the previous quarter and up 4 on a year ago. Despite a blip in confidence mid-year, both business and consumer confidence have rebounded to be firmly in positive territory.

Labour market indicators sit at 3 for the December 2015 quarter, up 8 on the previous quarter and up 1 on a year ago. After a long run of positive outcomes, the labour market took a slight hit over the second and third quarters of this year but qualitative data for the December quarter shows an improving outlook.

[1] The ECI tracks over 30 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the indicators (generally the number increasing minus the number decreasing) thus providing an overall measure of performance. In general, increases in an indicator are seen as positive (e.g. growth in GDP or employment) and declines as negative. However, this is not always the case; for example, declines in unemployment are seen as positive and increases as negative.

PART 2: THE NZ ECONOMY – WHERE ARE WE HEADING?

1.1 Economic growth (GDP) – approaching 3 percent

Economic growth approaching 3 percent is forecast out for the year to December 2017 (see below) and is still relatively solid compared with the growth rates of many of the countries we normally compare ourselves to.

Forecasts: Real GDP % Growth

	Years Ending		
	Dec 15	Dec 16	Dec 17
Highest	2.3	2.9	3.4
Average	2.2	2.2	2.7
Lowest	2.2	1.8	2.0

Source: ANZ, ASB, BNZ, and Westpac

Most sectors are putting in solid performances and growth is generally widespread across the economy, with some exceptions e.g. agriculture.

The BNZ–BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show economic growth holding up well, while other forward-looking indicators such as the ANZ Truckometer (a measure of freight movements) is also trucking along quite well. The PSI is currently at an 8-year high.

Adding to the mix, a lower exchange rate and historically low interest rates are providing a buffer against generally lower international commodity prices.

Both construction and tourism show continued strong growth and continuing strong growth in net inward migration is adding to the demand.

The construction sector continues to boom based largely on three factors:
First, the continued rebuild and enhancement of Christchurch, providing continuing activity for years to come (there are indications that the rebuild has plateaued but it still continues apace)
Second, a pent-up demand for housing in Auckland, driven partly by continued record migration levels (the majority in Auckland) requiring major housing and associated infrastructure development
Third, continued earthquake strengthening of the commercial sector - already well under way - in areas particularly vulnerable to earthquake risk.

Tourism is being assisted in two ways. A much lower dollar is attracting overseas tourists to New Zealand and the country's relative isolation from recent terrorism events means it is probably seen as a safe tourist destination. Accommodation occupancy continues to rise strongly with particular growth in the South Island, evidenced by recent official statistics.

The retail trade remains in positive mode with increased motor vehicle sales, often a key indicator of greater consumer confidence.

The agricultural sector is a mixed bag and still faces some headwinds, particularly the dairy sector where milk prices, while improving, are still somewhat off the pace if Fonterra is to deliver on its forecast payout for the 2015/16 year. Fonterra has left the forecast payout at $4.60 and the Fonterra Board has stated that its stable forecast reflects the board and management's view that international prices will keep improving in the first half of 2016.

El Nino weather patterns, characterised by warm winds, are already affecting some regions and drier than expected conditions for this time of year are another factor to be considered. Put into the mix relatively high levels of debt, particularly in the dairy sector, and certainly some farmers will struggle to break-even this year. Total (NZ) milk volumes are expected to be down by at least 6 percent over the current season, reflecting both lower price expectations (culling marginal stock) and weather events which raises an important question. If the NZ economy is to become more resilient to climatic change and adverse events better risk minimisation strategies will be required. In respect to agricultural production, this inevitably raises the case for the greater use of irrigation.

Putting aside the challenging issue of who pays - irrigation regimes can range from being largely of full private benefit to having significant public benefits - the potential for irrigation to improve relative certainty of production outcomes is undeniable.

The work of the Land and Water Forum (LWF) is crucial to getting greater economic efficiencies in the use of available water in NZ while ensuring, to the extent possible, that the externalities associated with water use are internalised to a reasonable degree. The LWF has just issued its 4th report which makes some 60 recommendations for improving the regulatory regime applicable to water allocation and use. Water reform is still one of the key areas where further progress is needed if NZ is to make the most of its abundant natural resources.

1.2 Monetary conditions – further loosening unlikely

Interest rates – stability moving forward

The 90-day bill rate is forecast to decline slightly for the year to December 2016 and then regain some ground out to December 2017 (see forecasts below).

Forecasts: Interest Rates (90 day bills)

	Years ending		
	Dec 15	Dec 16	Dec 17
Highest	2.9	2.7	3.8
Average	2.7	2.4	2.9
Lowest	2.5	2.0	2.0

Source: ANZ, ASB, BNZ, and Westpac

The Reserve Bank reduced the Official Cash Rate to 2.5 percent (down from 2.75 percent) in its latest review on 10th December and has not completely shut the door on further cuts (or indeed rises) if economic conditions warrant them. A rate reduction was largely contemplated but the issue of timing was one of debate with a number of economists and other commentators suggesting that the Reserve Bank should hold fire until the pros and cons of current economic activity were more clearly understood. Certainly this was the majority - but far from unanimous - view of the Institute of Economic Research's (NZIER's) Shadow Monetary Policy Board.

A very slight majority of the Shadow Board (52 percent) voted for the OCR to stay at 2.75 percent, increasing to 61 percent support for keeping the OCR at 2.75 percent or above. By contrast, 39 percent supported lowering the OCR to 2.5 percent (or lower still).

There are reasons why the Reserve Bank might hold off any further cuts to interest rates next year, although several respected commentators consider it will lower the OCR to around 2 percent by the end of 2016. However, in our view, there is a range of reasons for the Bank to settle for keeping the OCR at 2.5 percent for some time (before possibly raising rates to more neutral levels well down the track).

First, while headline inflation (which measures consumer prices) is still outside the Reserve Bank's target band of 1-3 percent, core inflation, discounting one-offs, is much more in the line of 1.5 percent. There can be an argument that the public is more in tune with headline inflation. However, the role of the Reserve Bank is to look broadly through one-off results and focus on the longer term. On this basis it can be argued that core inflation is a much more credible number for the Reserve Bank to target over the medium term.

While international oil prices have taken a hit (and continue to do so), many tradeable inflation issues are largely outside NZ's control and hence the need, as outlined above, to see through the dips and focus on the longer term.

Second, as has been stated earlier, the broad NZ economy is now performing relatively strongly (after the earlier dip mid-year) and with strong and prolonged high net inward migration levels and continued housing price pressures, lowering the rate further might fuel even greater domestic demand and put the economy at risk.

Third, with interest rates at historically low levels, it is debatable whether lowering them even further will have much impact on investment activity. Maybe investment opportunities and risk are more dependent on the regulatory framework than on interest rates per se, an issue which has surfaced in recent discussions with BusinessNZ's Affiliated Industries Group (AIG) members.

The NZ dollar – drifting sideways

Forecasts below show the NZ dollar as generally expected to drift slightly lower against the Australian and US dollars for the year to December 2016 before rising slightly against the US dollar in the year to December 2017. Predicting its future direction is difficult with forecast rates for the Trade-weighted Index (TWI) ranging from a high of 72.8 down to a low of 62.9 in the year to December 2017.

International moves towards more normalised monetary policy settings still appear to be a long way off. In the meantime uncertainty persists and will necessarily result in some ongoing volatility.

Forecasts: Exchange Rates

AUD (cents)			
	Dec 15	Dec 16	Dec 17
Highest	0.97	0.92	0.92
Average	0.93	0.90	0.89
Lowest	0.89	0.87	0.87

USD (cents)			
	Dec 15	Dec 16	Dec 17
Highest	0.65	0.62	0.68
Average	0.63	0.61	0.64
Lowest	0.60	0.59	0.59

TWI			
	Dec 15	Dec 16	Dec 17
Highest	71.7	69.3	72.8
Average	70.0	66.4	67.4
Lowest	67.6	63.3	62.9

Source: ANZ, ASB, BNZ, and Westpac

Inflation – remains subdued

Forecasts below show inflation firmly under control over the period to September 2017, remaining well within the Reserve Bank's target range of 1-3 percent.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Dec 15	Dec 16	Dec 17
Highest	0.6	2.3	2.3
Average	0.5	1.9	2.0
Lowest	0.3	1.6	1.8

Source: ANZ, ASB, BNZ, and Westpac

Despite a significant decline in the NZ dollar over the past six months and a levelling out of late, tradeables' inflation has not been an issue to date with declines in international commodity prices (e.g. oil) well and truly offsetting any cost flow-ons as a result of a lower currency.

Most inflationary pressures appear to be still on the downside. These include:

- Relatively flat international commodity prices, despite some increase in dairy prices of late
- Record low interest rates reducing debt servicing costs to both businesses and households
- Strong and continuing competition in many sectors (particularly retail) keeping a lid on general prices
- High population growth on the back of continued strong net migration inflows along with relatively high labour force participation rates keeping wage pressures under firm control while making it difficult to make headway on the unemployment front
- An international economy awash with money looking for a home
- Some continuing downward pressures on the Consumers' Price Index, including the recently announced $450 million cuts to ACC levies as they apply across the Work, Earners' and Motor Vehicle Accounts.

1.3 Business activity and consumer confidence – bouncing back

Business activity – back on board

Key indicators of business activity and confidence have risen substantially after the free-fall experienced mid-year, although this is not universally the case.

The inaugural New Zealand Chambers of Commerce Business Confidence Survey (November 2015) found that while in all parts of the country businesses were positive about the economy overall, sentiment was broadly stronger the further north one went.

A net 44.2 percent of businesses in the upper North Island expect the NZ economy to improve over the next 12 months, compared with a net 44 percent in the central and lower North Island, 30.9 percent in the upper South Island and 34.3 percent in the lower South Island.

When respondents were asked about their own business situation, a net 65.2 per cent said they expect to see an improvement over the next 12 months.

Other surveys of business confidence show investment and employment intentions firmly back on track after faltering mid-year.

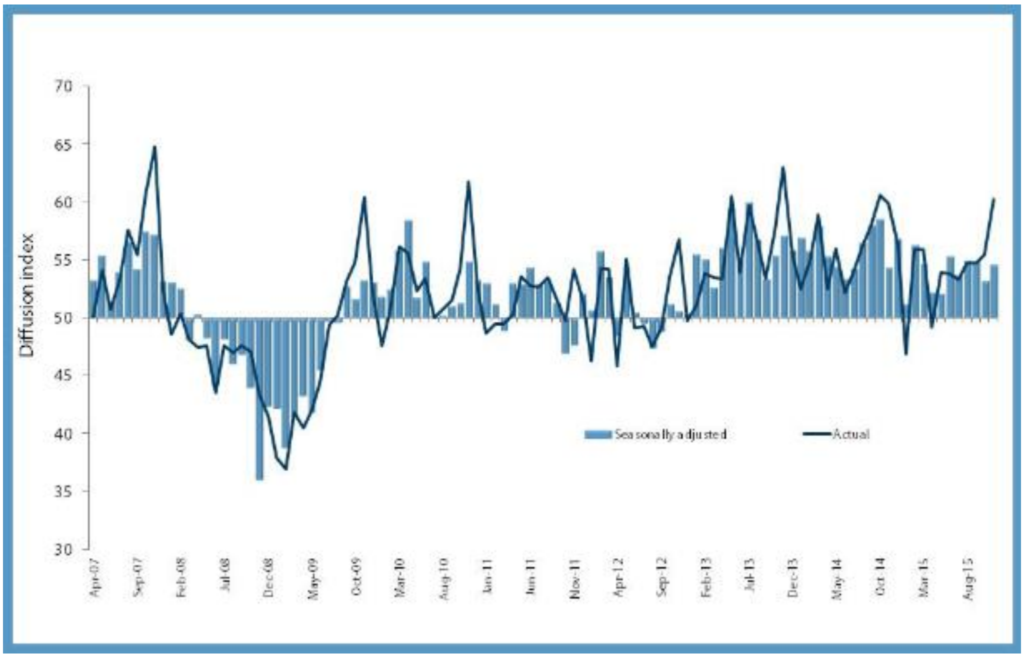
The ANZ Business Outlook shows business confidence continuing to improve in November, rising to a six month high. However, while positive, the latest result needs to be put into perspective in that confidence dived mid-year and is still well short of the dizzy heights reached a couple of years ago. Nevertheless, fundamental factors for future economic growth, such as investment and employment intentions, have, along with export intentions, continued to rise, the latter likely to be partially the result of a generally lower exchange rate.

More importantly, businesses have relatively strong expectations when it comes to their own business activity levels, a far more crucial point than their perceptions of the general economic outlook.

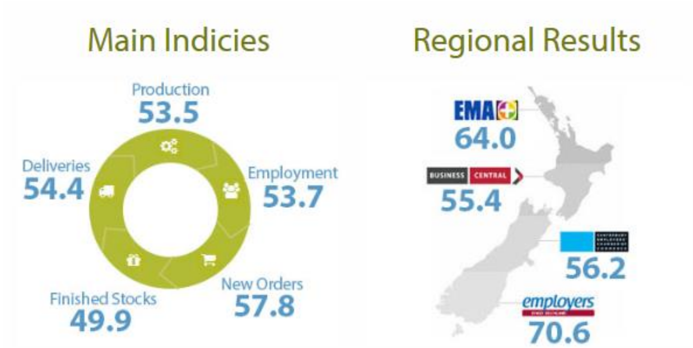
This is where hard (quantitative) data is much more important for determining future growth prospects than soft (qualitative) data. And key surveys giving quantitative results, such as the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) both show continued solid growth.

The seasonally adjusted PMI for November 2015 was 54.7 (a reading above 50.0 indicates that manufacturing is generally expanding; below 50.0 that it is declining), that is, 1.5 points higher than in October and very similar to expansion levels experienced in both August and September. The sector has now been in continued expansion since October 2012.

BNZ-BusinessNZ Performance of Manufacturing Index (PMI)
(2007 onwards)



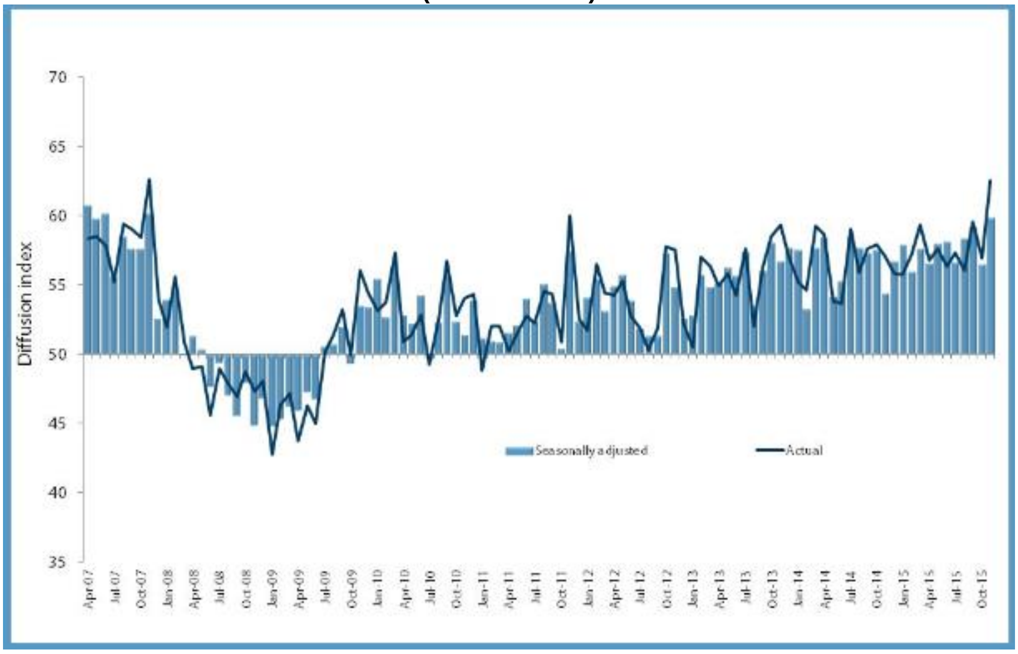
New orders (57.8) were at its highest levels since June 2015, as was employment (53.7). Also, the proportion of positive comments for November (68.6%) was a healthy pick-up from both October (61.8%) and September (58.7%). A number of comments centred on seasonal factors at play, although others mentioned good customer demand, both domestically and offshore.



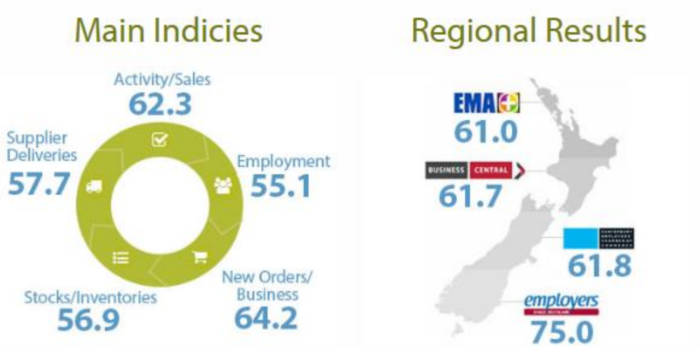
The PMI's sister survey, the BNZ–BusinessNZ Performance of Services Index (PSI), continues strongly, with further expansion in November. The PSI for November was 59.8, 3.3 points higher than October and at its highest level since November 2007. (A PSI reading above 50 indicates that the service sector is generally expanding; below 50.0 that it is declining).

The proportion of positive comments in November (71.0%) showed a sizeable lift from both October (61.8%) and September (65.8%). For those who stipulated positive influences, some seasonal patterns were obviously at play, but general comments centred on a steady stream of activity and opportunities for growth.

BNZ-BusinessNZ Performance of Services Index (PSI)
(2007 onwards)



The key indicators of activity/sales (62.3) and new orders/business (64.2) have consistently remained in healthy territory and this has flowed through into the overall result.



Consumer confidence – building up

Consumer confidence, like business confidence, took a big hit mid-year but some recent surveys suggest that a significant recovery is underway.

A number of factors are likely to be driving solid consumer confidence.

These are, in no particular order of importance:

- Seasonal factors: (summer holidays and warmer weather)
- Continued low inflation and associated reductions in interest rates to historically low levels, providing some relief in terms of debt servicing costs
- House prices holding up despite some recent plateauing in Auckland (a feel good factor in terms of housing equity)
- Reasonable employment opportunities (although tempered somewhat by high levels of net migration which are keeping the unemployment rate elevated)

- Relatively robust retail sales and an expansion of motor vehicle sales (a surge of 5.0 percent in the September quarter)
- $450 million cuts to Accident Compensation Corporation (ACC) levies which will impact particularly on motorists but also in a minor way on employees through a very slight reduction in the Earners' Account (which covers employee injuries outside the workplace).

1.4 Labour market – improving after mid-year dip

Employment – growth continues but offset by a growing population

Employment, as measured by the Household Labour Force Survey (HLFS), turned slightly negative in the September quarter after significant rises for the preceding 3 years.

Employment fell 0.4 percent in the quarter, following a rise of 0.2 percent rise in the June quarter. Annual growth slowed from a crisp 3.0 percent down to 1.5 percent.

October migration results saw a record monthly net gain of 6,200 migrants, including a seasonally-adjusted net gain of 200 migrants from Australia. On an annual basis, the net gain of 62,500 migrants in the year to October 2015 is a new record and put in context is close to 2 full Westpac Stadiums.

As a result, the unemployment rate is likely to remain relatively flat at best and possibly increase over the near term, as outlined in the forecast below. The unemployment rate is expected to reach 6.4 percent by December 2016, declining thereafter to 6.1 percent by December 2017.

On the positive side, forward-looking confidence surveys point to stronger employment growth.

The New Zealand Chambers of Commerce Business Confidence Survey (November 2015) shows positive staff hiring responses. When asked what changes they expect to total staff numbers over the next three months, a net 30.79 percent of businesses said they expect to be looking for more staff (39 percent expect to hire while just 8.21 percent expect staff numbers to decrease).

Finding skilled staff continues to be challenging for businesses with just 6.6 percent saying it was easier to find skilled staff than it was 12 months ago and 41.6 percent saying it was harder.

The positive results reflected in the Chambers' survey of employment intentions are backed up by a number of other surveys, including the BNZ-BusinessNZ Performance of Manufacturing Index (PMI) and its sister survey, the BNZ-BusinessNZ Performance of Services Index (PSI) both of which show continued solid growth in employment.

A number of other surveys, including the ANZ New Zealand Job Ads report, show job ads still rising but at a relatively lower rate.

Forecasts: Unemployment percentage (HLFS)

	Quarter		
	Dec 15	Dec 16	Dec 17
Highest	6.3	6.5	6.6
Average	6.2	6.4	6.1
Lowest	6.1	6.1	5.7

Source: ANZ, ASB, BNZ, and Westpac

Labour costs – slowly slowly

Forecasts below indicate that labour costs are expected to increase only slowly to 1.8 percent for the year ending December 2017.

Despite reasonably solid employment growth, wage pressures are likely to be constrained overall, given the high numbers of people entering the labour market, including the ongoing impact of strong net inward migration.

Forecasts: Labour cost index percentage change (wages & salaries)

	Years ending		
	Dec 15	Dec 16	Dec 17
Highest	1.6	1.8	2.0
Average	1.6	1.8	1.8
Lowest	1.5	1.7	1.6

Source: ANZ, ASB, BNZ, and Westpac