BUSINESS NZ

PLANNING FORECAST

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BusinessNZ

NZ Economy – On course but some risks

Executive Summary

The NZ economy is looking at around 3.5 percent growth per annum over the next couple of years – still one of the highest growth rates in the OECD.

Key forward-looking indicators such as The BNZ - BusinessNZ Performance of Manufacturing Index (PMI) and the Performance of Services Index (PSI) show economic growth remaining at respectable levels and increasingly spreading through the different sectors. The construction sector is showing very strong growth (not unexpectedly) while the agricultural sector continues to be the backbone for NZ's recent positive export data, as evidenced by both volumes and prices.

Although coming off historic highs, business and consumer confidence remain solid, while a number of indicators, including labour force participation rates, show strong signs of labour market growth.

There has been some focus of late on reductions in global dairy prices but this reduction needs to be put in context. Prices are still well above their long-term average even though dairy farmers are likely to face significant payout cuts for the upcoming 2014/15 season compared with the previous season.

Notwithstanding still very positive business and consumer sentiment, risks need to be acknowledged.

First, NZ's reliance on China, and to a lesser extent Australia, exposes the country to significant risk if either economy fails to perform given that, in aggregate, around 50 percent of NZ exports are centered on Australia and China.

Second, international growth forecasts have reduced slightly of late with moves towards more normalised monetary policies across both Europe and the US appearing as yet to be still some way off.

Third, continued interest rate rises in NZ will likely impact on export sector competitiveness, particularly as NZ has been one of the first countries in the developed world to raise interest rates. The potential for flow-on impact on the NZ dollar should not too readily be discounted.

Fourth, debt levels remain a concern, particularly with agricultural debt, largely dairy-focused, currently sitting at over $50 billion. Interest rate rises already appear to be having some impact on both business and consumer confidence, although this is not really unexpected.

Fifth, strong net migration inflows (approaching 40,000 per annum) will impact on inflationary pressures (particularly housing in Auckland).

Sixth, both actual inflation and inflationary expectations will have a considerable bearing on how the Reserve Bank proceeds with adjusting its interest rate towards more "neutral" levels. The job of the Reserve Bank Governor (balancing all these factors) is not likely one which many people would envy at present.

Finally, there is a general election in September with no certainty either of the outcome or of the policy implications – particularly if post-election policy negotiations prove to be a major consideration.

HIGHLIGHTS

The BusinessNZ Economic Conditions Index (ECI) sits at 10 for the June 2014 quarter, down 1 on the previous quarter and down 3 on a year ago.

Key economic indicators continue to track in positive territory, while forward-looking indicators such as business and consumer confidence are still firmly in positive territory despite dropping to arguably more realistic levels of late.

Export growth continues and despite further falls in commodity prices (notably dairy), prospects still appear to be positive.

The international economy remains in a state of flux with little indication that either the US or Europe really knows how to transition towards a more prudent monetary policy regime. International uncertainty is likely to persist.

Notwithstanding a generally positive outlook for the NZ economy, risks remain – particularly from the impact of significant rises in the cost of capital and the continued elevated exchange rate.

High levels of debt continue to be a concern, with household debt levels again on the rise and farm debt, particularly in dairying, remaining high.

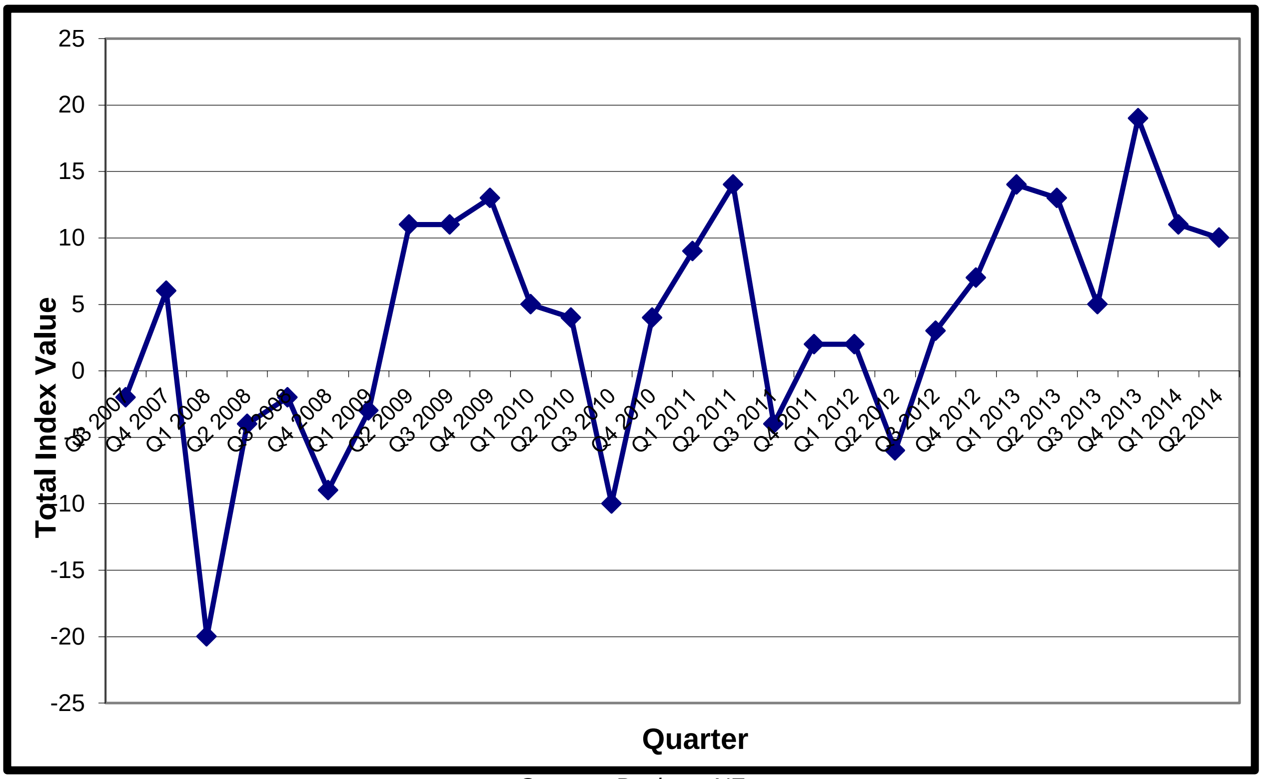
Finally, the outcome of the general election in September is still anyone's guess and could provide some post-election policy uncertainty.

PART 1: THE NEW ZEALAND 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 10 for the June 2014 quarter, down 1 on the previous quarter and down 3 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

In terms of the ECI sub-groups:

Economic growth/performance indicators sit at 6 for the June 2014 quarter, as for the last quarter but up 4 on a year ago. Despite some reductions in international commodity prices of late (particularly dairy), both export volumes and prices continue to remain solid, resulting in the highest terms of trade in 40 years, along with reductions in the current account deficit.

Monetary policy/pricing indicators sit at -2 for the June 2014 quarter, up 2 on the last quarter but down 5 on a year ago. Further interest rate rises, a continued elevated exchange rate and moderating commodity prices are putting some downward pressure on this sub-group.

Business/consumer confidence indicators sit at -1 for the June 2014 quarter, down 6 on the previous quarter and down five on a year ago. While business confidence surveys have generally shown a drop in sentiment over the last few months, confidence is still high by historical standards.

[1] The ECI tracks 32 indicators on a quarterly basis. The overall index value for any particular quarter represents the net balance of the 32 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.

<u>Labour market indicators</u> sit at 7 for the June 2014 quarter, up 3 on the previous quarter and up 3 on a year ago. The labour market is now experiencing relatively strong employment growth while unemployment should continue to dip, despite increasing numbers of people entering (or re-entering) the labour market as conditions improve. Increasing net migration will also boost numbers.

<u>PART 2: THE NEW ZEALAND ECONOMY – WHERE ARE WE GOING?</u>

1.1 Economic growth (GDP) – solid

Economic growth is forecast to remain solid at around 3.5 percent for the year ending June 2015 (see below), making NZ one of the faster growing economies in the Organisation for Economic Cooperation and Development (OECD).

Forecasts: Real GDP % Growth

	Years Ending		
	Jun 14	Jun 15	Jun 16
Highest	3.6	4.0	3.0
Average	3.6	3.5	2.7
Lowest	3.5	3.2	2.5

Source: ANZ, ASB, BNZ, and Westpac

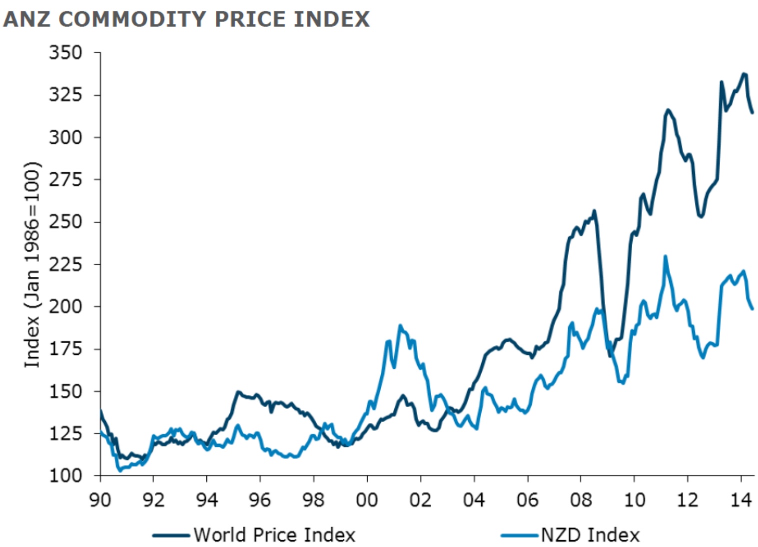
While there have been a number of dents in the economic outlook over recent months (e.g. lower export prices and higher interest rates), overall confidence remains relatively remain high with growth much more widespread than simply the rebuild of Christchurch and Auckland housing.

Factors identified as positive for future economic growth include:

- **Commodity prices still solid despite drifting lower**

Despite a dip in commodity prices of late (particularly dairy), such movements needs to be put in context; commodity prices are still at elevated levels.

The ANZ Commodity Price Index currently sits at 314.7, marginally down (-0.3 percent) on a year ago but still well above historical levels as can be seen from the graph below. When converted into NZ dollars, the decline over the last year is more significant (-7.8 percent), underpinned by a relatively strong $NZ compared with our major trading partners. Notwithstanding the above, commodity prices in $NZ are still relatively robust and this has underpinned Fonterra's reasonably optimistic forecast payout for the 2014/15 season yet to commence. However, Fonterra's forecast payout is likely to come under some pressure if commodity prices keep falling and/or the NZ dollar remains at elevated levels.



Source: ANZ

- **Construction sector showing strong growth**

Both official and unofficial data show the construction sector to be entering a growth phase. This is underpinned by 3 principal factors. First, and fundamentally, is the rebuild of Christchurch which is devouring resources at both the commercial and residential levels. Second, is the major growth in housing development, particularly in Auckland. Third and finally, is the significant earthquake strengthening programme, the consequence of both market expectations, and legislation (principally the Building (Earthquake-Prone Buildings) Amendment Bill currently before the Local Government and Environment Select Committee.

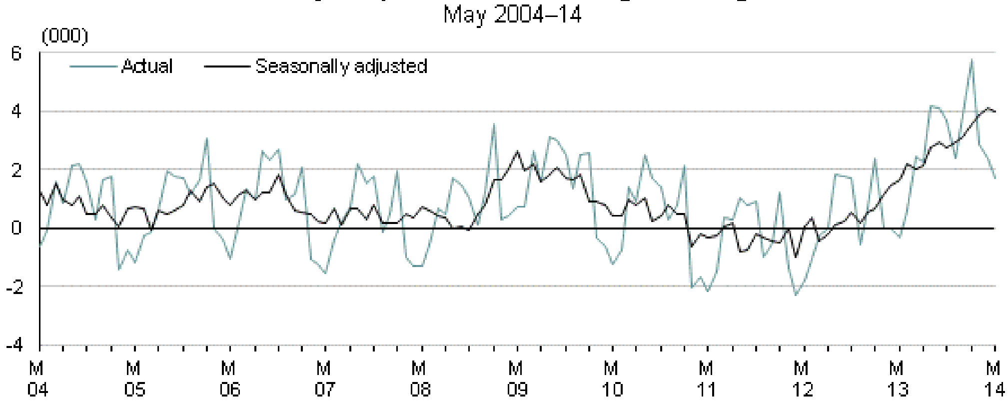
- **Strong growth in net migration**

Net migration levels are often a key leading indicator of economic growth with generally higher levels of net migration when the economy is in the early stages of an upturn.

In the year to February 2014, there was a net inflow (permanent and long-term migration) of 36,397 compared with a net inflow of 6,242 in the previous year and a net outflow of -3,653 in the year to May 2012, the highest net gain in a decade.

Such inflows are adding to domestic demand while putting upward pressure on housing, notably in Auckland.

Monthly net permanent and long-term migration
May 2004–14



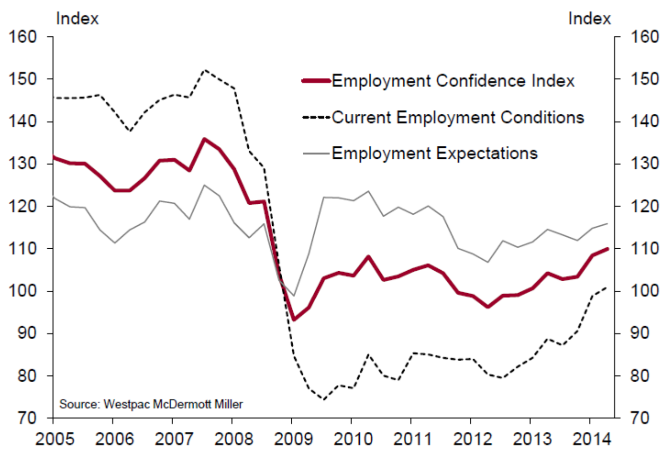
Source: Statistics New Zealand

- **Rising household confidence on the back of an improving labour market**

Consumer confidence remains at elevated levels for a number of reasons, assisting in improved retail and electronic sales. An improving labour market is key to consumer confidence and in this respect, both official labour market data and more qualitative forward-looking data are very positive.

The latest Westpac McDermott Miller Employment Confidence Index is sitting at 109.9 – a fresh post-2008 recession high. Not surprisingly, Christchurch is leading the way but many other regions are starting to catch up providing yet more evidence that economic growth is now more widespread than the Christchurch rebuild.

Employment confidence index



While, as outlined above, a raft of positive factors is impacting on NZ's growth prospects, a number of factors may act to constrain growth over the medium term. These include:

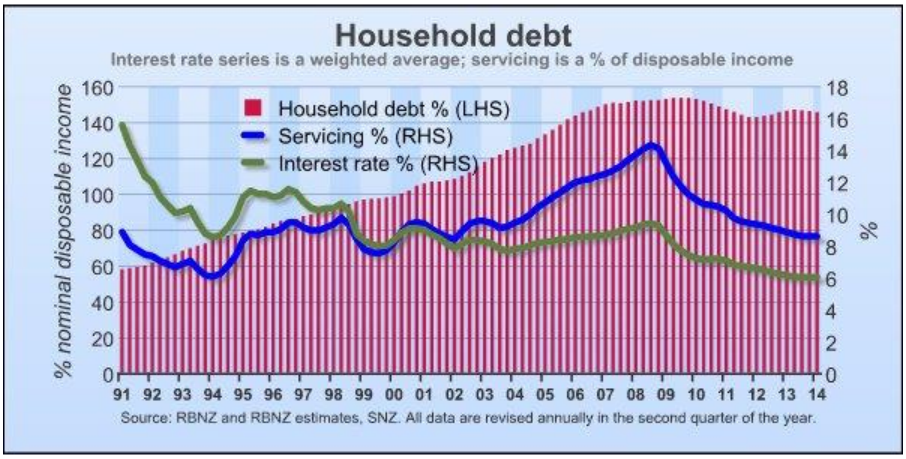
- **The future outlook for the international economy….particularly our major trading partners**

There is strong demand from NZ's major trading partners, particularly China, for NZ's agricultural commodities, with this greater demand reflected in historically high prices and the best terms of trade in 40 years. While currently a positive for NZ, the country remains dependent on continuing improvement in its key export markets.

The wider international economy remains in a state of flux with weak evidence that either the US or Europe has really thought too much about how to transition towards a more prudent monetary policy regime. International uncertainty is likely to persist.

- **Rises in the cost of capital given NZ household's relatively high debt levels**

Household debt levels remain a concern and many will be affected if interest rates rise significantly. While the agricultural sector continues to boom and provide valuable export dollars, agricultural debt, largely in dairy farms, is currently sitting at around $50 billion.



There is an increasing risk of relatively rapid rises in the OCR as the Reserve Bank grapples with controlling inflation next year and beyond.

Interest rate rises will also likely impact on export sector competitiveness, particularly as NZ has been one of the first countries in the developed world to raise interest rates. The potential for a flow-on effect to the NZ dollar should not be readily discounted.

- **Election (regulatory) uncertainty**

There is a general election in September with no certainty of either the outcome or the policy implications – particularly if post-election policy negotiations are a major consideration. Investors loathe risk and require significant margins to compensate for known (and for potential but unknown) risks, particularly when investing in long-life assets with high sunk costs. Any change in the rules of engagement, with neither adequate time to prepare nor compensation for loss, will constrain much-needed investment.

1.2 Monetary Conditions – tightening will continue

Interest rates – continue to rise

The 90-day bill rate is forecast to increase to 4.4 percent by June 2015 and further to 4.9 percent by June 2016, as evidenced by the forecasts below.

Forecasts: Interest Rates (90 day bills)

	As at end of		
	Jun 14	Jun 15	Jun 16
Highest	3.7	5.0	5.2
Average	3.5	4.4	4.9
Lowest	3.4	4.0	4.5

Source: ANZ, ASB, BNZ, and Westpac

There is some debate as to the speed of interest rate movements upward, given that the NZ Reserve Bank is in rather a unique position in the developed world as one of the few countries increasing rates at this stage (see below).

There is a fine line between moving too fast and moving too slowly.

Moving too fast risks exposing households and businesses to significant increases in the cost of capital, and also, given international interest rates are close to zero, will attract foreign capital into NZ in search of better returns, putting added pressure on the $NZ.

Major Central Banks Overview

Central Banks	Current Interest Rate	Next Meeting	Last Change
Bank of Canada	1.000 %	07-16-2014 - 14:00	09-08-2010 - 13:00
Bank of England	0.500 %	07-10-2014 - 11:00	03-05-2009 - 12:00
Bank of Japan	0.100 %	07-10-2014 - 03:00	12-19-2008 - 05:27
European Central Bank	0.150 %	07-03-2014 - 11:45	06-05-2014 - 11:45
Federal Reserve	0.250 %	07-30-2014 - 18:00	12-16-2008 - 19:15
Reserve Bank of Australia	2.500 %	07-01-2014 - 04:30	08-06-2013 - 04:30
Reserve Bank of New Zealand	3.250 %	07-23-2014 - 21:00	06-11-2014 - 21:00
Swiss National Bank	0.000 %	09-18-2014 - 07:30	08-03-2011 - 07:00

Second, there is the added complexity that capital will simply be sourced from overseas, largely undermining the efforts of the Reserve Bank to increase the cost of capital.

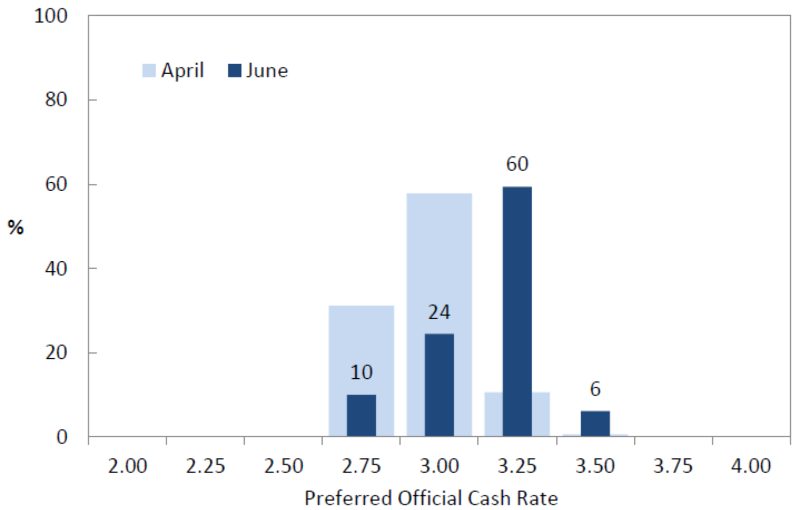
Third, around a third of debt in NZ is currently floating, so raising the OCR is likely to have some lag effects before it starts to bite into the borrowing costs of households and businesses, although recent dips in business confidence do appear to be driven in part at least by higher interest rates.

On the other hand, waiting until solid evidence of actual inflation pressures can be detected in the headline Consumers' Price Index (CPI) runs the risk of having to move rates higher and faster than might otherwise be the case. This is the Reserve Bank's current dilemma.

The New Zealand Institute of Economic Research's (NZIER) Shadow Monetary Policy Board (which has the task of recommending interest rate settings ahead of each decision by the Governor *of* the Reserve Bank) found most of its members supported the Reserve Bank's mid-June move to increase the OCR to 3.25 percent.

"Right now, interest rates need to move higher. But risks from the flying Kiwi, Auckland's housing market and a slowing Chinese economy mean future rate increases are less assured." (NZIER, 11 June 2014).

NZIER's Shadow Board says interest rates need to move higher



Source: NZIER *Monetary Policy Shadow Board*

The New Zealand dollar

Forecasts below show the NZ dollar is generally expected to drift lower against both the Australian and US dollar.

Forecasts: Exchange Rates

AUD (cents)			
	Jun 14	Jun 15	Jun 16
Highest	0.93	0.93	0.89
Average	0.92	0.91	0.87
Lowest	0.91	0.90	0.85

USD (cents)			
	Jun 14	Jun 15	Jun 16
Highest	0.96	0.85	0.83
Average	0.88	0.81	0.75
Lowest	0.83	0.75	0.68

TWI			
	Jun 14	Jun 15	Jun 16
Highest	80.8	79.7	75.8
Average	79.7	76.7	72.3
Lowest	77.7	73.7	70.0

Source: ANZ, ASB, BNZ, and Westpac

Notwithstanding such forecasts, over the short-term at least, there is likely to be further upward pressure on the NZ dollar against our major trading partners simply because of the country's relatively strong projected growth and a relatively stable economic environment. Perhaps even more importantly, NZ is raising interest rates at a time when most developed countries have interest rates close to zero. This could put upward pressure on the NZ dollar – despite rises being well-signalled by the Reserve Bank.

Inflation - pressure points well understood

Forecasts outlined below show inflation likely to rise slightly to reach 2.2 percent by June 2015, and 2.6 percent by June 2016.

Forecasts: % Change in Inflation (CPI)

	Years Ending		
	Jun 14	Jun 15	Jun 16
Highest	1.9	2.2	3.1
Average	1.8	2.2	2.6
Lowest	1.7	2.1	2.4

Source: ANZ, ASB, BNZ, and Westpac

The key drivers of inflationary pressures are generally well known but for the record include:

- Increased net inward migration adding to demand pressures
- Elevated housing demand, particularly in Auckland, as building activity tries to catch up with pent-up demand
- Still relatively strong demand for NZ commodities underpinning domestic prices for staple products e.g. meat and dairy products
- Earthquake-strengthening building costs
- Rebuild capacity pressures in Christchurch
- Improved labour market outlook which will (eventually) put increased pressure on wage rates
- Continued repricing of insurance risk

On the other hand, factors which may act in concert to take some of the heat out of the inflationary pressures include:

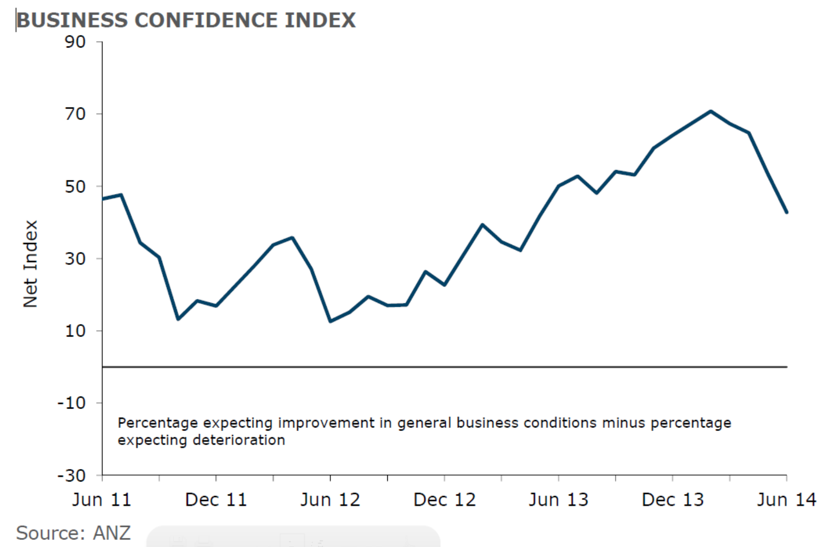
- A continuing elevated exchange rate which will take any heat out of tradables sector inflation
- Recent interest rate rises acting to subdue demand, particularly given high levels of household debt
- Strong and continuing competition in many sectors continuing to keep downward pressure on prices (particularly retail).
- On a minor scale, significant proposed reductions in accident insurance (ACC) premiums for both motor vehicle owners and earners which could have a minor downward impact on transport costs.

1.3 Business and consumer confidence – down but still high by historic standards.

Business confidence – at more realistic level

While business confidence has taken a bit of a hit of late, this needs to be put in context. Although coming off historic highs, business confidence still remains firmly in positive territory but with recent results suggesting a more realistic assessment of future growth outcomes than the euphoric rises recently experienced.

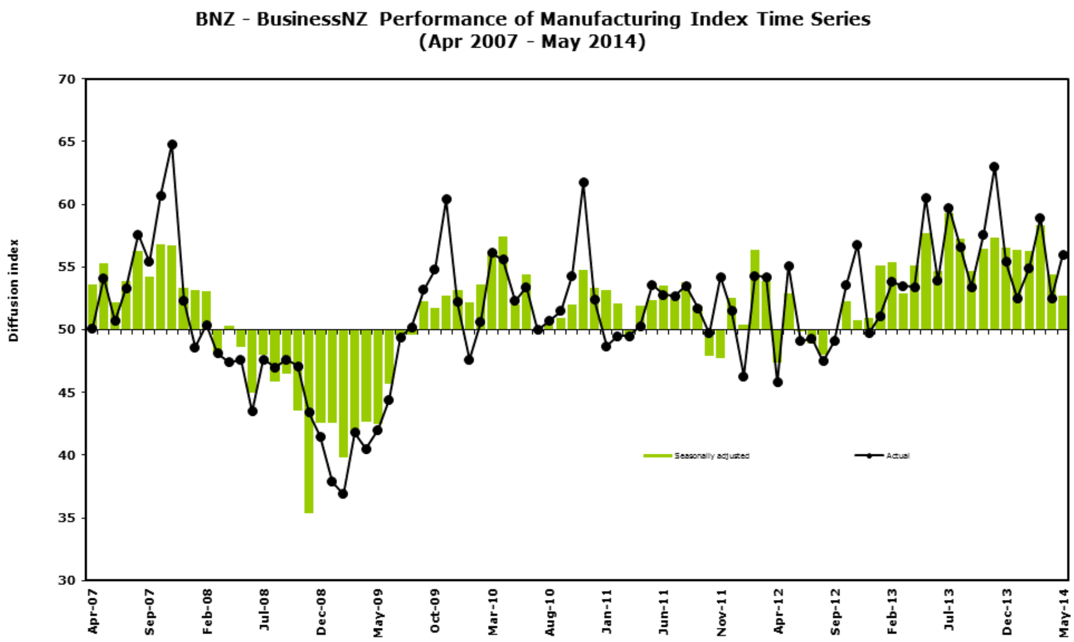
The ANZ Business Outlook shows that for the month of June 2014, a net 43 percent of respondents expected business conditions to improve over the year ahead – a drop of 11 points on the previous month. However, while down, this is still (at 33 points) significantly above the long-run average of +10. The latest result shows that confidence fell in all sectors, except retail, with by far the largest drop seen in agriculture. The result for agriculture is not surprising given that continued falls in commodity prices have been reflected in Fonterra's reduced forecast payouts to dairy farmers, with a continued elevated exchange rate reflected in reduced expectations of payments when converted back into $NZ.



Firms' activity expectations for their own businesses eased slightly from +51 to +46, still well above the long-run average. Rather than seeing the latest results as unfortunate, they should be seen as indicating the existence of headwinds and the need for businesses to make realistic assumptions on a whole host of factors. These include, but are not limited to, future market demand, potential exchange rate movements, and the cost of capital moving forward.

The BNZ-BusinessNZ seasonally adjusted PMI for May stood at 52.7, 1.7 points lower than the previous month, although still showing expansion. Despite a second consecutive dip in expansion levels, the sector has now been in expansion for 20 consecutive months.

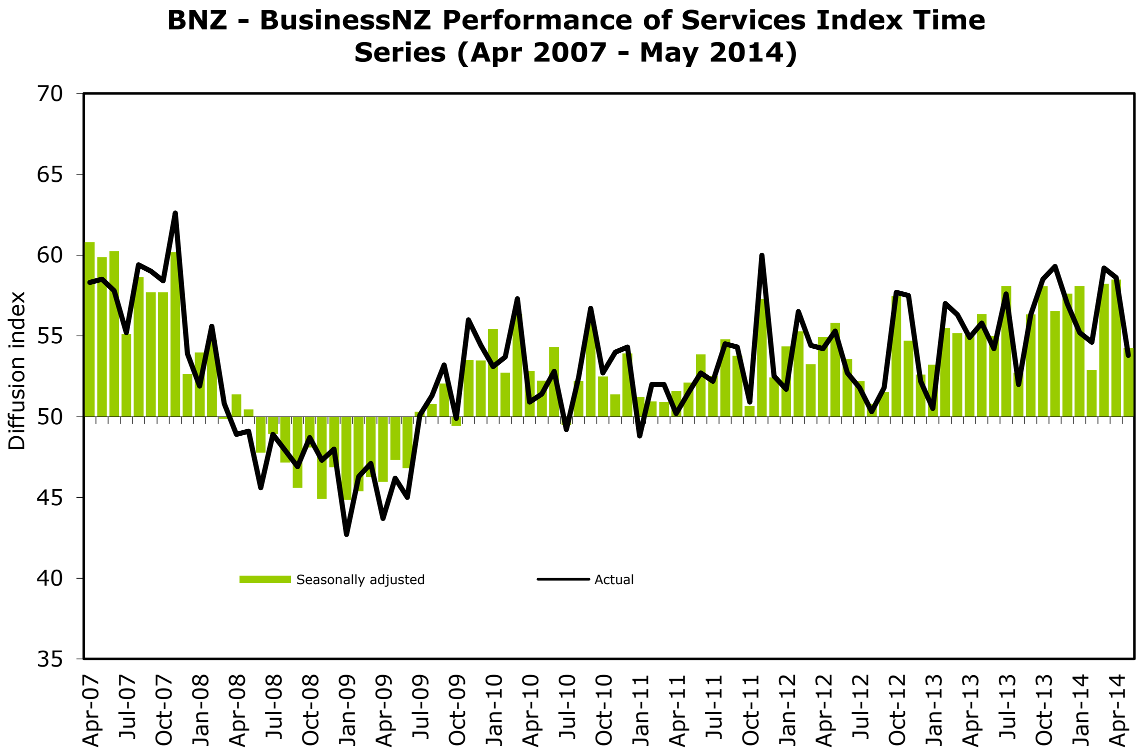
All five seasonally adjusted main diffusion indices were in expansion during May. *Production* (55.2) again led the way for the current month with a value unchanged from April. In contrast, *New orders* (51.6) fell to its lowest level of expansion since December 2012. *Employment* (53.8) remained in healthy territory, despite falling 0.5 points over the month while *Finished stocks* (52.6) went back into expansion during May and *deliveries* (51.4) dropped for the fourth consecutive month.



Three of the four regions were in expansion during May. In the North Island, the *Northern* region (57.4) increased 4.4 points, while the *Central* region (56.4) recovered most of the drop experienced the previous month. In the South Island, the *Canterbury/Westland* region (56.7) showed solid expansion levels, while the *Otago-Southland* region (48.1) slid 9.6 points to record its first decline in activity since April 2013.

Manufacturing by industry sub-groups was mostly in expansion during May. *Machinery & equipment manufacturing* (61.4) continued to build momentum with a strong result for the current month, while *petroleum, coal, chemical & associated product manufacturing* (55.0) went back into expansion. *Food, beverage & tobacco manufacturing* (53.1) slipped downwards, most probably due to the change of seasons, while *metal product manufacturing* (53.0) increased from April.

Despite the dip in overall activity, the proportion of positive comments for May (60.8%) was up from April (58%), although still slightly down from March (61.3%). Globally, the JPMorgan Global Manufacturing PMI for May (52.2) ticked higher in May, as companies raised output in response to rising levels of new business and international trade volumes.



Source: BusinessNZ

Activity remained positive throughout the country. In the North Island, the *Northern* region (55.5) reverted back to levels seen in August 2013, while the *Central* region (51.2) fell back after three consecutive months of solid results. In the South Island, the *Canterbury/Westland* region (54.5) remained in positive territory despite easing expansion, while the *Otago/Southland* region (51.3) managed to keep its head above water with minor expansion.

Service sector results by sub-sector were mostly positive during May. *Property & business services* (60.1) picked up pace from April, while *wholesale trade* (54.7) eased back from the previous month. *Accommodation, cafes & restaurants* (43.6) fell back into negative territory after three solid months, most likely due to changing seasons, while *health & community services* (48.4) fell back to negative territory. *Transport & storage* (56.4) also experienced a lower value from the previous month, although remained in expansion for May.

Indicators of confidence in other sectors generally remain sound. As mentioned earlier, confidence in the construction sector is high with construction activity increasing 12.5 percent in the March 2014 quarter. This is the second highest quarterly increase ever.

The agricultural sector is still positive, although significantly down on a year ago, mainly driven by lower export prices and higher interest rates. While beef and sheep farmer confidence has risen to a 3-year high according to the latest Rabobank Rural Confidence Survey, overall farm confidence has dropped significantly, led by a slide in dairy farmer confidence. On a brighter note, overall farmers' investment intentions remain solid with 93 percent of farmers intending to increase or maintain the level of investment in their farm business. Notwithstanding this result, the sector composition has changed with sheep and beef farmers increasing their investment intentions and dairy farmers lowering investment intentions

Consumer confidence – drifting higher for now

Consumer confidence is firmly in positive territory and recent surveys suggest that it is drifting higher – largely on the back of an improving labour market encouraging consumers to open their wallets. On the other hand, high levels of household debt remain a significant impediment and as mortgage rates rise, consumers are likely to take a more cautious attitude to new expenditures.

That only around one-third of debt is currently floating (as opposed to fixed) would suggest that the Reserve Bank hikes in the OCR will take some time to really bite.

Retail and electronic sales are starting to improve, and with limited headline inflation to date, consumers are beginning to increase their expenditure on more discretionary items.

1.4 Labour market – solid growth

Employment – continuing to rise

Employment growth is on the rise with associated reductions in unemployment forecast, as outlined below. The unemployment rate is expected to reach 5.2 percent by June 2016 (see below).

Forecasts: Unemployment % (HLFS)

	Quarter		
	Jun 14	Jun 15	Jun 16
Highest	6.0	5.7	5.3
Average	5.9	5.4	5.2
Lowest	5.7	5.2	4.9

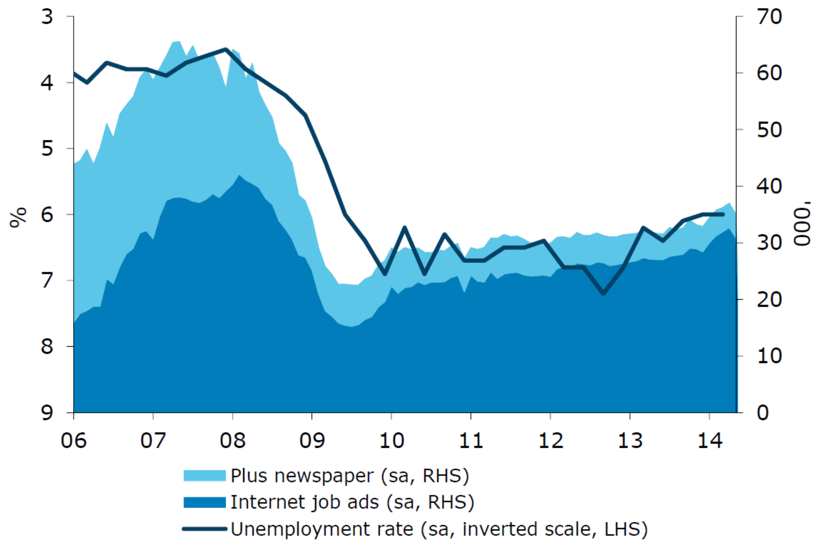
Source: ANZ, ASB, BNZ, and Westpac

The BNZ - BusinessNZ PMI and PSI surveys show solid growth in employment outcomes, both in the manufacturing and services sectors. Other business confidence surveys also indicate strong employment growth prospects, particularly in the construction sector. The BNZ-BusinessNZ PMI employment sub-index sat at 54.4 for the month of May 2014. Meanwhile the PSI sat at 53.6.

The ANZ NZ Job Ads series shows a reasonably positive outlook for job growth although the number of job ads fell significantly in May.

The level of internet job advertising is 14 percent higher than a year ago while newspaper advertisements continue to trend lower (down 7.7 percent compared with May 2013.

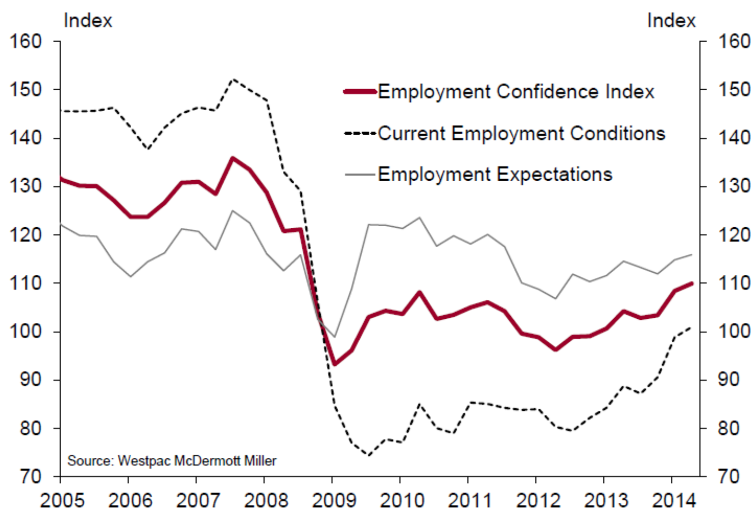
FIGURE 1. JOB ADS AND THE UNEMPLOYMENT RATE



Source: ANZ, Statistics NZ, Seek, Trade Me, Dominion Post, Hawke's Bay Today, Manawatu Standard, NZ Herald, ODT, The Press, Waikato Times

Other forward-looking indicators of future employment growth, such as the Westpac McDermott Miller Employment Confidence Index for the June 2014 quarter, are generally optimistic. The Index rose from 108.4 to 109.9 in the June quarter, a new post-recession high.

Employment confidence index



Perhaps of more importance than the aggregate figure is the fact that a regional breakdown shows growth as generally across the economy rather than focused on Christchurch, as can be seen below. Given the large population base in the Auckland region, the fact that confidence in Auckland is up 4.2 percentage points to 117.3 bodes well for aggregate employment growth in NZ.

Employment Confidence by region

Region	Mar-14	Jun-14	Change
Northland	102.0	102.1	0.1
Auckland	113.1	117.3	4.2
Waikato	115.2	98.0	-17.1
Bay of Plenty	96.1	103.1	7.0
Gisborne/Hawkes Bay	104.2	103.7	-0.5
Taranaki/Manawatu	97.8	105.5	7.8
Wellington	104.4	110.0	5.5
Nelson/Marlborough/Westland	106.5	102.5	-4.1
Canterbury	114.0	115.0	1.0
Otago	103.2	102.5	-0.8
Southland	103.8	110.3	6.6

Relatively strong growth in net inward migration will also boost demand for goods and services and hence provide further employment opportunities.

Labour costs – slowly rising

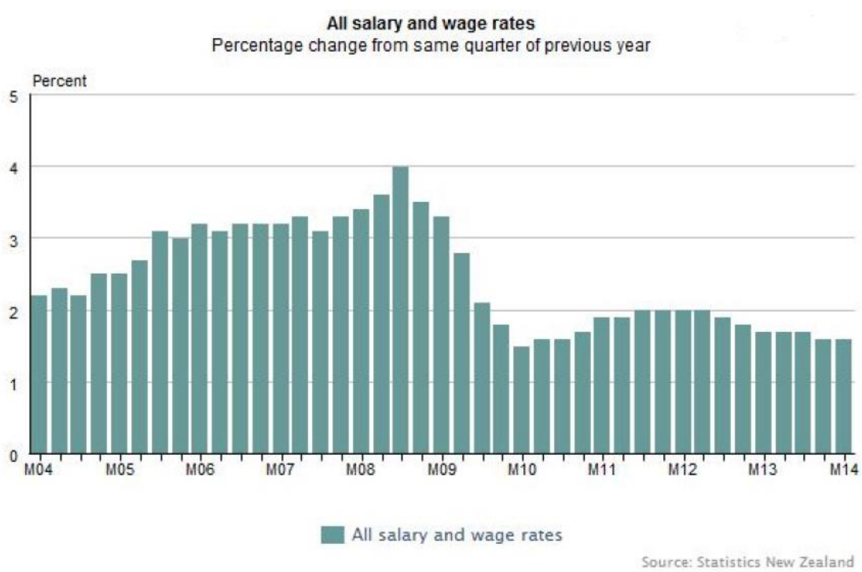
Forecasts below indicate that labour costs are expected to increase only slowly to around 2.3 percent for the years ending June 2015 and 2016. This is very much in line with the long-run average for the Labour Cost Index and is up slightly on recent annual increases which have averaged around 1.7 percent. Forecasts largely reflect the pick-up expected in labour market outcomes predicted over the medium term.

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

	Years ending		
	Jun 14	Jun 15	Jun 16
Highest	1.8	2.9	2.6
Average	1.7	2.3	2.3
Lowest	1.6	2.0	2.1

Source: ANZ, ASB, BNZ, and Westpac

Private sector salary and wage rates (including overtime) increased 1.6 percent in the year to the March 2014 quarter. Public sector salary and wage rates (including overtime) increased 1.2 percent in the year to the March 2014 quarter.



There will likely be some upward wage pressure over the coming year as labour resources become increasingly constrained, although there is little evidence of any significant upward pressure at this stage.