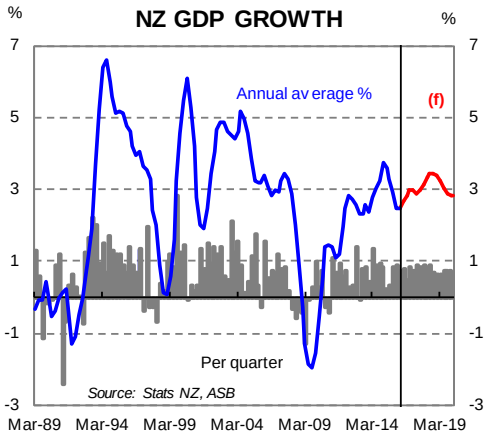
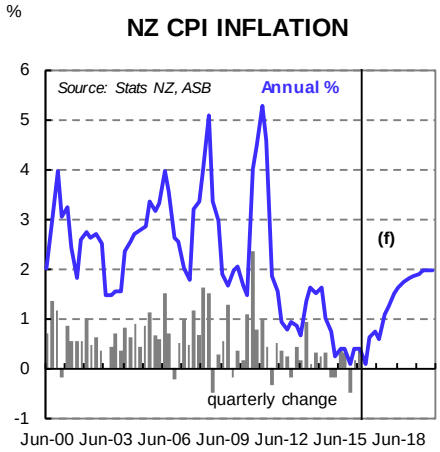
Bouncing onwards and upwards

- NZ growth outlook remains respectable, boosted by migration, construction and kiwifruit.
- Inflation remains weak, with inflation projected to remain below 1% for a 3rd year.
- Rampant housing market of 2016 may come off the boil in 2017, but still simmer.

2016 is managing to be a year of diverse risks and surprises, making one feel like a pinball bouncing from one odd event to another. But, economic life continues. So far the global economy has weathered China's New Year equity meltdown, the blowtorches being applied to European banks, the surprise Brexit vote and subsequent market gyrations, and a US Presidential Election lead-up that has had perhaps all too much entertainment value. **The response to many of these events has been even more monetary and fiscal stimulus**, pouring oil onto the briefly troubled waters. **Growth in NZ's trading partners is heading for a slightly below-average performance**, still a reasonable backdrop, but **vulnerable to material surprises**.



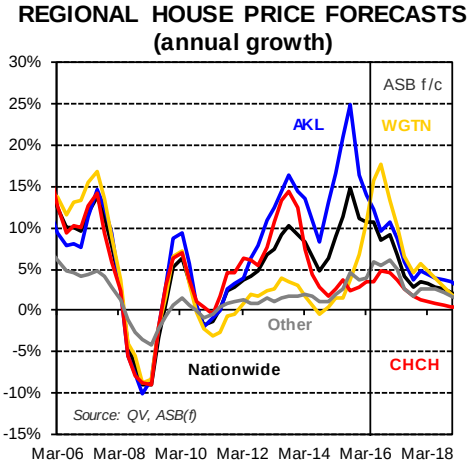
Despite all these pinball-like swings from one development to the next, the **NZ growth outlook is still very respectable**. **Migration inflows remain strong** and will support growth, even though the flows will gradually slow over the next few years. Housing market and **construction strength** are rippling out to many regions. **Interest rates are extremely low** and set to stay that way. **Exports in general are faring well**, with one recent standout being the kiwifruit sector's record exports. The NZ dollar is off its 2014 highs, though its rebound this year has reduced some of the gains in competitiveness. Collectively the drivers are strong enough for us to expect per-capita growth, which has been weak recently, to recover to an above-average pace.



But it is still **an environment of weak inflation**. We don't see inflation exceeding 1% (the bottom of the RBNZ's target) until the second half of 2017, at which point inflation will have been below 1% for nearly 3 years**.** Generalised inflation pressures are elusive outside of the construction sector. Low fuel prices are doing their bit to perpetuate the weak outcomes.

But a more persistent challenge to the RBNZ getting inflation back up is the **high NZ dollar.** The RBNZ's evident reluctance to cut interest rates for several months fuelled the recent rebound, along with the US Federal Reserve's reluctance to increase interest rates. And NZ appears a good risk for overseas investors, with its non-zero interest rates, reasonable growth prospects, and a degree of political stability that can no longer be taken for granted in a surprising number of developed countries.

Even lower interest rates are needed to get inflation back from a near-zero level. **The rampant housing market has been the main reason for the RBNZ's hesitance to follow up on March's OCR cut.** But the additional investor lending restrictions the RBNZ is introducing give the RBNZ a little more room to address low inflation with a reduced risk of further inflaming the housing market. **We expect the RBNZ to drop the OCR to 1.75% by November and, if the NZD continues to hold up, an even lower OCR is possible.**



And what of the rampant housing market? The **new lending restrictions will slow the housing up and down the country over the rest of this year**, but in areas where supply is still trying to catch demand the impact is likely to wear off. Auckland, in particular, is unlikely to see building consent issuance match population growth requirements for a couple of years. NZ house prices may bounce slightly in the first half of 2017. But the sort of price growth a number of regions have experienced over the last couple of years will not be sustained. **Expect 2017 to be much quieter on the housing front**.

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International outlook – Initial Brexit fallout relatively contained

It has been another volatile quarter for global financial markets. The main headlines belonged to the **UK's decision to exit the EU, taken on June 24.** There was significant volatility in the build-up to the event, with various polls dragging markets back and forth. The surprise result saw a short-term move towards safe-haven assets. However, **once the initial reaction passed, stock markets were quickly back on the front foot**, along with commodity currencies such as the NZD and AUD.

In Europe, Brexit will have a greater long-term impact than in NZ, and not just on the UK. As one of only four net contributors to the EU, it is a blow to the Union, while there is also the possibility it could encourage other nations to make for the exit door. The new relationship between the UK and EU is the great unknown and the UK is to be led by a new PM, with David Cameron quickly falling on his sword and former Home Secretary Theresa May stepping up after a short leadership contest. **Once the UK triggers the formal mechanism for exit (Article 50), there are just 2 years to get a new deal in place** and so far the EU has shown no sign of allowing informal talks before the UK pulls the trigger.

But in response to likely economic weakness, **the Bank of England (BoE) has cut its benchmark interest rate 25bp to 0.25%** and resumed purchases of assets – both government and corporate bonds. It has signalled it will take its interest rate down to near zero by the end of the year.

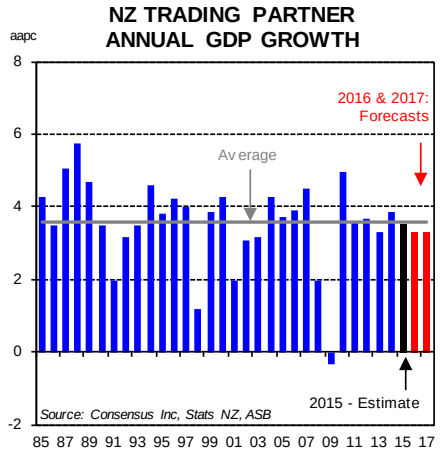
In Australia, the **Reserve Bank of Australia surprised with a 25bp rate cut in May**, in response to soft Q1 inflation data. Since then **the flow of economic data has been generally upbeat**, with Q1 GDP in particular surprising to the upside. But inflation has remained moderate and the RBA cut rates again in August. We expect a final cut in November, after the next inflation release.

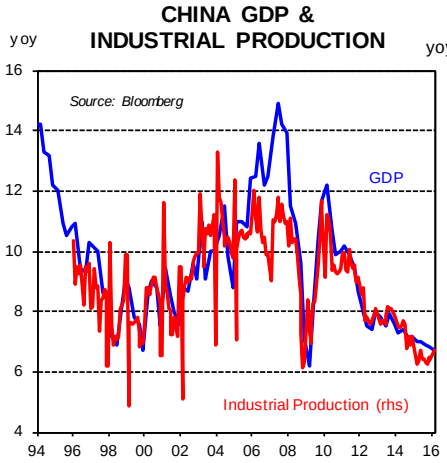
The US Federal Reserve didn't make any adjustments to its monetary policy in the quarter, but that didn't stop speculation having a profound impact on markets. Indeed, the talk was of a hike as soon as July, but poor employment data for May pushed expectations much further back. In addition **the Brexit event also played on the minds of the various Committee members**, giving another reason to delay the next move. The slower pace of tightening should benefit those with USD-denominated debt, including many emerging markets, although areas such as South America and Russia continue to struggle with domestic difficulties.

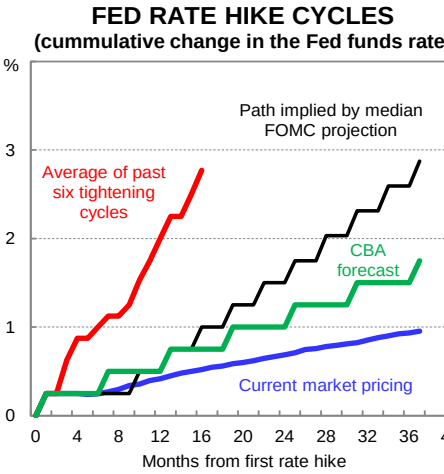
China remains a key source of concern in the global economy. However, China is beginning to show tentative signs of stabilising after growth dropped to the lowest level in 25 years at the end of 2015. Chinese growth stabilised at 6.7% yoy in Q2 vs the drop to 6.6% expected and the quarterly data also beat estimates. **There are also tentative signs of a pick-up in industrial production and some services sectors**, driven largely by the continued easy policy conditions.

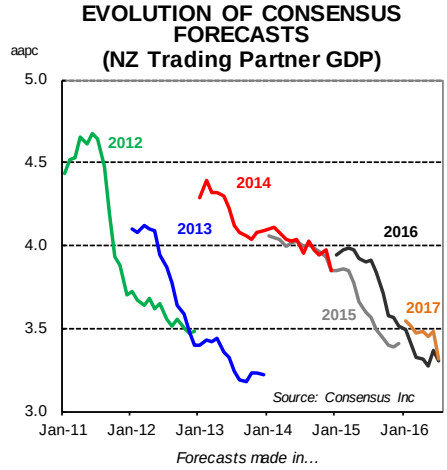
In Europe negative interest rates continue to become more common, keeping concerns over bank profitability on the table. Italian banks are seen as being higher risk than their European counterparts, although in the wake of Brexit some UK institutions are also being viewed less favourably.

Overall we continue to expect global growth to have a few headwinds and come in slightly below average over 2016 and 2017. There are still **a large number of unknowns that could impact growth.** These include the outcome of the US Presidential Election in November, the pace of rate hikes from the US Federal Reserve, how the UK-EU negotiations progress, how long the Brexit timetable is, and the usual watching eye on China's economic path.



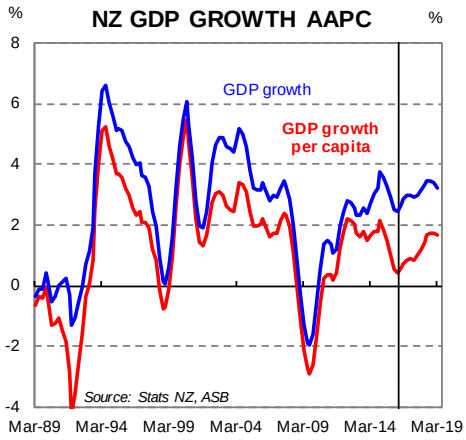




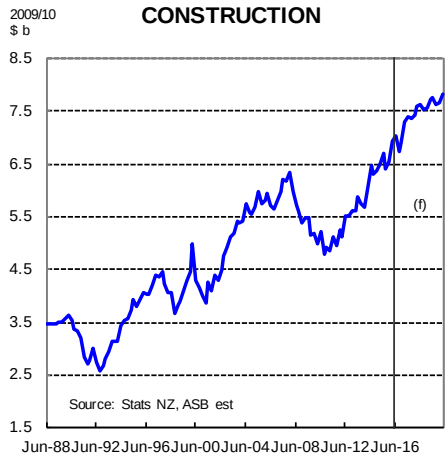


The New Zealand Economy – *gradual journey*

Economic growth is gradually regaining momentum over 2016, after slowing over 2015. The recovery in growth is **led by the construction** sector, with residential building demand broadening across NZ. Consumer spending remains **restrained by weak dairy incomes**. We expect growth will remain supported by **population growth, tourism, construction and low interest rates**. A pick-up in per-capita demand over 2016 and 2017 is important for a more sustainable recovery in the economy.

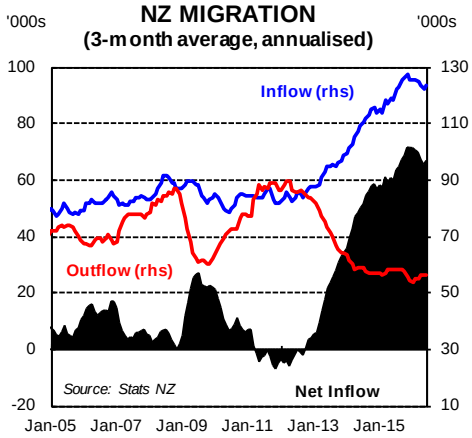


Dairy incomes will remain weak over this year. We continue to expect that **dairy prices will recover sharply in coming months** as reduced global production hits supply, but cash flows may not start to improve until 2017. **Non-dairy exports have performed strongly over the past year**. In particular, tourism has performed exceptionally well over the past year. Meanwhile, Kiwifruit has recovered from the Psa blight of 2013 and 2014. However, the broader export outlook will be vulnerable to any slowing of global growth and a less supportive NZD than previously forecast.



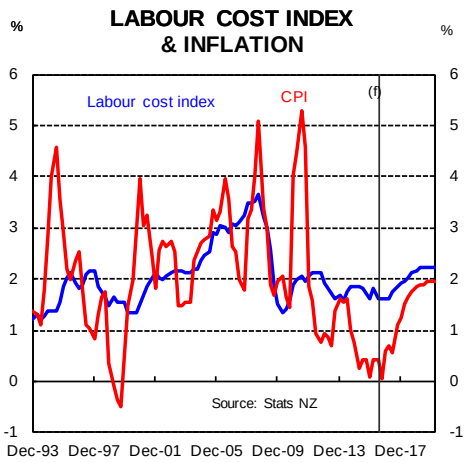
Net migration continues to post record highs on an annual basis, continuing to fuel NZ population growth. The drivers are broad, including relative economic strength vs Australia, high levels of arrivals on student visas, and the impact of growing skill shortages and the ever-increasing need to recruit offshore. However, it **does appear that net migration is close to peaking**, with the monthly trend starting to turn. Nonetheless, while the level will slow, the **rate of inflow will remain historically high and remain a source of stimulus to the NZ economy.**

Housing demand has broadened across NZ, with sales of existing houses and building consents now growing strongly in regional centres as well as Auckland. **Auckland remains supply constrained** (our current estimate is by 25,000 houses). Confirmation of the unitary plan in coming months should clear the way for further building activity, with investors/developers able to move forward with plans for intensification. However, with **construction already at record-high levels, capacity constraints in the building sector are likely to limit the pace of house building over the coming years.**



Commercial and infrastructure development will also compete for construction resources over the coming years. Business appetite for investment remains robust, while a number of key infrastructure developments (such as the rail loop) will keep pipe-line demand steady.

Over the past year, the **unemployment rate has started to trend sideways**, as labour supply expanded through the record lift in net migration, along with high levels of labour force participation. StatsNZ has recently revised its estimates of trend unemployment lower, as it been overestimating the degree of active job-seeking in recent years. Going forward, we are starting to see **early signs of the labour market tightening**. This will feed through to slightly **stronger wage inflation,** which has been weighed by the recent slack in the labour market and falling inflation expectations.



A **stronger labour market** and the **lagged impact of interest rate declines** will be key drivers of an **increase in per-capita demand over the coming years.** This lift in per-capita demand is critical to see a more sustainable lift in economic momentum and a subsequent lift in domestic inflation pressures. **Headline inflation is likely to remain very subdued over the next year.** The recent appreciation in the NZD and still-soft global commodity prices mean the traded sector continues to weigh on inflation. However, over 2017 we expect to see a lift in global inflation coupled with stronger domestic inflation pressures. **Nonetheless, inflation's return to the mid-point of the RBNZ's target range will be gradual journey with many downside risks to overcome along the way.**

Interest Rates and Exchange Rates – *back into action*

The RBNZ held fire for months after it cut the OCR 25bp in March. The RBNZ was stuck trying **to juggle its monetary policy and financial stability mandates, which put the brakes on more OCR cuts.** However, the **NZD continued to move higher.** New macro-prudential housing tools now mean greater scope to respond to the weak inflation outlook. Meanwhile, the NZD has firmed against the UK Pound and euro since the Brexit vote.

The RBNZ opted to leave the OCR on hold at the April and June meetings, as monetary policy and financial stability mandates clashed. But the clash simply got worse: housing continued to heat up and the NZD kept rising rather than falling as the RBNZ had been hoping for. However, the introduction of further investor LVR restrictions to tackle financial stability have reduced some of the friction between the mandates and opened the door for the RBNZ to respond to a more subdued inflation environment than the RBNZ envisaged just months earlier.

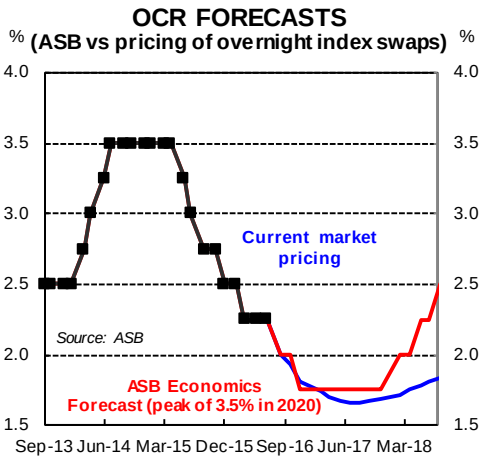
We expect the RBNZ to follow up an August OCR cut with another in November, **taking the OCR to a record low of 1.75%. If anything, the risks are skewed to an even lower OCR.** How the RBNZ responds over coming months to the seemingly unsinkable NZD will be a key influence on where the OCR settles. The impact on banks of rising credit risk premia may also blunt the effectiveness of OCR cuts. And the growing need to fund strong borrowing demanding will at some point put a floor under how low deposit rates can go while still attracting funding. These influences, quite acute in 2009, are starting to come back into the mix.

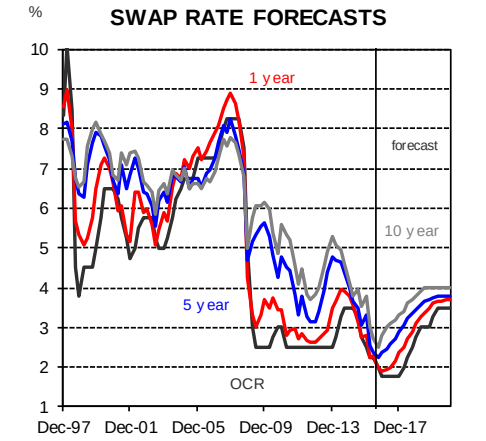
NZ longer-term interest rates are also impacted by global interest rates. All up, NZ longer-term interest rates are likely to **stay near recent lows into 2017**. The **risks to the global outlook suggest that global interest rates are likely to stay low** for a while yet. Even **US rate rises are set to be slow.**

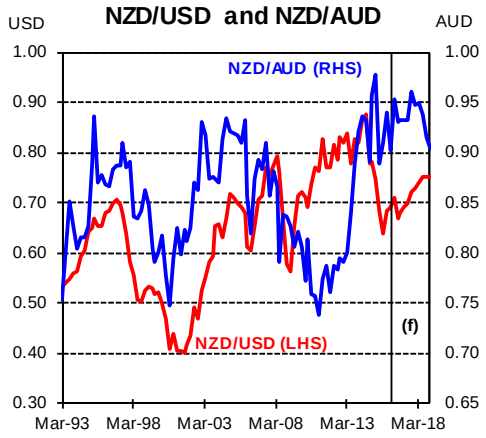
The high NZD has been a thorn in the RBNZ's side. So far over Q3, the **NZ trade-weighted index is sitting 6% higher than the RBNZ forecast in the June MPS.** Structural factors including the **high Terms of Trade**, as well as **relatively high interest rates, have supported the NZD**. The recent **Brexit vote also saw the NZD lift against the GBP and the EUR** and we revised our FX forecasts in June to reflect the new post-Brexit outlook. Further, the slower than anticipated US Fed tightening cycle has limited NZD downside.

Overall, **we expect the NZD to retain a degree of strength, especially given the supportive structural factors**. In the short term**, additional OCR cuts by the RBNZ will constrain the NZD/USD.** However, impacts on the **NZD/EUR and NZD/GBP will be more muted** as the EUR and GBP continue to be impacted by the Brexit outcome. T**he NZD/AUD is likely to hold up** as the RBA leans towards a further interest rate cut later this year.

Finally, we expect the NZD/JPY to grind higher over time. The Japanese Government is embarking on another fiscal stimulus package to bolster the economy**. The Bank of Japan is likely to follow suit with more stimulus.**







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Economic Forecasts

ASB economic forecasts		Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Mar-19
		<< actual	forecast >>								
NZ GDP real	**AA%**	**2.5**	**2.7**	**2.8**	**3.0**	**3.0**	**2.9**	**3.0**	**3.1**	**3.3**	**3.2**
private consumption	AA%	2.5	2.5	2.7	2.5	2.6	2.7	3.0	3.4	3.7	3.6
dwelling construction	AA%	5.6	6.0	6.8	8.5	8.4	8.9	8.0	6.6	5.7	1.2
other investment	AA%	1.4	2.2	2.5	5.2	7.3	7.7	9.4	8.8	7.5	5.0
exports	AA%	5.3	4.1	2.0	1.4	1.6	1.0	1.0	1.1	1.2	3.3
imports	AA%	2.0	0.4	0.7	1.5	2.6	3.8	4.1	4.4	4.5	4.1
NZ GDP real	A%	2.8	3.3	2.9	2.8	2.8	3.0	3.3	3.4	3.5	2.9
NZ GDP real	Q%	0.7	0.8								
NZ CPI	**A%**	**0.4**	**0.4**	**0.1**	**0.6**	**0.7**	**0.6**	**1.1**	**1.3**	**1.5**	**1.9**
NZ house prices (QV index)	A%	10.9	10.5	8.0	9.0	7.4	4.1	2.7	3.5	3.3	1.8
NZ unemployment (sa%)	Qtr	5.2	5.5	5.5	5.4	5.5	5.4	5.3	5.2	5.2	5.0
NZ private sector wages (LCI)	A%	1.8	1.6	1.6	1.6	1.6	1.8	1.9	1.9	2.0	2.2
NZ current account ($b)	Yr	-7.5	-7.2	-7.2	-7.1	-7.0	-7.3	-7.6	-7.8	-8.0	-9.0
as a % of GDP	Yr	-3.0	-2.9	-2.8	-2.8	-2.7	-2.8	-2.9	-2.9	-3.0	-3.2

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	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Mar-19
(end of quarter)		<< actual	forecast >>							
NZ cash rate target	2.25	2.25	2.00	1.75	1.75	1.75	1.75	1.75	2.00	3.00
NZ 90-day bank bill	2.34	2.41	2.1	1.9	1.9	1.9	1.9	2.0	2.2	3.2
NZ 3-year swap rate	2.31	2.28	2.1	2.1	2.1	2.2	2.4	2.6	2.8	3.4
NZ 10-year gov't stock	2.98	2.34	2.4	2.6	2.7	2.8	2.9	3.0	3.1	3.6

ASB foreign exchange forecasts	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Mar-19
(end of quarter)		<< actual	forecast >>							
USD per NZD	0.691	0.710	0.67	0.68	0.69	0.70	0.72	0.73	0.74	0.75
GBP per NZD	0.481	0.530	0.52	0.54	0.57	0.58	0.61	0.62	0.63	0.66
AUD per NZD	0.903	0.954	0.93	0.93	0.93	0.93	0.96	0.95	0.95	0.90
JPY per NZD	77.8	72.9	70	72	75	77	81	85	87	89
EUR per NZD	0.610	0.639	0.61	0.62	0.62	0.61	0.62	0.61	0.61	0.58
CNY per NZD	4.478	4.72	4.29	4.28	4.28	4.20	4.25	4.23	4.37	4.43
TWI - 17 country	73.2	76.0	71.6	72.0	72.2	72.1	73.5	73.5	74.1	73.6

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