

**REDWARD
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ASIA-PACIFIC

MACRO & FX OUTLOOK

Realm of New Zealand

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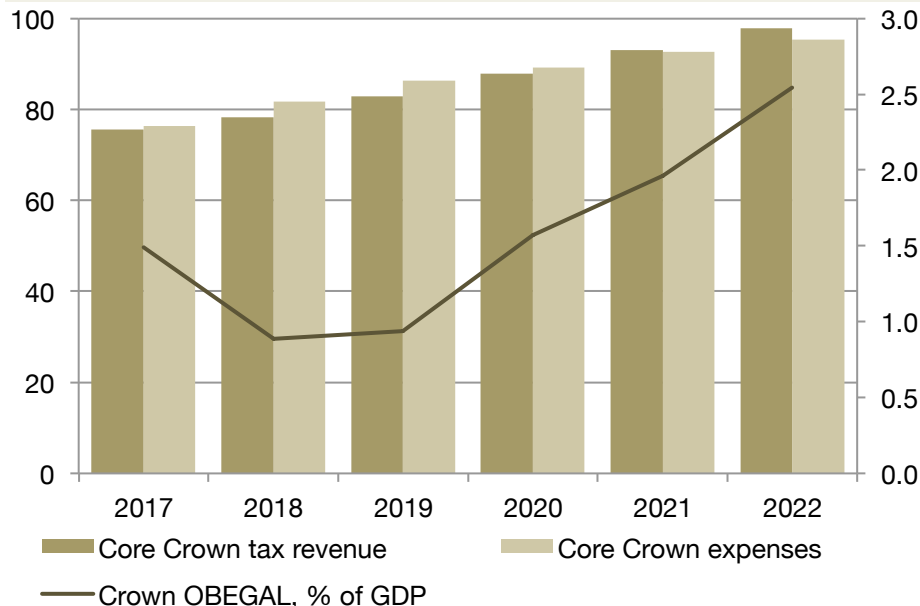
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Fiscal policy is set to loosen...

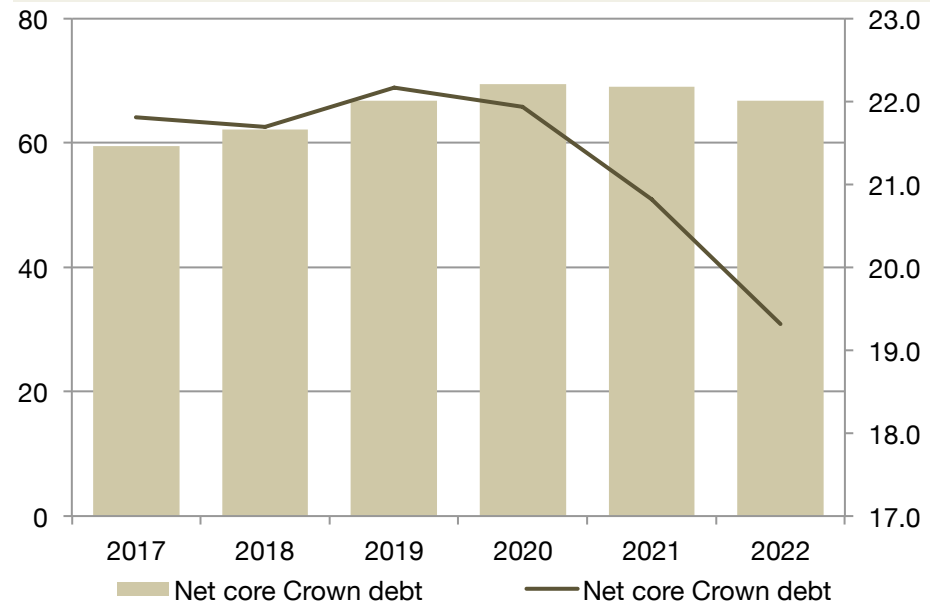
- In December, the Treasury published the new government's 'mini-budget' with much of the projections consistent with Labour's pre-election campaign to fund fiscal expansion via the cancellation of planned tax cuts and moderation in fiscal surpluses.
 - New operating spending through to FY2022 (+NZD8.4bn) while capital spending is also revised higher to NZD41.7bn (+NZD4.9bn).
 - Key economic assumptions include the expectation for annual real GDP growth to accelerate at a slower rate, rising to 2.9% by June 2018 and peaking at 3.6% by Q1 2019, accompanied by a steady decline in the unemployment rate from 4.6% currently to 4.4% by 2019.
 - The fiscal operating balance before gains and losses for the total Crown (OBEGAL) will remain in surplus over the coming years and increase from NZD4.1bn (1.5% of GDP) in FY17 to NZD8.8bn (2.5% of GDP) by FY22, while net Core Crown debt is expected to be gradually paid down from NZD59.5bn (21.8% of GDP) to NZD66.8bn (19.3% of GDP) over the same period.

Figure 1: Fiscal forecasts, NZDbn



Source: Treasury (HYEFU), Redward Associates

Figure 2: Core Crown net debt, NZDbn

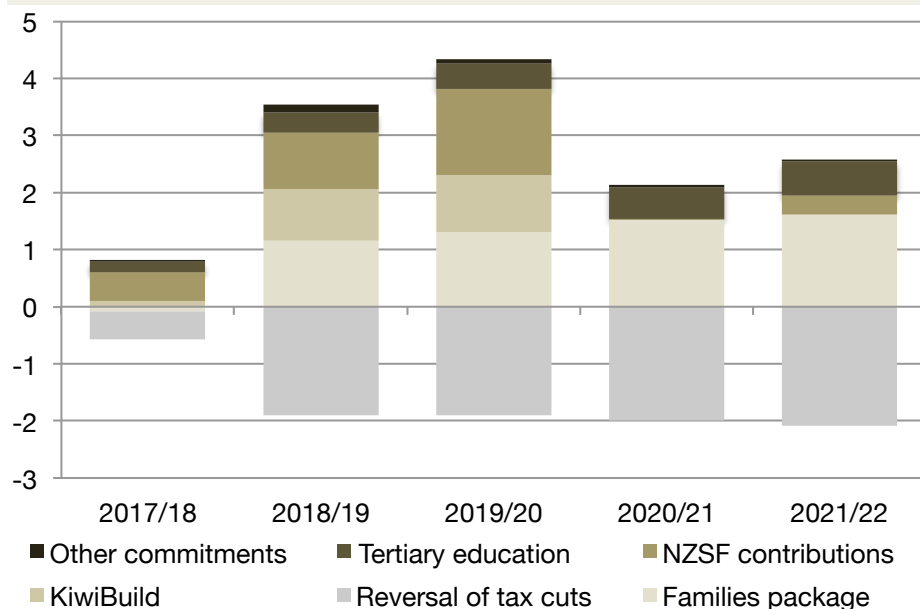


Source: Treasury (HYEFU), Redward Associates

...but policy shifts will weigh on the NZD.

- The Labour-led coalition is set to focus on the following:
 - i) funding for the Families Package (NZD 1.2bn), healthcare (NZD0.8bn), education (NZD 0.9bn) relative to Treasury's baseline projections.
 - Annual net issuance of NZGBs remains steady (NZD7.0bn p.a.), and we estimate NZGBs on issue falling to NZD67.1bn (20.2% of GDP) in FY21.
 - Reduced NZGB on issue likely to lead to NZD selling; assuming foreign share constant around 60.4% implies selling of NZD 5bn in bond maturities.
- Contributions to the New Zealand Superannuation Fund (NZ Super Fund) will start immediately.
 - Contributions of NZD 0.5bn in 2017/18, increasing to NZD 1.0bn and NZD 1.5bn in the following 2 years.
 - Portfolio is 85% foreign assets implying outflows of NZD 0.425bn in 2017/18, rising to NZD 0.85bn in 2018/19 & NZD 1.275bn in 2019/20.
 - Restrictions on foreign buyers is likely to drive at least a temporary moderation in foreign capital inflows to the residential property sector.
 - Our back-of-the-envelope calculations suggest lower immigration and house buying will reduce NZD demand by NZD 0.5-0.6bn.

Figure 3: 100-Day Fiscal Plan, NZDbn



Source: Treasury (HYEFU), Redward Associates

Figure 4: NZGB issuance & outstanding, NZDbn

Year ended June (NZDbn)	2018	2019	2020	2021	2022	Total
Gross issuance	7.0	7.0	7.0	7.0	7.0	35.0
Maturity & Redemptions	9.1	7.9	7.3	11.1	0.0	35.5
Net issuance	-2.1	-0.9	-0.3	-4.1	7.0	-0.3
NZGBs on issue	72.3	71.4	71.2	67.1	74.1	
% of GDP	25.2%	23.7%	22.5%	20.2%	21.4%	

Source: NZ Debt Management Office (14 Dec 2017)

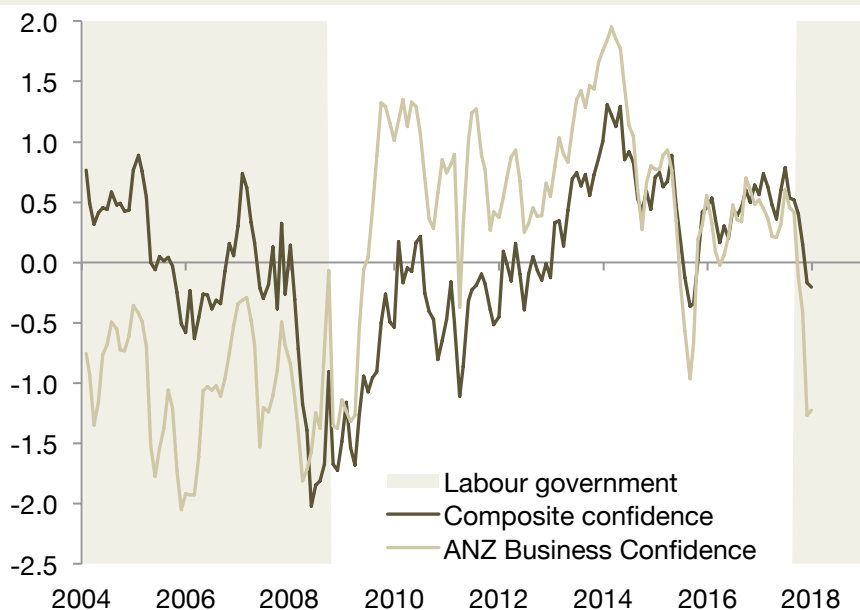
Monetary policy reset... but will it change anything?

- The Labour-led coalition has recently announced the *Terms of Reference for a Review of the Reserve Bank Act*.
 - This announcement is consistent with our own view (see New Zealand: It's time for a Reserve Bank change, 13 March 2017).
- Policy changes are a direct consequence of the shortcomings of the existing Act as revealed by Governor Wheeler's term.
 - These issues included: i) the aborted rate hike cycle in 2014, ii) failure to keep "future average inflation near the 2 per cent target mid-point", iii) a leak of the OCR decision in March 2016, iv) the 'Toplis Affair' of May 2017, v) a communications program geared towards insiders, vi) long-running compliance breaches at one major bank, vii) unhappiness with the manner and approach of the bank to macro-prudential policy changes.
- The Review will be conducted in two phases:
 - Phase 1:
 - i) Recommend changes to the Act to provide for requiring monetary policy decision makers to give due consideration to maximising employment alongside the price stability framework.
 - ii) Recommend changes to the Act to provide for a decision-making model for monetary policy decisions, in particular the introduction of a committee approach including the participation of external experts.
 - iii) Consider whether changes are required to the role of the Reserve Bank Board as a consequence of the changes to the decision-making model.
 - Phase 2:
 - i) The Reserve Bank and Treasury will jointly produce a list of areas where further investigation of the Reserve Bank's activities are desirable. This list will be produced in consultation with an Independent Expert Advisory Panel.
- The core of these changes will occur before the commencement of Governor-Designate Orr's term in late March.
- We expect Governor-designate Orr to implement both the letter and the spirit of the changes being implemented.

Confidence has dipped but activity should remain supported...

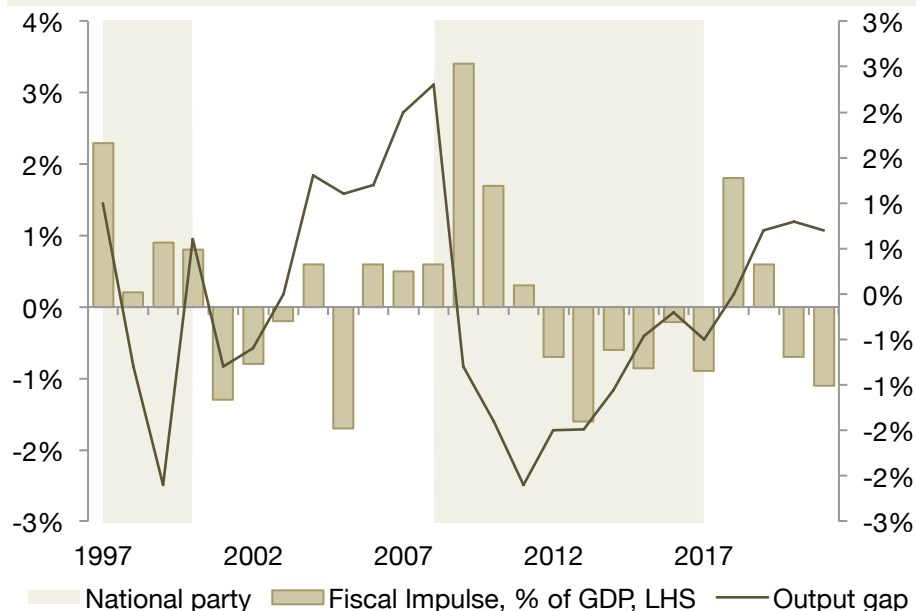
- The RBNZ and Treasury project a significant acceleration in real GDP growth through 2018/19.
 - RBNZ project March year (annual) 3.0% and 3.5% for 2018 & 2019 while Treasury project June year (annual) 3.0% & 3.6%, respectively.
- While we see scope for a pick up in activity, we are less sanguine.
 - i) Slowing net migration, ii) softer commodity prices, iii) risk of slower Chinese demand for exports (dairy & logs) iv) wind-down of Christchurch rebuild, v) softer credit card transactions, vi) signs of weakness in business & consumer confidence & PMI's.
- We project annual real GDP to expand 2.7% in March 2018, rising to 3.1% in March 2019.
 - Personal Consumption Expenditure growth to soften: absent tax cuts, real income growth will be slower, lower net migration gains & less wealth effect.
 - Elevated asset values – both equity & real estate – support a high Tobin's q, suggesting impetus for investment, offset to an extent by net exports.
 - Fiscal impulse likely to be in the region of 1-1.5pp in FY18/19 but the impulse will prove transitory.

Figure 5: Confidence indicators



Source: ANZ, Bloomberg, Redward Associates

Figure 6: Output gap & Fiscal impulse % of GDP

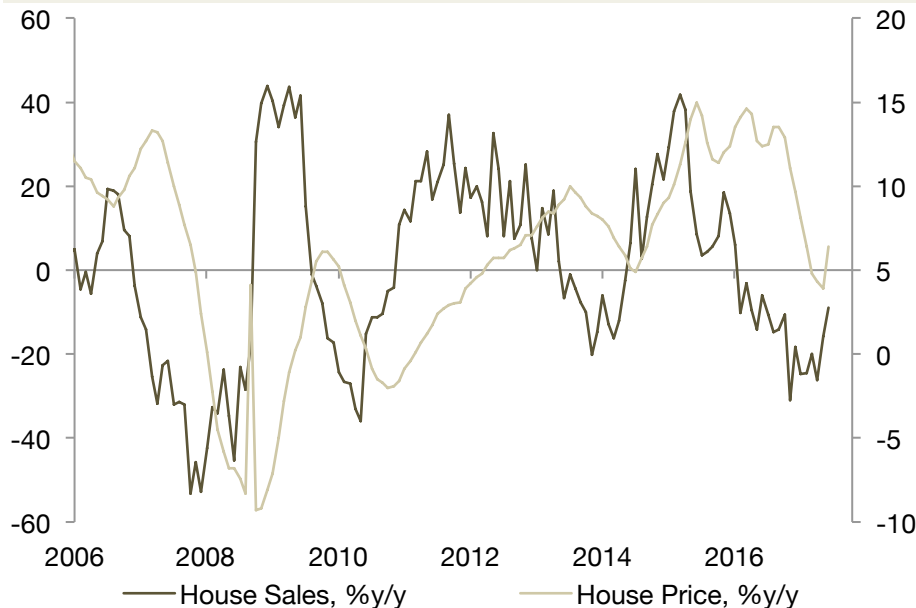


Source: NZ Treasury, Redward Associates, *Pre-election impulse

...despite weakness in the housing market.

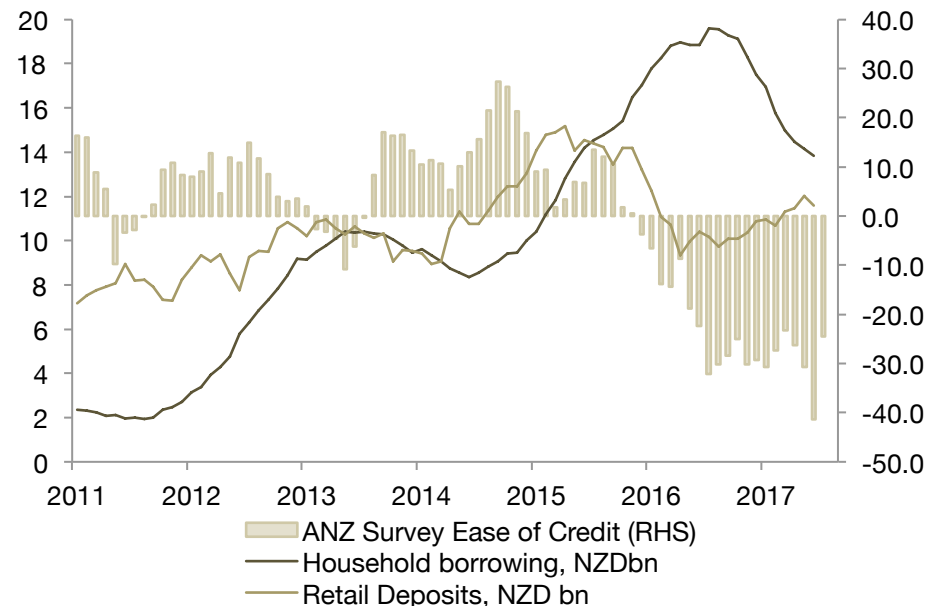
- REINZ show a significant slowdown in house sales (-9%/y/y) over much of the past year with median prices NZD 540k (3.8%/y/y).
- Auckland median prices gained just 0.6%/y/y amid a 17%/y/y fall in sales volume with auction transactions plunging 34%/y/y while inventory rose 23%/y/y and time to sell to improved slightly to 35 days from a month ago.
- The 'Halo Effect' of rising Auckland prices on surrounding areas looks set to move into reverse with few areas having genuine supply-demand imbalances based on: i) population increase, ii) constraint on land availability, iii) constraint on builder availability.
- The effect of Basel III – notably the core funding ratio – and macro prudential policies has been credit rationing.
 - As demand for credit eases, the constraint on bank's core funding ratio will ease and credit availability should improve.
 - A softening housing market is likely to lead to the Debt-to-Income (DTI) constraint being shelved & LVR restrictions may be eased.

Figure 7: House sales and prices, %y/y



Source: Bloomberg, REINZ, Redward Associates

Figure 8: Credit indicators

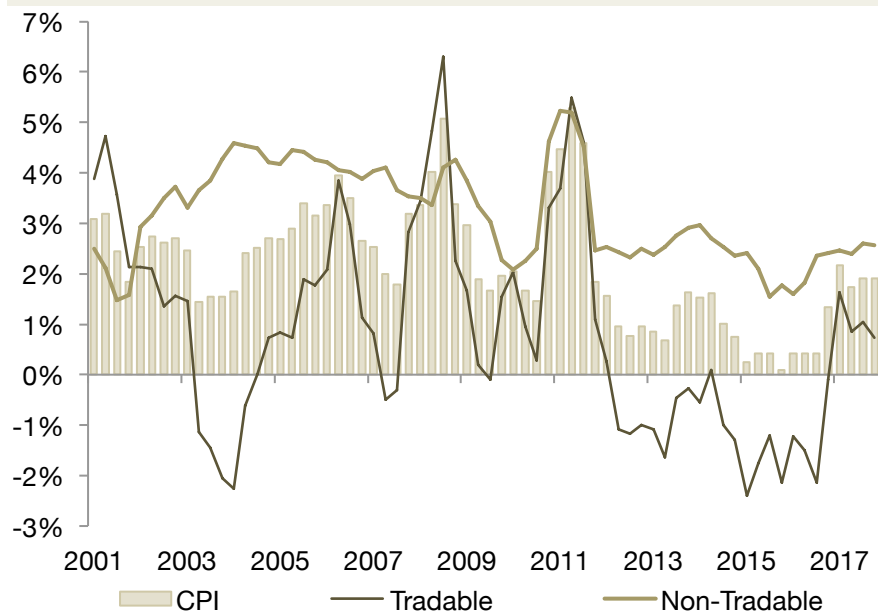


Source: ANZ, RBNZ, Redward Associates

Inflation remains subdued in Q4 2017...

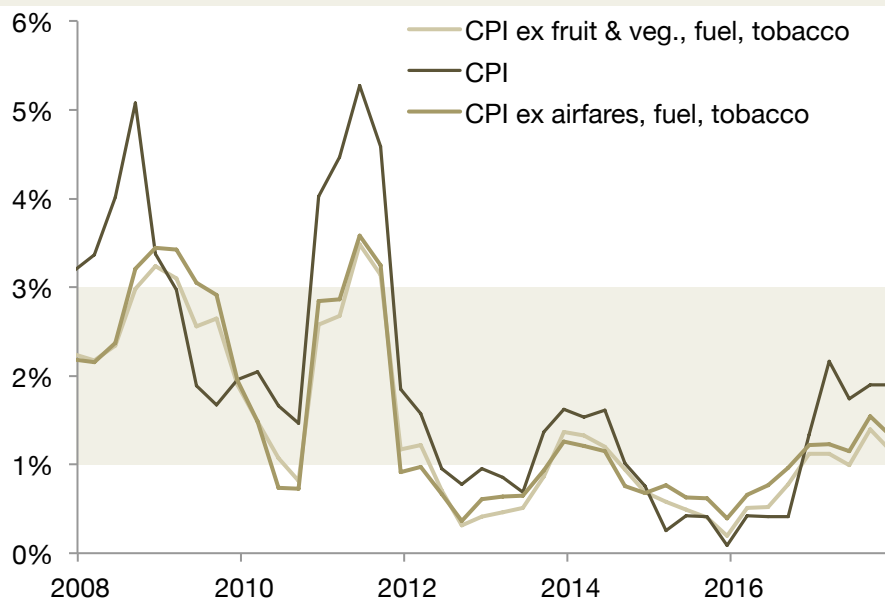
- Our initial projection is for headline CPI inflation to increase 0.4%q/q (1.9%/y/y) in Q4 2017.
 - Calendar year CPI inflation rises 1.9% with tradables rising 0%q/q (0.7%/y/y) & non-tradables rising 0.6%q/q (2.6%/y/y).
 - Our projection assumes a 6.4%q/q (6.8%/y/y) rise in petrol prices, contributing 0.34pp to quarterly CPI inflation.
 - Other significant movements include: vegetables, down 14% (-0.2pp), domestic & international airfares up 7.3% (0.15pp).
- Core inflation remains subdued.
 - CPI excluding volatile items – fruit & vegetables, fuel & tobacco – is expected to rise just 1.2%/y/y.
 - Our projection is in line with the Reserve Bank's and is consistent with the sector factor model rising 1.4-1.5%/y/y.
 - As with recent CPI out-turns, the primary driver of inflation remains petrol prices, administered charges and housing.

Figure 9: CPI inflation, %/y



Source: Bloomberg, Redward Associates

Figure 10: CPI inflation, %/y

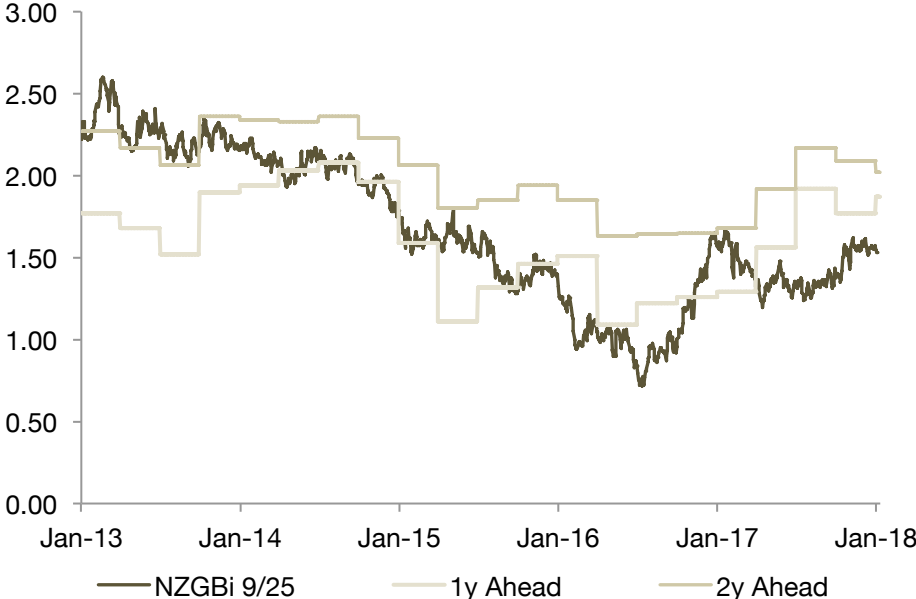


Source: Bloomberg, RBNZ, Redward Associates

...but the Phillips curve is gradually firming.

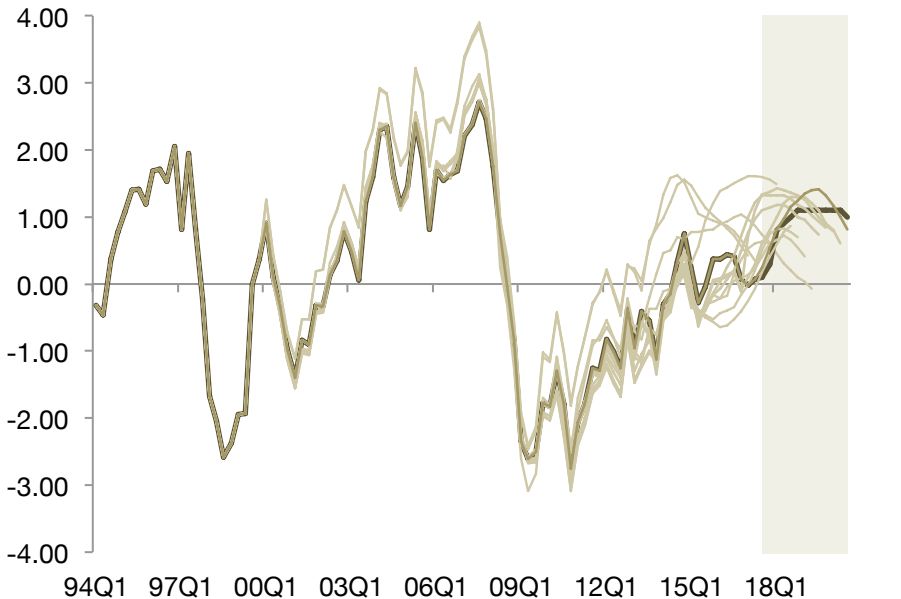
- Inflation expectations appear to be finally drifting higher.
 - In their November Statement, the Reserve Bank notes: *“Long-term inflation expectations remain well anchored at 2 percent”* while *“short-term inflation expectations have increased from a year ago, consistent with the lift in headline inflation, and are also close to 2 percent.”*
 - We note the TIPS inflation breakeven rate remains just 1.53%, close to the sector factor model rate of inflation of 1.4%/y.
- The Reserve Bank believes that the economy is operating close to capacity. We remain (mildly) skeptical.
 - The Reserve Bank has persistently over-estimated the output gap & their forecasts suggest that trend’s likely to continue through 2018/19.
 - Acting Governor Spencer commented on 9 November that *“presently, estimates of the NAIRU vary between four and five percent.”*
 - Higher public sector wage settlements & minimum wage hikes coupled with rising global prices – albeit predominantly energy-related – & a weaker NZD have increased our back-of-the-envelope calculations of the NAIRU but it’s still hovering around 4%, suggesting a limited amount of slack.

Figure 11: Inflation expectations, %



Source: Bloomberg, RBNZ, Redward Associates

Figure 12: Output gap, % of GDP

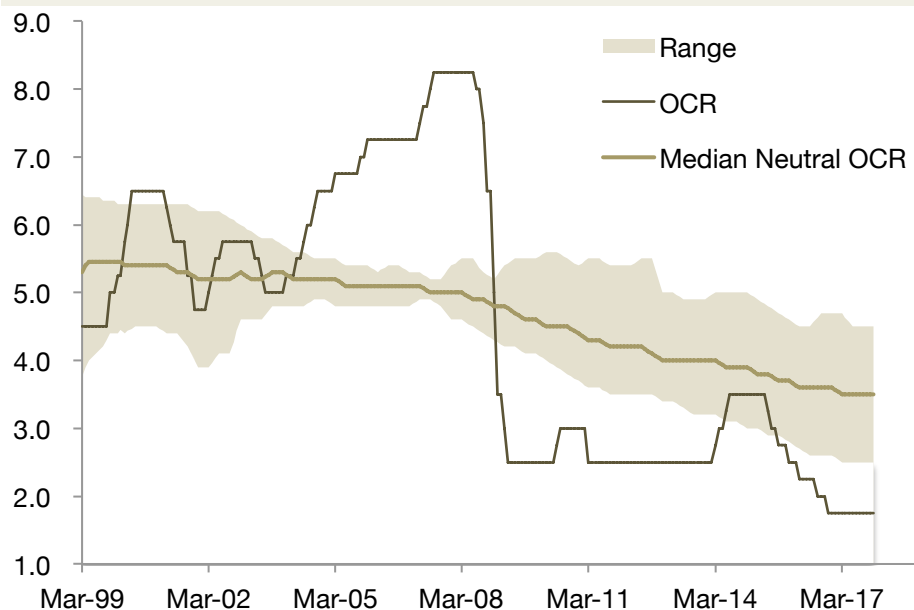


Source: RBNZ, Redward Associates

RBNZ to commence a gradual tightening cycle in H2.

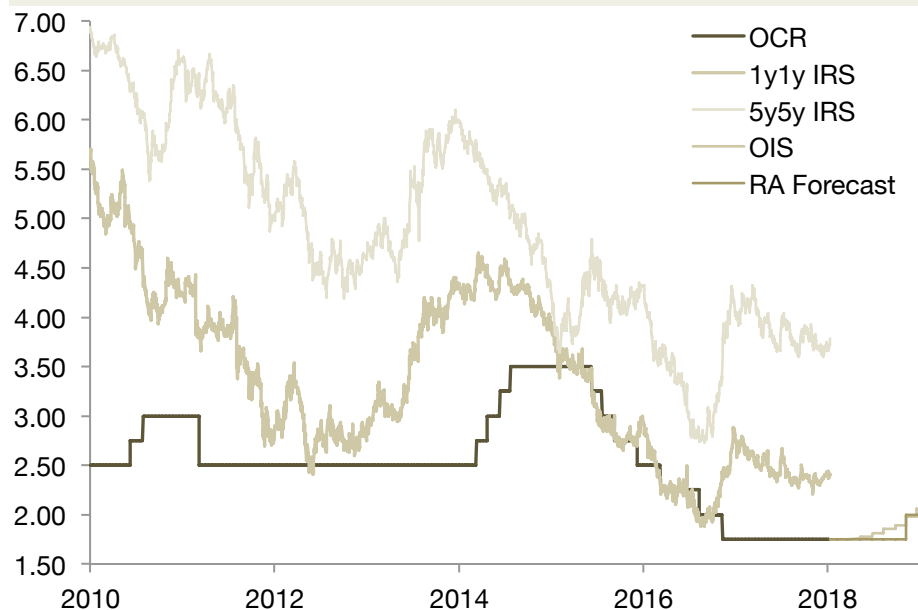
- In their November Statement, the Reserve Bank indicated that policy would “*remain accommodative for a considerable period.*”
- However, forward guidance & the Reserve Bank’s inflation forecasts suggest their bias is shifting.
 - In August 2016 the end-point projection was 1.6%, now 2.3% with a hike likely mid-2019 suggesting RBNZ thinking is beginning to shift.
- We now expect the Reserve Bank to commence a tightening cycle, raising rates 25bp in November with an August hike possible.
 - Much depends on: i) strength of commodity prices & NZD, ii) emerging capacity constraints & core inflation, iii) wage inflation & inflation expectations.
 - At present, the OIS market prices the first rate hike at the November 2018 Statement with 1½ hikes priced by February 2019.
- We have closed our NZD 1y1y IRS received position and we favour paying NZD 5y5y IRS at 3.78%.

Figure 13: Official Cash Rate, r^* and the OIS, %



Source: Bloomberg, RBNZ, Redward Associates

Figure 14: IRS yields, %

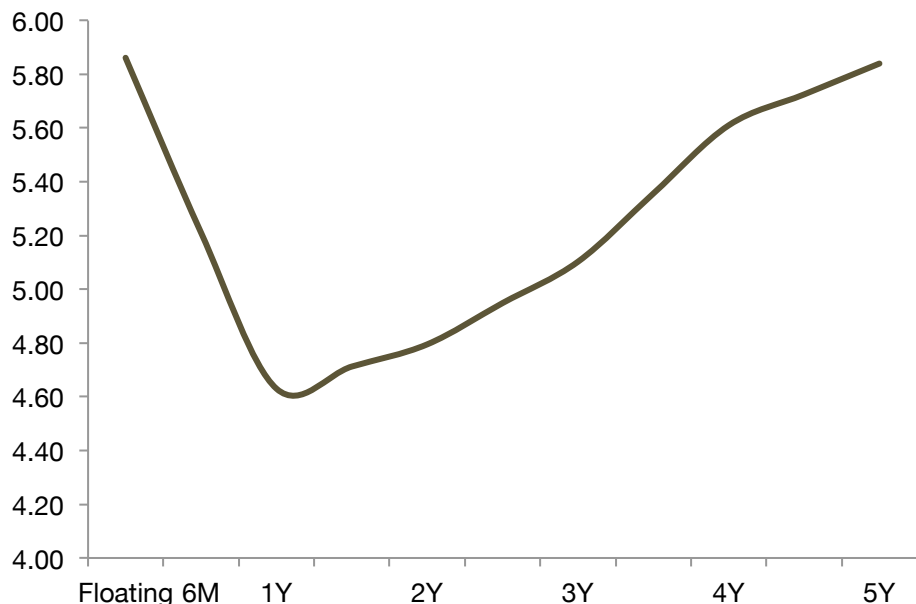


Source: Bloomberg, Redward Associates

Mortgage fixing remains a significant risk to the IRS market.

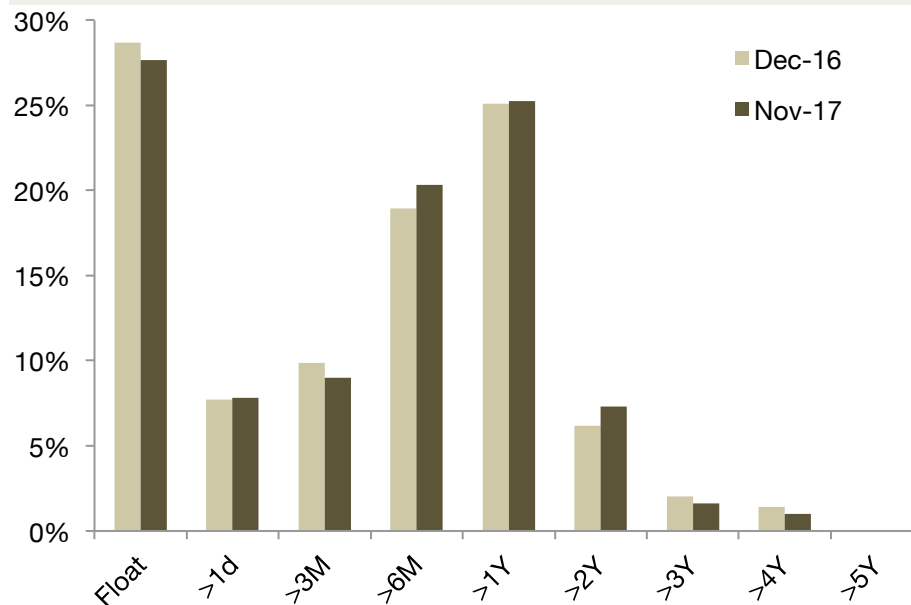
- Were expectations of rate hikes to re-emerge, we see ample scope for fixing pressure to impact the IRS market.
 - As of end-November, owner occupied residential mortgages were valued at NZD 186.4bn (5.7%/y/y).
 - Surprisingly, given the term structure of interest rates, fully 27.6% of residential mortgages (NZD 51.5bn) are on floating rates.
 - Consistent with lower rates in the 6m-2y maturity buckets, NZD 116.3bn (62.4%) of owner-occupied mortgages are fixed.
- The Reserve Bank currently has ample capacity to impact household economic behaviour.
 - The shape of the mortgage yield curve and structure of household borrowing suggests a fairly rapid transmission of monetary policy to households.
- The relatively illiquid nature of the New Zealand IRS market and the concentration of mortgage lending within an oligopoly of essentially four major institutions suggests scope for highly elastic yield response should fixing pressure re-emerge.

Figure 15: Mortgage interest rate, LVR <80%



Source: Interest.co.nz, Redward Associates

Figure 16: Term structure, % of total (owner occupy)



Source: RBNZ, Redward Associates

Commodity prices remain elevated but turning down...

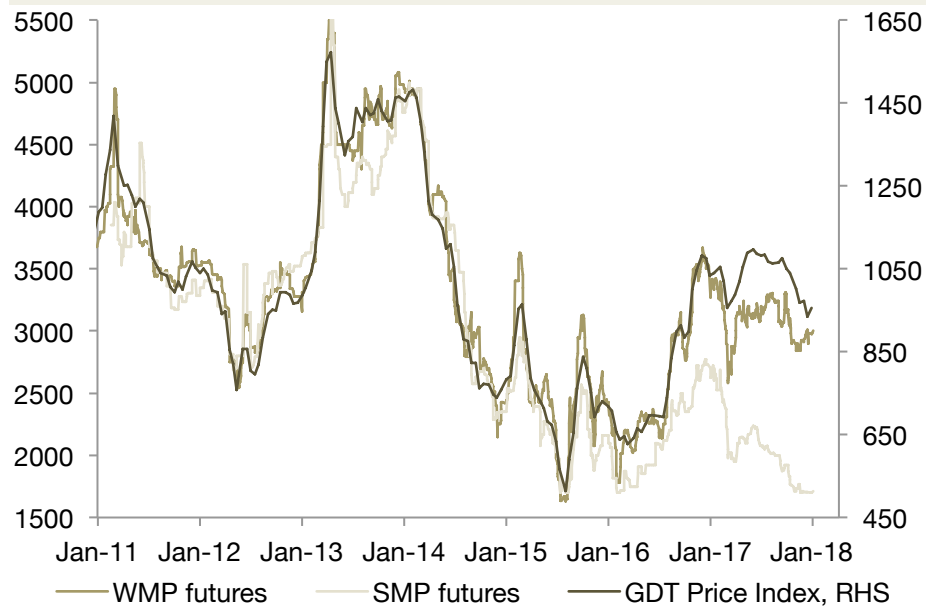
- Our New Zealand commodity index strengthened 5.8% in 2017.
 - Strength in prices of lamb (+3.3pp), forestry (+3.0pp), kiwifruit (+0.9pp) and wool (+0.7pp) more than offset weakness in dairy (-3.6pp).
- Through 2017, the GDT Price Index weakened 13.1% although the latest auction (2 Jan) posted a modest recovery of 2.2%.
 - At the latest event, WMP gained 4.8% and SMP gained 1.4% while butter rose by 0.6% and AMF rose by 0.2%.
 - We believe that the earlier fall in SMP prices partially reflects the strength in demand for milk fats and proteins such as cheese and butter.
 - In line with global dairy milk production increases, we expect downward pressure on prices to re-emerge and we note that the milkfat premium is beginning to correct particularly for butter prices.
- Slowing Chinese property prices are likely to weigh on forest product prices (+17.1%/y, 18.6% of our index weighting).

Figure 17: Commodity price index



Source: Bloomberg, Redward Associates

Figure 18: Milk futures, USD/MT

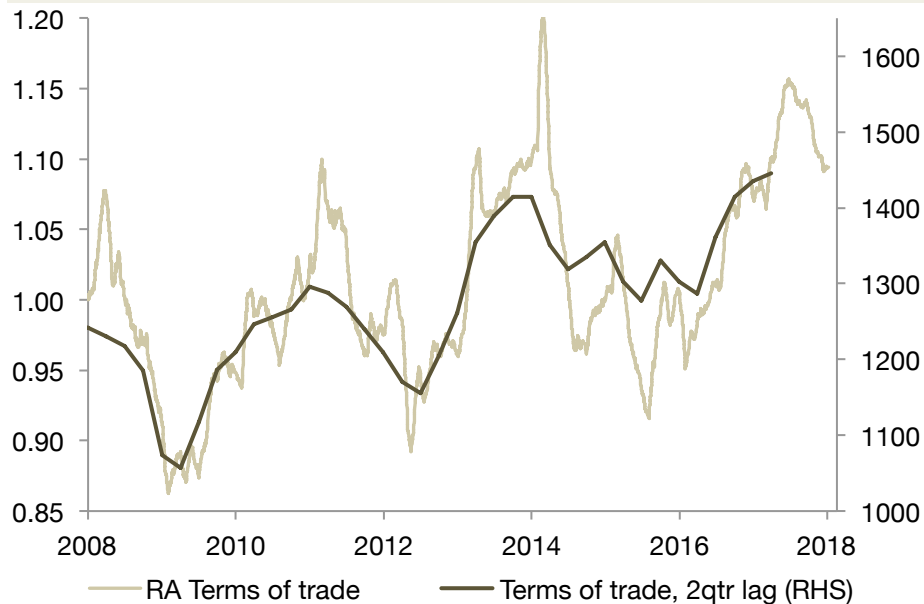


Source: Bloomberg, Redward Associates

...weighing on the Terms of Trade.

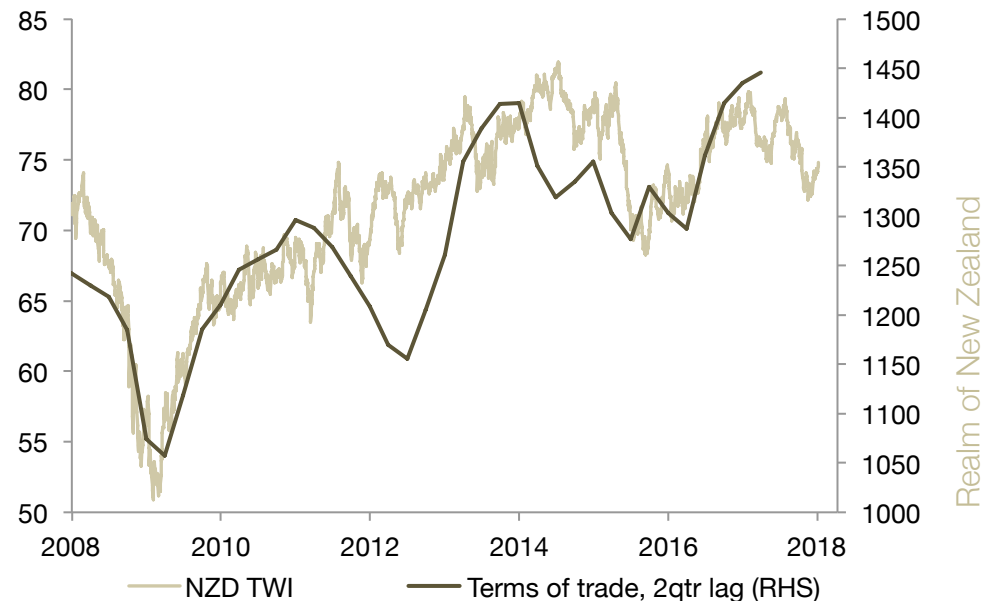
- Our bespoke Terms of Trade (ToT) index has fallen 5.4% from its June 2017 peak but remains up 2.0% for the full year in 2017.
 - Since its mid-2015 trough, our ToT index has increased 19%, driven largely by rising dairy, lamb and forestry products.
- Falling commodity prices suggest near-term downside risk to the Terms of Trade.
 - We see scope for weakness in dairy, beef, lamb and forest products to weaken our commodity price index and lower the ToT.
- However, we see limited scope for a major move – perhaps 10-15% – and this will constrain downside in the NZD TWI.
- For the ToT to correct meaningfully (i.e. to levels seen in the 1980's or 1990's) we'd need to see import prices rise.
 - Rising petrol prices may temporarily distort (lower) the ToT but are unlikely to drive a major downtrend.
 - What would be required to drive the ToT substantially lower would be inflation in manufactures (e.g. apparel, autos, electrical & mechanical equipment).

Figure 19: Terms of trade



Source: Bloomberg, Redward Associates

Figure 20: Terms of trade & NZD TWI



Source: Bloomberg, Redward Associates

The current account deficit looks set to widen.

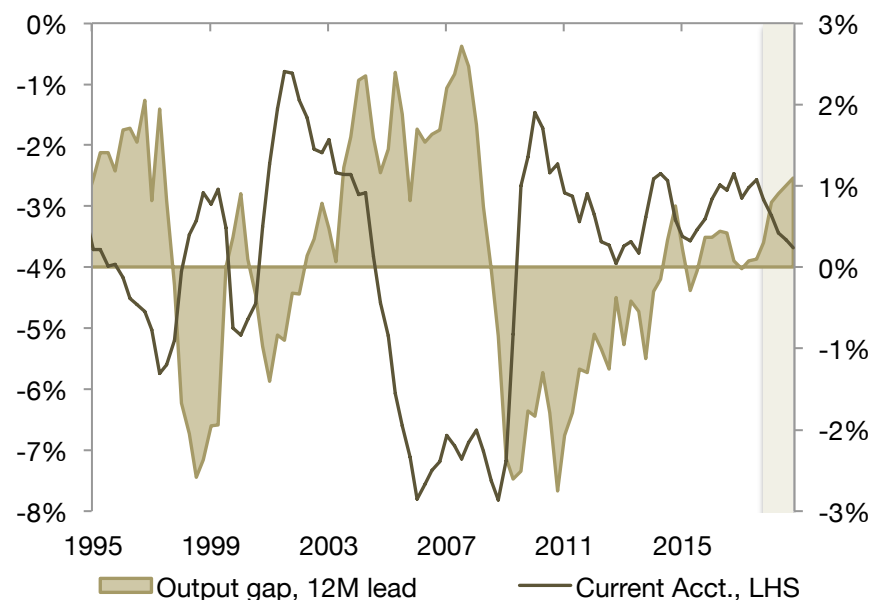
- The current account deficit looks set to widen.
 - We project a current account deficit of NZD 8.1bn (2.9% of GDP) in 2017, widening to NZD 10.8bn (3.7% of GDP) in 2018.
- The current account deficit has improved from a deficit of NZD 14.7bn (7.8% of GDP) in 2008.
 - New Zealand has been a beneficiary of low global interest rates & Quantitative Easing (QE).
 - Key factors improving the C/A have been: i) terms of trade, ii) increased air links to Asia, and: iii) significantly lower NZ interest rates.
 - Weaker dairy prices, increased oil prices & import volumes and higher interest rates should all weigh on the current account.
- Funding of the current account deficit looks likely to tighten as the deficit gradually widens & global credit markets tighten.
 - Assuming net FDI inflows of NZD 2.0bn (0.7% of GDP), the basic balance is likely to post a deficit of NZD 8.8bn (3.0% of GDP) in 2018.

Figure 21: Balance of payments, NZD bn

Year	2014	2015	2016	2017e	2018f
Goods	1.1	-2.3	-2.6	-2.8	-3.9
Services	1.5	3.9	4.3	4.3	3.9
Income	-9.9	-9.2	-7.4	-9.0	-9.7
Transfers	-0.4	-0.4	-0.9	-0.7	-1.1
Current Acct.	-7.7	-8.0	-6.6	-8.1	-10.8
% of GDP	-3.2%	-3.2%	-2.5%	-2.9%	-3.7%
Net FDI	2.4	-0.3	4.1	2.5	2.0
% of GDP	0.99%	-0.11%	1.57%	0.9%	0.7%
Basic bal.	-5.4	-8.2	-2.5	-5.6	-8.8
% of GDP	-2.2%	-3.3%	-0.9%	-2.0%	-3.0%

Source: Statistics NZ, Redward Associates

Figure 22: C/A & Output gap, % of GDP

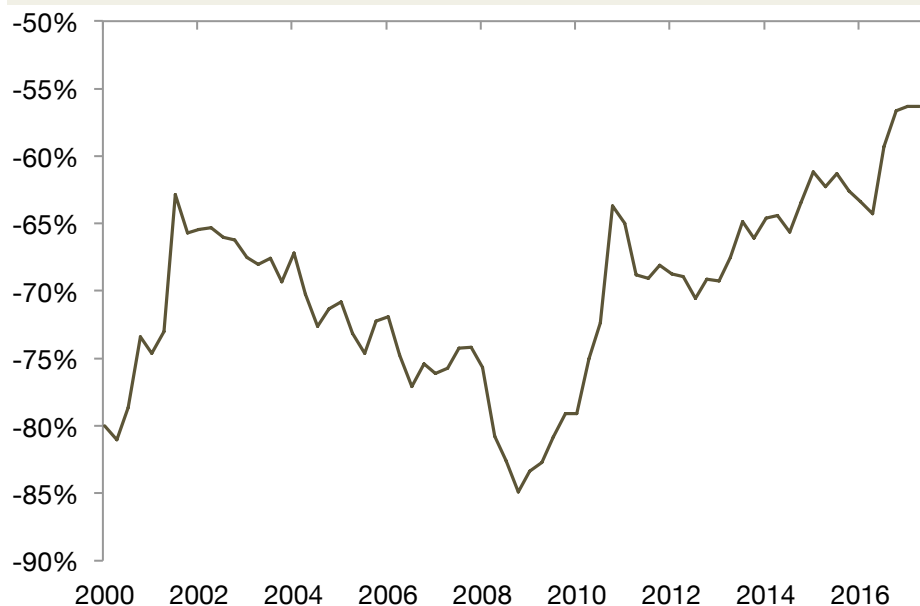


Source: Bloomberg, Redward Associates

The balance sheet suggests vulnerability to rate differentials...

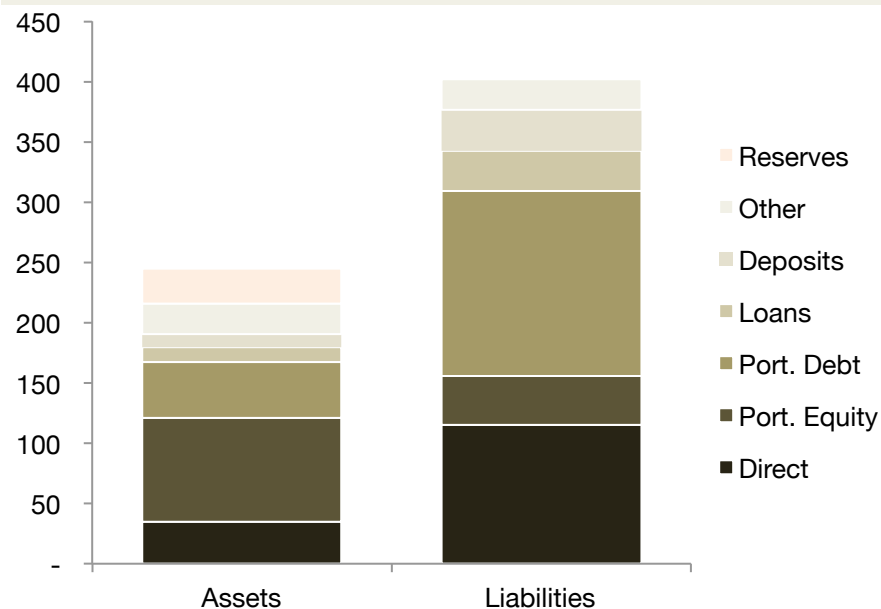
- New Zealand's Net International Investment Position (NIIP) continued to improve in Q3 2017 as a share of GDP.
 - The NIIP is currently NZD -156.7bn (56.3% of GDP) compared with NZD -155.2bn (82.6% of GDP) as of end-2008.
 - Foreign assets currently total NZD 245.1bn (88.1% of GDP) while liabilities total NZD 401.8bn (14.4% of GDP).
- The imbalance in New Zealand's external balance sheet remains heavily skewed towards net debt-liabilities.
 - New Zealand's net debt liabilities are concentrated in; portfolio debt (NZD -106bn), loans (NZD -22bn) & deposits (NZD -23bn).
 - Given the current level of NZ interest rates and external trade balance, we see the NIIP remaining stable but wide.
- The structure of New Zealand's external liabilities still leaves the NZD sensitive to a rise in global interest rates.
 - As NZ interest rates diverge with global rates, the attractiveness of NZD-denominated debt will diminish, weighing on NZD.

Figure 23: Net Int. Investment Position, NZD bn



Source: Statistics NZ, Redward Associates

Figure 24: Net International Investment Position

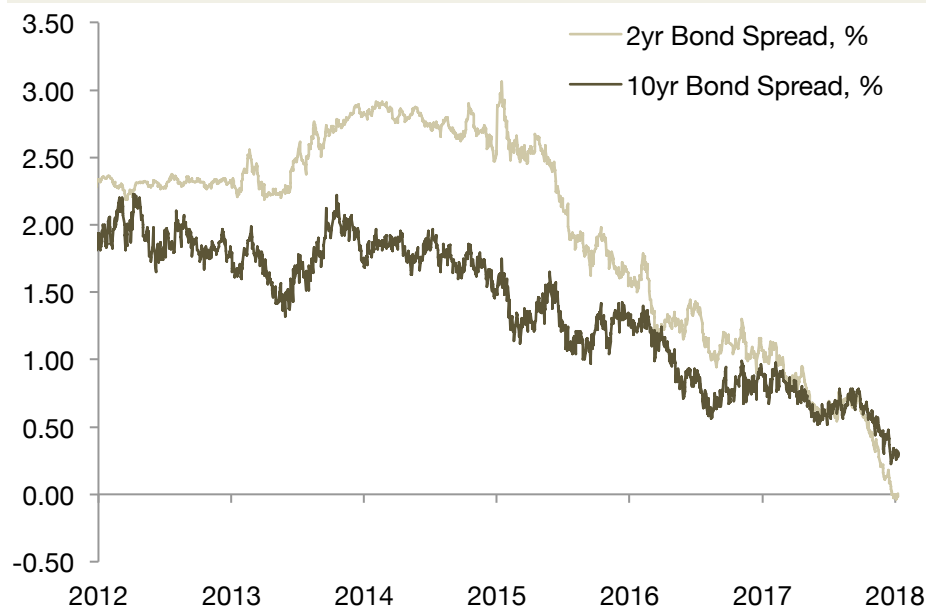


Source: Bloomberg, Redward Associates

...which continue to compress.

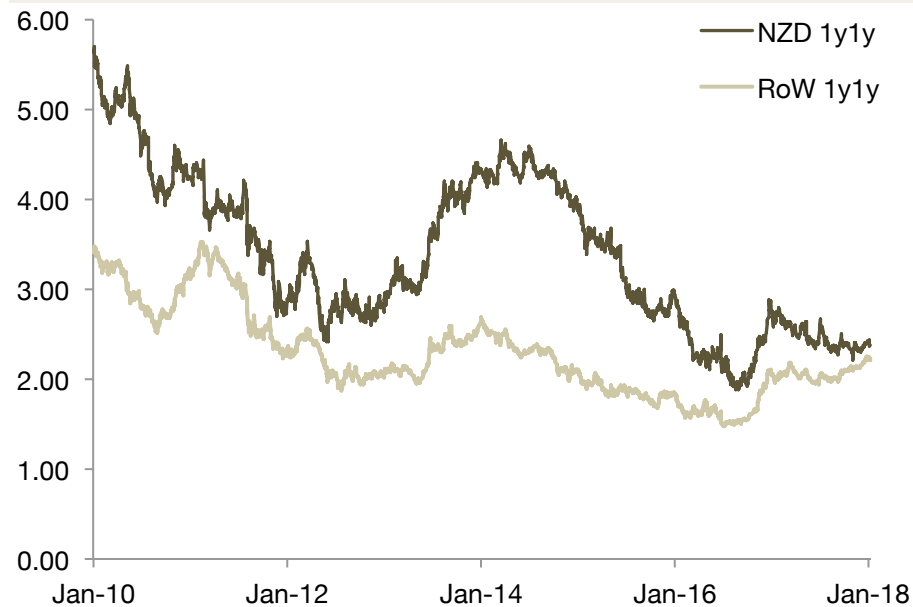
- New Zealand has largely lost its carry advantage – interest rate differentials against the US & on a TWI basis are compressing.
 - The NZ-RoW 1y1y IRS yield differential has compressed from 229bp in March 2014 to just 7bp today.
- Our NZD indicator model suggests yield curve compression played a significant role in weakening the NZD especially vs USD.
 - The NZ-US 2yr IRS yield differential peaked at 365bp in July 2014 & has compressed to just 6bp today (NZD peaked in July 2014 at NZD/0.8814).
 - Our model suggests that were the yield spread to rise to 365bp, ceteris paribus, NZD would rise to NZD/0.8312 (+21.3%).
- We expect yield compression to remain a key headwind for the NZD.
 - Assuming the Federal Reserve hikes 100bp & the RBNZ hikes 25bp by end-2018, the 2yr IRS yield differential could fall to -50-60bp.
 - NZD indicator model suggests 'fair value' would fall to NZD/0.6775 (-5.3%) with downside risk if commodities fall and/or risk aversion increases.

Figure 25: NZ & US bond yield differential, %



Source: Bloomberg, Redward Associates

Figure 26: NZ & RoW 1y1y IRS yield, %

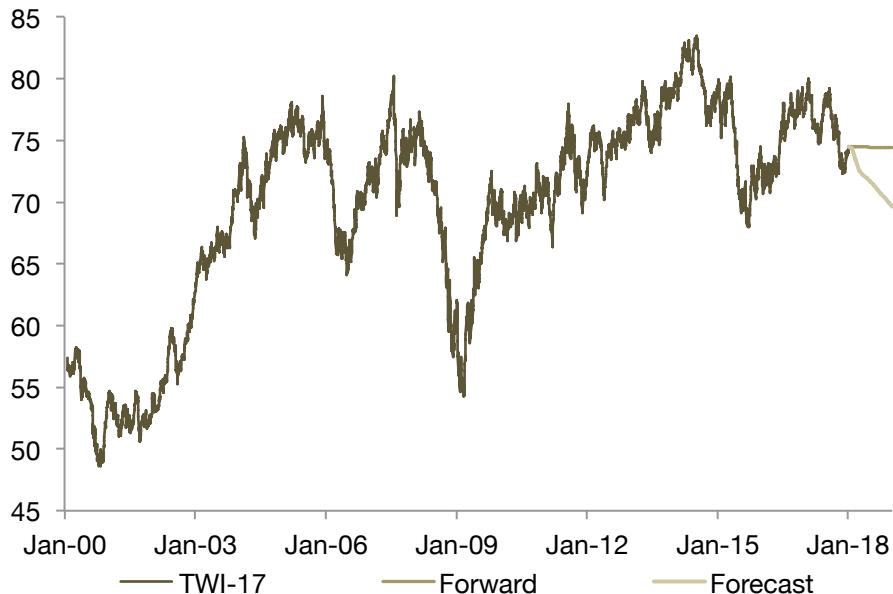


Source: Bloomberg, RBNZ, Redward Associates

NZD to fall to NZD/0.66 in 12-months.

- We project the NZD to weaken to 69.6 on a Trade-Weighted Index (TWI) basis in 12-months.
 - Our projections are based on a confluence of factors including:
 - i) weaker commodity prices/ToT, ii) narrower NZ-RoW rate differentials, iii) funding of NZ Super, iv) reduced immigration/housing buying.
 - Our projection implies a decline of 6.5% on a spot basis and 6.4% relative to the FX forward outright.
- Sensitivity analysis highlights the vulnerability of the NZD to a weaker TWI.
 - Assuming the TWI remains unchanged, our cross-rate forecasts push NZD to NZD/0.7072 in 12-months.
 - If NZD fell to 68 on a TWI basis – still historically elevated – our cross-rate forecasts project NZD/0.6456 in 12-months.

Figure 27: NZD TWI



Source: Bloomberg, Redward Associates

Figure 28: NZD sensitivity table

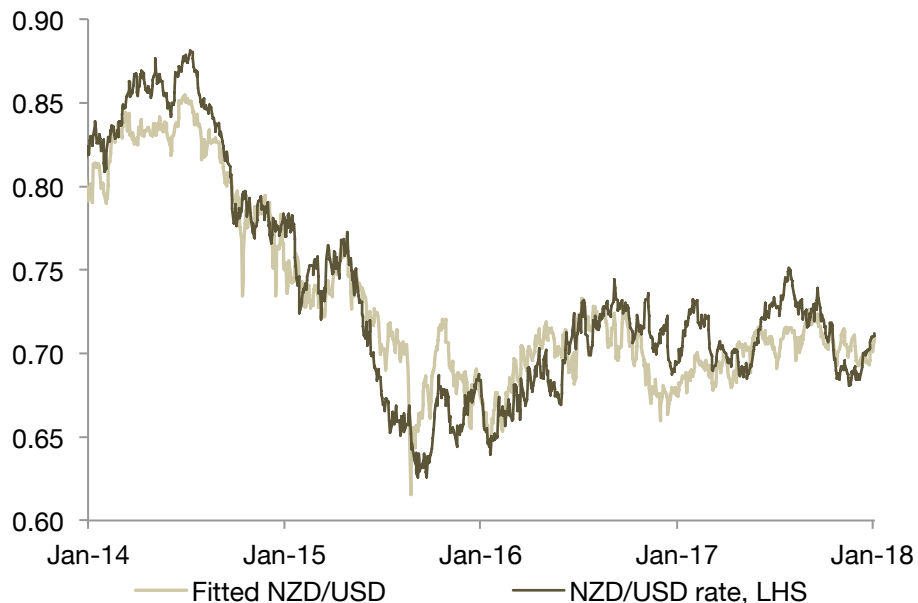
Currency	Spot	1M	3M	6M	12M
AUD	0.7855	0.77	0.75	0.74	0.73
JPY	112.85	113.0	115.0	118.0	120.0
EUR	1.2073	1.22	1.24	1.26	1.28
CNY	6.4779	6.48	6.52	6.55	6.60
NZD/USD conditioned on NZD TWI					
68.0	0.6536	0.6514	0.6484	0.6463	0.6456
70.0	0.6728	0.6706	0.6674	0.6653	0.6646
72.0	0.6921	0.6897	0.6865	0.6843	0.6836
74.48	0.7159	0.7135	0.7102	0.7079	0.7072
77.0	0.7401	0.7376	0.7342	0.7318	0.7310
68.0	-9.5%	-9.9%	-10.4%	-10.8%	-10.9%
70.0	-6.4%	-6.8%	-7.3%	-7.6%	-7.7%
72.0	-3.5%	-3.8%	-4.3%	-4.6%	-4.7%
74.48	0.0%	-0.3%	-0.8%	-1.1%	-1.3%
77.0	3.3%	2.9%	2.5%	2.2%	2.1%

Source: Bloomberg, Redward Associates

We remain short NZD targeting NZD/0.6925.

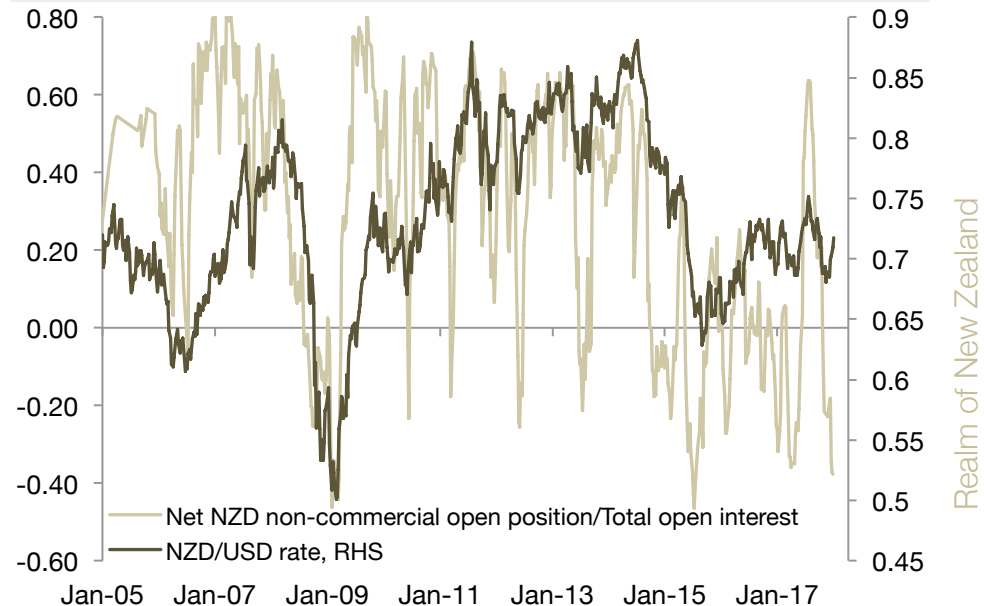
- NZD appears slightly 'over-valued' and 'over-bought'.
- Our NZD model currently projects 'fair value' at NZD/0.7025.
 - Our model is based on commodity prices (Gold, CRB), asset market volatility (VIX, MOVE) & rate differentials (NZ-US 2yr IRS).
- Technical indicators suggest NZD appears 'over-bought'.
- Scenario analysis employing our NZD model points to downside risk for NZD.
 - Assuming gold (USD 1,200/oz), CRB +10%, VIX 15%, MOVE 65% & NZ-US 2yr IRS -0.60%, NZD falls to NZD/0.63.
 - NZD remains highly sensitive to asset market volatility; a jump in VIX (30%) & MOVE (90%) would see NZD/0.60, ceteris paribus.
- We hold a short NZD exposure at NZD/0.7200 (USD 200k) targeting NZD/0.6925 with a stop-loss at NZD/0.7325.

Figure 29: NZD/USD exchange rate



Source: Bloomberg, Redward Associates

Figure 30: NZD/USD & CFTC positioning



Source: Bloomberg, CFTC, Redward Associates

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