HUGO*vision*

Assessing the economic and political environment in New Zealand

Medium Term Projections | July 13 2018 | **Confidential to HUGO members**

Medium Term Economic and Political Projections

Pages 4-9

This special 12-page edition of HUGO*vision* includes our annual medium term projections. While these include some updated economic forecasts, we emphasise that they are projections based on the broad sweep of major influences visible from the vantage point of 2018, not predictions.

Economic outlook – medium term

Pages 4-7

The NZ economy has been coming off the top of a mature economic cycle since before the 2017 election. Capacity constraints, weaker commodity prices and a significant new element – uncertainty about key govt policies – are conspiring to produce the conditions for likely under-performance against potential. However, growth remains robust, wages rise, and inflation returns to normal levels with a slow climb in interest rates.

Political outlook – medium term

Pages 8-9

Deepening, fundamental threats to the post-WW2 rules-based, western-led global order that has benefited small, open trading nations such as NZ frame the canvas on which domestic political dynamics will play out. That said, in our judgement, Labour will lead another coalition govt after the 2020 election, as long as Jacinda Ardern remains a popular PM. National lacks a credible coalition partner and Simon Bridges is likely to face likely leadership challenges.

Tweaking the dragon – a new chapter in NZ-China relations

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The Stategic Defence Policy Statement was frank about frictions created by Chinese expansionism in the South China Sea, provoking an unprecedentedly stern response from Beijing. Having avoided “choosing” between China and the West until now, NZ faces diplomatic challenges that carry substantial economic and security risks.

Hipkins to China this week

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Apparently anticipating a frosty reception from the Chinese authorities to the newly expressed NZ defence policy stance, Education Minister Chris Hipkins travels to China this week to meet his counterpart. Of the 100,000 international students in NZ, around a third are Chinese.

Business lobby wobbles?

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The Auckland business community appears particularly exercised by uncertainty created by govt policy. Both the Auckland Chamber of Commerce and Employers and Manufacturers Association are adopting aggressively negative language. Tensions are emerging too with the EMA’s Wellington ‘embassy’, Business NZ. Its ceo, Kirk Hope’s, decision to join the Jim Bolger-led tri-partite committee on employment relations reform has ruffled feathers.

Nurses’ industrial action

Our timing was off – we thought the nurses would strike on July 4 and call off strike action on July 11. The order was reversed, but we still believe there will now be a swift settlement within the existing $520m ‘envelope’. Behind the scenes, Labour ministers and activists are putting huge pressure on the NZ Nurses Union to recognise the political damage extended action could cause.

Text finalised July 13

POLITICS AND POLICY

NZ-China relations face major new tests

NZ's so-called 'special relationship' with China faces a serious test following what is thought to be **Beijing's first official rebuke of NZ foreign and defence policy**.

The strength of the two countries' mutually shared story of a series of important 'firsts' in relations between NZ, a developed nation, and communist China had been waning in recent times anyway – a combination of China's increasing confidence and widening range of international relationships and, to a lesser extent, the effect on Beijing's attitude to Wellington caused by cooling attitudes to Chinese inward investment and immigration to NZ.

MFAT has been reassessing the relationship since earlier this year, partly because of concern about over-reliance on China as a trading partner, but also because of the shift to a more authoritarian stance under President Xi Xin Ping.

The shift in emphasis in NZ govt commentary on China's geo-political positioning, contained in the Defence Policy Statement released by Defence Minister Ron Mark, takes NZ into new territory in its relationship with China. This is coinciding with the complexity of engagement with an increasingly volatile US foreign policy and defence stance. The **P-8 surveillance aircraft purchase** decision is a key element in this repositioning challenge.

The Defence Policy Statement received an unusually blunt response from China, especially as it ended NZ's equivocal position under National on China's territorial expansionist activity in the South China Sea. For example, under National, even RNZAF Orion patrols with the RAAF over the area were described as "training flights".

Turing link for NZ?

The govt is exploring links with the UK's Alan Turing Institution **to support a data science and AI research institution** here. The institution involves 13 UK universities and its CEO, Sir Alan Wilson, met with Megan Woods during a recent MBIE-sponsored visit.

The 2016 Defence White Paper said: "NZ does not take a position on the various territorial claims in the South China Sea, but it does oppose actions that undermine peace and erode trust. New Zealand supports the rights of states to seek recourse to international dispute settlement through international institutions, as well as solving disputes through direct negotiations."

By contrast, the July 6 defence policy update explicitly criticised China's human rights record and directly named it in criticism of the island-building efforts in the South China Sea. It says: "Notably China has created an extended multiple artificial island features in the Spratly and Paracel Islands upon which it has constructed bases … (these) provide China with the ability to quickly deploy a range of additional capabilities in and around key international shipping areas."

And in an obvious reference to China, it discussed unilateral actions escalating tensions and raising the risks of miscalculation in the region.

The **enthusiasm which greeted the Defence Statement from the Australian and British High Commissions gave a clue to its real intent:** it was designed to reassure the traditional western partners that NZ was still part of the club.

That was not how it was seen in China where the Foreign Ministry spokesperson devoted part of the Ministry's routine Monday press briefing to NZ. "We have lodged stern representations with NZ on the wrong remarks it has made on China," the spokesperson said. "We urge NZ to view the relevant issue (the South China Sea) in an objective way, correct its wrong words and deeds and contribute more to the mutual trust and cooperation between our two countries."

These comments are thought to be the first made by her that were critical of NZ.

Foreign Minister **Winston Peters revealed that China had begun complaining to him as early as May when he visited Beijing.** Those complaints presumably related to his off-the-cuff comments at the Lowy Institute in March when he questioned the Belt and Road initiative which NZ, alone among the Five Eyes partners, has signed up to.

Beijing backlash – what to watch for

For now, there have been **no real-world impacts for NZ from the offence taken in Beijing** to the defence policy statements.

However, if the past and the recent experience of Australia – where the govt has engaged in far more explicit criticisms of Chinese policy, alleged corruption, and foreign direct investment, the following areas may be first in line for retaliatory gestures:

- **impediments to goods clearing Chinese Customs**. Fonterra's food scares earlier this decade caused immediate difficulty for exporters to China of a far wider range of goods than just dairy products;
- **even slower progress** than at present on an upgrade to the **NZ-China FTA**;
- **tourism inflows**. Beijing has nominated 2019 the

Year of New Zealand Tourism, meaning official encouragement for Chinese nationals to travel here. That tap could be turned down with ease;

- **international education**. Australian universities have suffered substantially reduced enrolment by Chinese nationals as a direct result of rising tension between Beijing and Canberra;
- unwillingness to accord **PM Jacinda Ardern** a high level of engagement in her **planned visit to Beijing in October** to open the new NZ embassy there. Hints of difficulty with this official visit have already emerged.

Hipkins to China this week

Education Minister Chris Hipkins will make a four day visit to Guangzhou and Beijing this week, where he will meet his Chinese counterpart, Minister Chen Baosheng. The visit **appears to have been hastily arranged in the few weeks prior to the release of the govt's Defence Policy Statement** which drew the sharp and highly unusual rebuke detailed above.

The govt will be acutely concerned about potential for the Chinese govt to respond with actions that could damage the country's fourth largest export sector – export education, worth an estimated $4.4b. A third of the 100,000 international students enrolled in NZ come from China.

Business lobby's own winter of discontent?

Business NZ's constituent employer associations, particularly the **Auckland-based EMA**, are believed to be under pressure from their members to take a more aggressive stance on the govt's proposed employment relations changes, particularly Fair Pay Agreements. That explains the "Fix the Bill" campaign the constituent associations are running and is consistent with comparatively aggressive media comments from the **EMA's Kim Campbell**, a hot-headed, old school lobbyist whose style is at odds with Business NZ's Wellington CEO **Kirk Hope**.

Business NZ, which is funded by the regional constituents while operating often as if it leads them, is missing from the list of sponsors of the campaign. Hope is understood to have faced board criticism for agreeing to join the Bolger Committee, which will help the govt make the proposed reforms work.

Hope has invested in a productive relationship with PM Ardern and likely takes the view that working inside the tent will yield greater results than throwing stones from outside – especially if a version of the current administration is returned in 2020.

Shorting the kiwi

Traders have **bet more than US$1b that the kiwi dollar will fall against the greenback**, adding to the risk of a corrective rebound even though US interest rates are unusually higher than those in NZ. CFTC data shows that speculative traders' net positions are short NZD and long USD to the tune of US$1.2b, levels reached only a few times since 2010.

Confidence at post-GFC levels

Business confidence hit a seven-year low in June as cost pressures weighed on profitability and the downbeat sentiment is beginning to impact on future planning**. A seasonally adjusted net 19% of firms surveyed by NZIER** expect economic conditions to deteriorate over the coming months compared with a seasonally adjusted 10% that had expected a deterioration in the prior quarter. It was the **lowest since March 2011**. The QSBO showed a net 16% of respondents reported lower earnings in the three months ended June 30. "The net measure does suggest some weakness in corporate earnings for the upcoming reporting season," said NZIER principal economist **Christina Leung.** The QSBO also showed **farmer confidence** fell amid concern about the impact of Mycoplasma bovis cattle disease. The number of farmers expecting the rural economy to improve in the next 12 months was stable at 26% but the **number expecting the rural economy to worsen jumped to 24%, from 12% in the previous quarter**.

NZ investors are still relatively upbeat about the state of the local markets, which they see as being reasonably stable and backed by a solid economy, according to the **FMA's annual investor confidence survey**, which showed 62% of respondents were confident in the local markets, although **investors were far more optimistic than their non-investing counterparts**.

Fiscal strength continues

The govt has a **strong enough balance sheet to close the nation's infrastructure deficit sooner**, which the IMF says would generate long-term economic gains. The **latest IMF country review** gave the NZ govt a pass mark, saying "prudent macroeconomic policies" led to **solid economic growth with a favourable outlook**, albeit with some risks on the horizon.

The govt's operating balance before gains and losses (obegal) was a **surplus of $5.23b in the 11 months ended May 31 versus a forecast of $4.78b**. The result was offset by ACC's higher than forecast insurance expenses. Total insurance expenses were $4.62b versus a projected $4.40b. Of that, the majority is related to ACC.

MEDIUM TERM PROJECTIONS - THE ECONOMY

Economic Expansion Maturing

- Growth and profitability under pressure
- Economic drivers faltering
- Uncertainty hampers investment
- Capacity issues remain
- Inflation and interest rates to rise

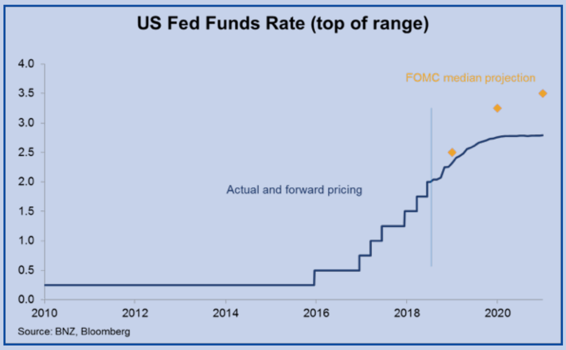
Economic cycles always come to an end. We can say that with certainty. At this stage our central projection is that the current cycle keeps on keeping on, but we caution that the expansion is already very mature, cracks are developing and it increasingly feels as if a tipping point is not far away. Importantly, even if our central projection of continued growth proves accurate, the operating environment for businesses and investors alike will be more difficult to navigate.

From a global perspective, the single biggest risk facing NZ is not tariff wars, Brexit, increasing Chinese debt or the ongoing political machinations of Europe. All these things are of interest and do have the potential to cause economic and financial market volatility but they are unlikely to be cycle-stoppers. In contrast, the prospect of tightening global monetary conditions poses a real threat to both real economic activity and asset prices – the latter already looking fully (or over) valued.

In terms of tightening:

- The Federal Reserve has already raised its cash rate eight times to 2.0%, and another four rate increases are pencilled in;
- The Canadians have raised rates three times;
- The UK has started its tightening cycle;
- The Europeans are talking about moderating QE;
- The Japanese are moderating QE;
- The Australians have a tightening bias.

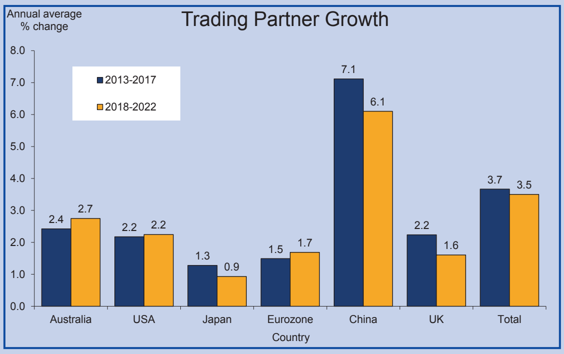
Fed Leads The Tightening Cycle



As global monetary conditions become more restrictive, world growth will inexorably slow and, implying that asset prices will correct. No one knows how this process will play out. But the potential for it to "go wrong" is high.

That said, these are risks rather than our central view. Our central view sees trading partner growth moderate but not collapse. We are looking at weighted trading partner growth of 3.5% per annum over the next five years compared with 3.7% for the last five. Much of this does depend, however, on an improving Australia and Eurozone offsetting the negative impact of slower, albeit still strong, growth in China.

Trading Partner Growth Moderates



Domestically, all the things that have driven the economic expansion over the last few years are either coming to an end, or moderating in their intensity. These factors include:

- Net migration;
- The terms of trade;
- Tourism growth;
- Confidence;
- House price inflation;
- Corporate profitability;
- Low interest rates; and
- Employment growth.

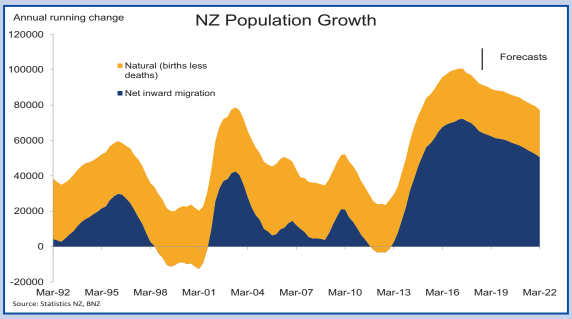
Looking at each of these factors in turn:

Net Migration

In 2016, NZ's population growth peaked at 2.2%. Of this, 1.6% can be attributed to migration. The other 0.6% was natural population growth. We expect annual total population growth to fall to 1.5% over the medium term as net migration declines.

MEDIUM TERM PROJECTIONS - THE ECONOMY

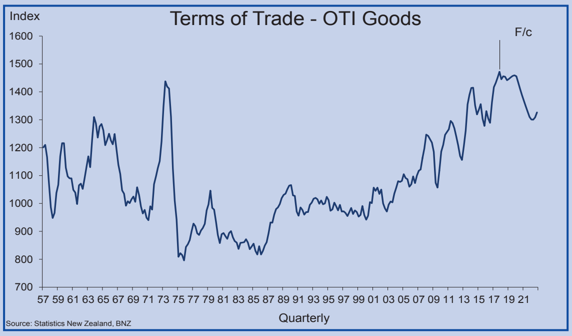
Population Growth To Slow



The Terms of Trade

NZ has benefitted from a spectacular rise in its terms of trade, delivering a huge positive impact on NZers' incomes. In the first instance this was brought about by increased commodity returns but over the last decade plummeting import prices, especially for manufactured goods, have been the biggest driver. Looking forward, we believe import prices will start to edge higher while the price of our commodities peaks – largely lead by dairy - will stabilise or decline.

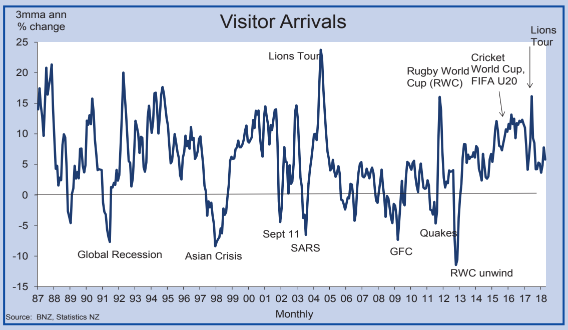
Terms of Trade Peaks



Tourism Growth

Over the last five years tourist inflows have risen almost 8.0% p.a. We think annual growth of around 5.0% is more likely over the next five years. This is not because demand for NZ as a destination will fall but rather because we are capacity-constrained in the sector.

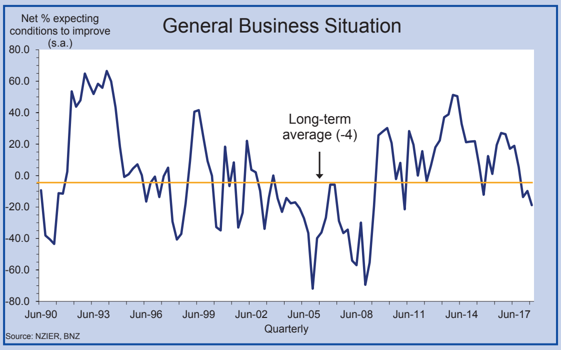
Tourism Growth Slowing



Confidence

Business confidence is under pressure. Businesses are clearly discomforted by a combination of rising input costs and changes to govt policy. The two are inter-related on many levels, including increasing minimum wages, higher petrol costs and the future costs of greening the economy. This marked decline in confidence has yet to spread to consumer confidence, but it is real, whether or not it is justified – that is largely a political question. Whatever the truth, confidence drives behaviours and we believe weaker average confidence levels will lead to weaker average investment growth. Total business investment has been expanding at an average of 5.4% over the last five years. We are forecasting just 3.4% over the next five. To protect the economy from further downside risk from this source, it is imperative that the govt looks to stabilise falling confidence as soon as is practicable.

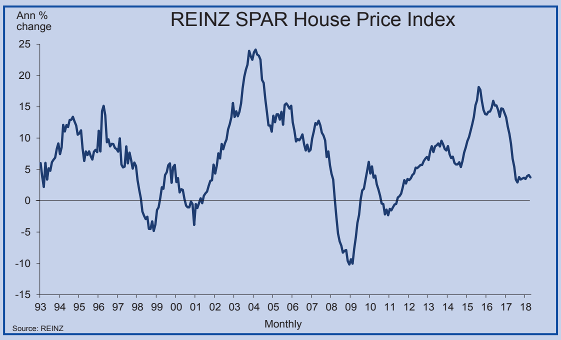
Business Confidence In Decline



House Price Inflation

Over the last five years house prices have been appreciating around 10% annually. A substantially reduced pace of appreciation can be expected over the next five years. We are not forecasting a major correction, given that excess demand for housing is expected to persist but, equally, substantial price increases look unlikely. Accordingly, the wealth effect on consumption will be lessened in the period ahead.

House Price Inflation Slows



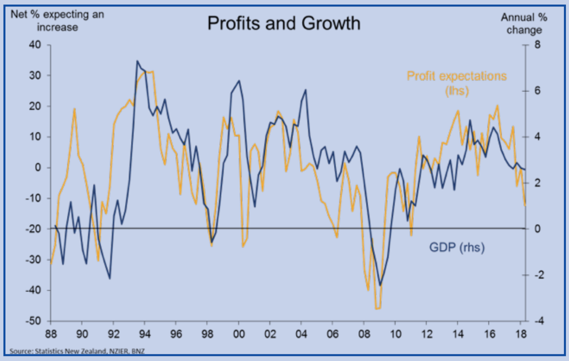
MEDIUM TERM PROJECTIONS - THE ECONOMY

As a consequence, the risks inherent in very high levels of household debt by international standards should not constitute a risk to financial stability or significantly alter existing household consumption patterns.

Corporate profitability

Corporate profits are under pressure. Demand growth is moderating while input costs are rising. It's hard to see this changing any time soon. Clearly this environment also has negative implications for the listed sector with equity returns likely to be reduced.

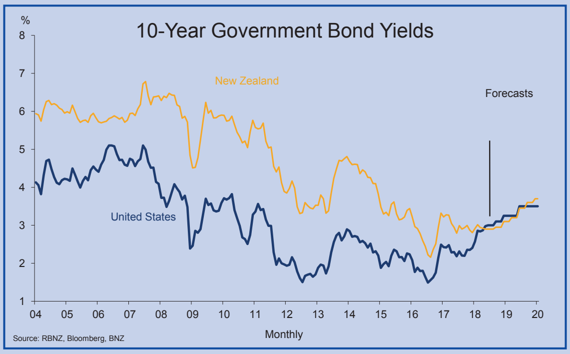
Profit Slump Worrying



Interest rates

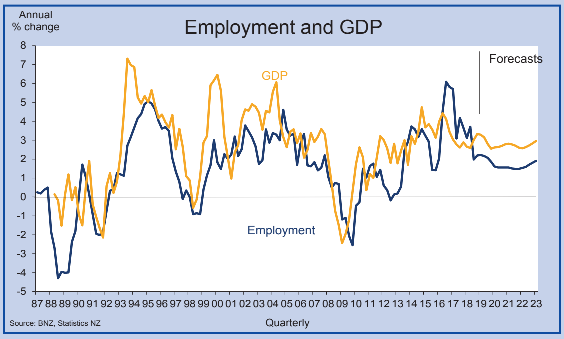
Interest rates are, and have been, incredibly low. At best, rates will not fall any further, notwithstanding the removal of a tightening bias in the language from the RBNZ's most recent monetary policy update. At worst significant upward pressure exists.

Interest Rates to Rise



Employment growth slows

Employment growth is likely to moderate. Rising wage costs will dent the desire to hire. But the big stumbling block to further growth will be the lack of an available supply of labour.

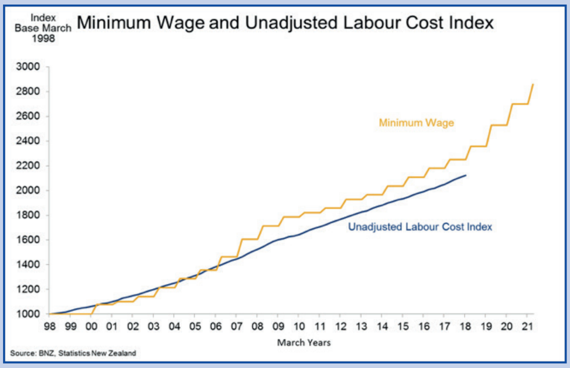


Implications for growth

Over the last five years economic growth averaged 3.2% per annum. Putting all the above together, over the next five we see the pace of growth slowing to average 2.8% per annum. Moreover, we believe the **risks are heavily weighted to the downside**. Indeed, as the economy's potential growth rate is around the pace of expansion we are forecasting, and the economy is already operating at potential, then the possibility of an upside surprise is very limited.

These factors add up to a significant problem. The economy appears to be severely capacity constrained. This constraint is very clear in the labour market where a significant number of businesses are reporting they can't increase output because labour is in short supply. Consistent with this, the unemployment rate at 4.4% is considered to be below the level that creates broader inflationary pressures. The future supply of labour is limited as net migration declines and tight labour markets across the globe mean the competition for labour increases. The only way for many to hold onto staff is to pay them more. In addition, there will be significant further upward pressure on wages from the increasing minimum wage and rising wages in the state sector. In theory at least, this should, eventually, put upward pressure on selling prices (namely CPI inflation).

Wage Growth Must Rise



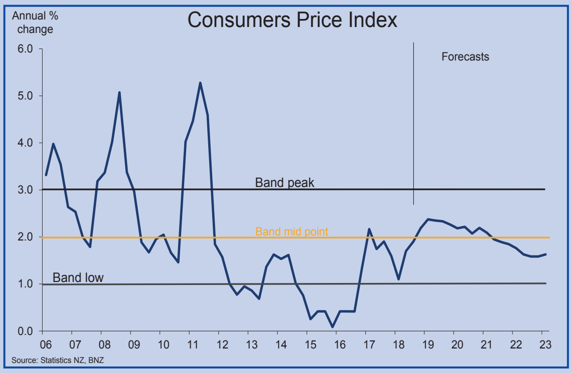
MEDIUM TERM PROJECTIONS - THE ECONOMY

One of the ways to mitigate the inflationary impact of a tighter labour market is to substitute capital for labour but, as already discussed above, the increasingly fragile state of business confidence means investment activity is likely to be postponed.

We are also seeing rising inflationary pressure emanating from increased fuel prices, heightened government (local and central) excise duties, higher global inflation, and a weaker exchange rate.

On one hand, it could be argued these are essentially 'good' problems of growth. On the other, uncertainty over govt policy and the potential for a more antagonistic relationship between capital and labour, and business lobbies and central govt, is adding to existing constraints. That adds up to a weighting towards the likelihood the economy will underperform its potential in the medium term.

Inflation Returns to Target



We believe headline inflation will soon move back towards the centre point of the RBNZ's target range. Average CPI inflation for the five years ended Dec 2017 was just 1.1%. We think it will average 2.0% over the next five year period.

While there will be no great urgency for the central bank to raise interest rates, and we do not expect rates will need to be pushed aggressively higher, there is also little argument for keeping the cash rate at record low levels.

We are forecasting the cash rate to move progressively higher, from mid next year onwards, peaking at 3.0% late 2020.

While this may be an overly aggressive forecast we can say with some degree of certainty that the economic impetus driven by falling interest rates over the last decade is unlikely to be repeated and should be, at least, partially reversed.

Note that there is even more upward pressure at the longer end of yield curves as global bond yields push higher.

This is particularly so for NZ where rates have so far failed to respond to the movement offshore and domestic securities are, effectively, pricing in long term CPI inflation of just 1.4%. In NZ's case, we also think there is now significant risk that bond issuance turns out to be greater than forecast as the govt succumbs to a combination of weaker-than-expected revenue growth, GDP forecasts fall short of Treasury's expectations, and higher costs, as the electorate demands greater reward for having inserted this govt into power.

While it remains committed to its Budget Responsibility Rules for the current term of govt, we anticipate growing pressure to drop or relax those rules in a second term, and for off-Crown balance sheet financing to increasingly mask growth in, particularly, capital spending.

While the overall picture is one of heightened risk, in an environment where it will be harder to sustain and grow profitability, it remains the case that everything is relative. The NZ economy still looks well placed by international comparison. In summary, NZ can still anticipate:

- relatively robust growth;
- a favourable fiscal position compared to almost every other OECD country, even if the net Crown debt position deteriorates, and barring further natural disasters;
- NZ bank balance sheets look sound;
- the central bank still has plenty of room to ease in the event that it needed to;
- the economy should still be underwritten by
    - ongoing service sector export expansion;
    - population growth (albeit slower);
    - state-led investment in infrastructure;
    - favourability as a tourism destination;
    - solid (albeit falling) commodity prices;
    - fiscal stimulus;
    - consumption growth from higher wages.

On balance, then, there still seems good reason for guarded optimism regarding the period ahead. However, businesses have to be prepared for a more difficult and variable operating environment as cost pressures increase and uncertainty rises.

Uncertain times to become more uncertain

NZ has been a primary beneficiary of the rules-based international order that emerged after the Second World War. Tucked under the wing of Western allies during the Cold War, essentially unpunished by those allies despite the 1984 anti-nuclear policy, NZ has ridden on the coat-tails of the Chinese economic miracle over the last decade, thanks to the boom in Chinese and wider Asian demand for protein.

Until now, it has been unnecessary to make choices between old friends and allies and new friends who represent economic and political competitive threats to those old friends.

If NZ is skilful in its diplomacy and international contributions, it may manage to avoid having to make those choices in the next few years as well.

However, there can be no confidence that, in a more unsettled geo-political environment, such choices will not be forced. Recent friction with China over defence strategy and suggestions that NZ is a weak link in the US-led 'Five Eyes' intelligence-gathering arrangements are indicative of these tensions.

Add to that mix three vital issues of global leadership:

- the **mercurial, mercantilist presidency of the US's Donald Trump**, whose foreign policy interactions are governed by a combination of instinct, ignorance, and binary approaches to friendships and loyalty;
- the **emergence of China as a dictatorship** after the March changes to the constitution that have effectively made President Xi Xin Peng president-for-life. **Expectations that China would slowly democratise have proven false.** "Socialism with Chinese characteristics" is now a clear competitor with liberal western democracies for supremacy as a global political ideology;
- the **turmoil in Europe**. The UK is demonstrably making a mess of Brexit, but the issues driving the populist instinct that delivered the Brexit vote are rife in Europe. The generation of voters that understood and supported the European "project " as an antidote to global war is giving way to a new generation of disenchanted voters who feel threatened by immigration, personally unrewarded despite booming economies, and open to more authoritarian styles of govt. The most recent Edelman Global Trust Barometer showed **trust in govts rising fastest in authoritarian states** and weakening in traditional liberal democracies.

Internationally, these risks can be summarised in three broad areas:

- **nationalism** – the globalisation backlash expressed through rising trade and border protectionism, the breakdown of the post-WW2 rules-based, Western-led international order;
- **global financial system interconnectedness and inherent instability** created by a decade of experimental monetary policy stimulus that has transferred the balance sheet crisis of the financial sector to govt balance sheets;
- **climate change** – firstly, the political challenge of executing policies that impose up-front costs on the existing generation of voters for uncertain gains to future generations. Secondly, climate disruption is increasingly visible as a primary source of geo-political tension. This can be expected to increase as access to water, exposure to extreme temperatures, and loss of coastal land to flooding and sea level rise. Some of the regions most exposed to these risks also have the youngest and fastest-growing populations. Social and political stresses in those societies will increasingly represent security risks to all developed nations, including NZ.

Domestic political drivers

Domestically, political dynamics will be driven by a combination of:

- the **high but often contradictory expectations** of the supporters of a second term Labour-led coalition;
- heightened concern about **social inequality** as housing costs remain high relative to wages;
- a **deepening clash of values between capital and labour**, especially if downside risks to economic performance are realised. Business risks being blamed if the Labour coalition runs into economic headwinds;
- the **search by the National Party for a new coalition partner** following the demise of the **Maori** and **United Future** parties, the wind-down of **The Opportunities Party** after contesting just one election, and the long term irrelevance of ACT.

New geo-political realities and political party funding

As political and official sensitivity grows over foreign influence and interference in NZ, we anticipate a **revival in the debate for political parties to be state-funded** and for a **stand-down period to be imposed on the country's politicians and senior officials** before taking up roles with major companies.

In recent years political parties have experienced a decline in membership along with public and corporate donations while at the same time they have seen a significant increase in ethnic community engagement and in what has been described as "truckloads" of donations from the Chinese community. It is observed that many of the large numbers of Chinese, Indian, Korean and Filipino NZers engaging with major parties here often expect more influence from such engagement than is practice in NZ. Growing potential for the formation of an Auckland-based Chinese political party is also increasingly acknowledged.

Also starting to attract scrutiny is the common practice of former NZ politicians and officials leaving public service and swiftly accepting commercial sector governance and management roles. Debate is brewing on **whether NZ should adopt the Australian model of requiring a stand down period** before they transition to these roles. Recent examples include John Key, who chairs the ANZ Bank (NZ) board and sits on the Air NZ board, former Bill English's recent appointment to Australia's Westfarmers board, and former Health Minister Jonathan Coleman's sudden departure from politics to be CEO with Acurity Health.

A crystal ball on the 2020 election

While the National Party continues to poll at or about the same level as the Labour Party at this stage of the electoral cycle, we s**truggle to see how National can win the 2020 election without the emergence of a credible, new coalition partner. The only such partner currently visible is NZ First,** which would need to experience a total breakdown of its relationship with the Labour Party to be an option for National. So far, that does not appear likely. The **chances of a Maori Party revival are remote at best**, and such a party might still rather work with Labour than National. The TOP party, which might have offered the kind of blue-green partner wishfully sought by National supporters, has folded its tent. Talk of its revival by former radio host **Sean Plunket** are fanciful. Its other potential leaders – **Dr Lance O'Sullivan and economist Geoff Simmons** – appear respectively to have turned down the offer or be seeking other opportunities after completing an extended OE.

Simon Bridges's tendencies as a minister towards prevarication and caution on big issues is increasingly evident in his leadership. He is likely to face leadership challenges, although obvious contenders **Amy Adams** and **Judith Collins** are less electable. It is **not clear that National's next PM has yet been elected to Parliament**.

Key to Labour's success remains PM Jacinda Ardern's personal popularity. She may preside over a Cabinet of middling ability, but she represents an optimistic and refreshing vision that is resonating with left-leaning and women voters. She is more of a threat to the Green Party than National is to Labour.

The **Greens** are increasingly internally divided. While co-leader **James Shaw** is showing some flair as a consensus-building Minister for Climate Change, he is struggling with party discipline, is perceived as too business-friendly by traditional supporters, and caused anger among colleagues and supporters with unilateral decisions, such as granting Green parliamentary questions to National. Far from increasing the potential for a Shaw-led Green Party to coalesce with National, these trends threaten to keep the Greens at or close to the 5% threshold. We believe they will make it back into the next Parliament, but it may be a near-run thing.

NZ First's mercantilist and interventionist style is **winning an unsung level of support in sections of the business community unconvinced by the market purism** of the previous three decades. Its most interesting challenge will be who replaces Winston Peters, and when. A staged departure after serving as Acting PM may be logical. Top contenders are the polarising Shane Jones and the invisible current deputy leader Fletcher Tabuteau, who may yet scrub up, especially given the potential for Jones's combination of impatience and imprudence to knobble his aspirations.

In the next issue of HUGOvision: Medium Term Projections – Sectoral Analysis and Outlook.

Climate change action

Sixty CEOs of some of NZ's biggest companies have signed up to a new climate change group, committing to measure and report on their emissions and work within their supply chains to keep emissions reduction targets in line with the Paris agreement's goals. **Z Energy CEO Mike Bennetts** is the group's convener and wants to achieve similar outcomes to the Health & Safety forum, where business leaders pushed each other to take tangible steps to reduce workplace harm.

Primary industries

A2 Milk lifted annual revenue 68%, just beating May guidance, and expects to maintain an earnings margin of about 30% in the coming year even with increased spending. Revenue was $922m in the year ended June 30, up from $549.5m a year earlier.

A2 and Synlait Milk have agreed to extend their infant formula supply deal and increase the volume of formula Synlait will supply as they focus on the Chinese market. The companies' arrangements were for a minimum of 5 years from 2016, but have been extended by 2 years to last until at least July 2023.

Craigs Investment Partners dropped the **Fonterra Shareholders' Fund** from its NZ equities portfolio, citing performance that has been "lacklustre at best". "Earnings and dividends have been highly volatile, gearing continues to trend higher and major capital investment has not translated into meaningful earnings growth. We no longer believe FSF meets our quality threshold and therefore remove it from our NZ equities portfolio." Craigs have increased their weightings of **a2 Milk, Mainfreight and Restaurant Brands.**

Unexpectedly weak prices for whole and skim milk powder at this week's **Global Dairy Trade** auction have seen market participants pile into a record volume of **dairy derivatives on the NZX**, with most of the jump in options to buy or sell the products. The record volume was 6,415 lots on July 3 (24-hour clock), according to NZX Dairy Derivatives data. That beat the previous record set in 2015 of 5,994. The GDT auction saw a larger-than-expected drop in whole milk powder, after Fonterra said an increase in its May production lifted its expectations for the season's milk collection. The GDT price index fell 5.0% from a fortnight earlier. The average price was US$3,232 a tonne. Whole milk powder sank 7.3 % to US$2,905 a tonne.

Fonterra welcomed the appointment of **Bao Xiufei** as general manager of **Beingmate Baby & Child Food**. "There are a number of opportunities to reverse Beingmate's current performance and we look forward to working with Mr Bao and seeing Beingmate fulfil its potential," said Fonterra CEO **Theo Spierings**.

PGG Wrightson declined comment on Australian media reporting that ASX-listed agribusiness company **Elders** is looking to buy it for $600m. The Australian newspaper reported Elders may seek to raise A$300m via a rights issue to help fund the purchase, with the remainder funded via debt.

Acting PM Winston Peters has put the Crown's liability for the outbreak of the kiwifruit bacteria Psa in 2009 at between $500m and $800m, a figure endorsed by claimants who brought a successful class action claim against **MPI** for failing in its duty when the outbreak occurred, costing the sector as much as $1b.

Seeka is putting nine orchards up for sale including six it recently acquired from **T&G Global** in a deal that targeted T&G's packhouse facilities and assets in Northland. It called for bids by Aug 15 for the 288-ha portfolio in Northland. The company acquired T&G's Kerikeri-based kiwifruit orchards, packhouse facilities and assets for about $40m, with the second stage of the transaction settling just two weeks ago. "It was always Seeka's intention to market the Northland land holding as it focused on refurbishing the post-harvest facility," **CEO Michael Franks** said. Meanwhile, First NZ Capital has initiated coverage of Seeka, which trades on the Unlisted platform, targeting a share price in the next 12 months of $7.25.

Steel & Tube Holdings' CEO Mark Malpass says the company paid too much to enter the irrigation sector, struggled to compete against bigger rivals and ended up writing off its investment to return focus to its core steel business. The company has put its **S&T Plastics** business up for sale. It paid almost $8m cash for the plant, buying Aquaduct NZ out of receivership in 2015 and spent a further $4m to get the machinery.

Retirement and healthcare

Summerset Group 1H profit rose around 26% as stronger development margins made up for a lower volume of new sales. Underlying profit, which excludes unrealised valuation gains in the fair value of investment property, was between $43m and $45m in the six months ended June 30 from about $36m a year earlier.

Ebos Group won a bid for a distribution deal with **Australia's Chemist Warehouse**, which could be worth A$1b of revenue in the first year. The two expect to sign a 5-year supply agreement, starting July 2019, which could potentially be extended by 3 years, after Ebos won the tender to be the exclusive third-party distributor of pharmaceutical products to over 400 Chemist Warehouse and My Chemist stores.

UK-based private equity firm Hg will acquire **Orion Health's Rhapsody** business for $205m and take a quarter stake in its Population Health unit for $20m, leaving the NZ company in 100% control of just its hospitals division.

Retail

Michael Hill International increased revenue 3.3% in its 2018 fiscal year as it opened more namesake brand stores in Australia and Canada, exited its US operations and began the closure of its Emma & Roe chain. Sales lifted to A$599.7m in the 12 months ended June 30, from A$580.3m a year earlier.

Diversity

Women's Minister Julie Anne Genter wants half of the directors on all state sector boards and committees to be women by 2021. At the end of 2017, 45.7% of govt board and committee members were women and Genter said the govt needs to be more ambitious. Around 2,600 appointments are made each year. She is also challenging the private sector the lift its game, where only 19% of board members are women.

Capital markets

Gentrack Group raised about $52.4m in a discounted stock offer to institutional investors as part of a two-stage share sale aimed at raising funds to repay debt used for a recent flurry of acquisitions. Total take-up under the institutional entitlement offer was 60%.

The **Local Government Funding Agency**, which sells bonds on behalf of local authorities, isn't expected to lose its sovereign-equalling credit rating as a result of **Standard & Poor's** new rating methodology for public sector funders, investors say. In May, S&P placed ratings on 10 non-US public-sector funding agencies under what it calls "under criteria observation" (UCO), including the LGFA.

Courts and regulation

The **Commerce Commission** is seeking further submissions by July 25 over concerns with French payments systems provider **Ingenico**'s planned acquisition of **Paymark**, as it might substantially lessen competition. Paris-based Ingenico wants to pay $190m for Paymark, which operates more than three-quarters of NZ's eftpos terminals, ending a two-year sales process run by owners **ANZ, ASB, BNZ and Westpac**. The commission said the request "does not mean that the commission intends to decline to clear a merger," which is also subject to **Overseas Investment Office** approval.

The administrators of **CBL Corp** have reached an agreement to sell CBL's UK-based **Professional Fee Protection** business to US private equity firms **Highbridge Principal Strategies and Madison Dearborn Partners,** on undisclosed terms and subject to regulatory approval.

ACC and Crown Asset Management are among investors to have settled litigation in the Cayman Islands with **Pyne Gould Corp's Torchlight Fund**, deciding not to take their claims of mismanagement any further and agreeing to a price with Pyne Gould to redeem their units. The Crown entities ended up with units in the distressed asset fund as a result of the collapse of **South Canterbury Finance**.

The UK Supreme Court has rejected the **NZ Superannuation Fund's** attempts to pursue a debt recovery claim, made with others, against **Portugal's Novo Banco** in the UK, in part because the liability claim is not recognised in Portugal. The case relates to a $199m loan the Superfund made to **Banco Espirito Santo** of Portugal by buying bonds in a **Goldman Sachs** entity, called **Oak Finance** and written under UK law. Shortly after, BES collapsed amid fraud allegations.

Corporate actions

Xero has appointed **Kirsty Godfrey-Billy** as its new chief financial officer, replacing **Sankar Narayan** who is set to leave amid the latest executive reshuffle for the Wellington-based accounting software developer.

Economic indicators

Auckland's residential property market slowed in June, with fewer new listings and a slip in the median price, according to the city's largest realtor. The median price fell 1.2% to $810,000 from May, and was down 3.6% from June last year, **Barfoot & Thompson** said.

Retail spending on electronic cards rose across all industries for the first time in seven months in June. Seasonally adjusted retail spending on credit and debit cards rose 0.8% in June following a 0.6% lift in May. Core retail spending, which excludes vehicle-related industries, rose 0.6% in June, matching the increase in May.

New car sales dropped in June, as demand for commercial and passenger cars slid from the hot pace of the same period a year earlier, though the month still recorded the second-best June ever. New motor vehicle registrations sank 8.2% to 15,172 last month from the same period a year earlier, **MIA** figures show. **Toyota** remains the market leader.

Total guest nights in May rose 1.6% to 2.54m from May last year to a new record for the month.

LEGISLATION

A testy session ends

The govt faced significant hurdles with its Overseas Investment Act and regional fuel tax legislation during the last four week sitting session. Parliament is now on a fortnight's recess, resuming on July 24 with the 11-hour Estimates Debate the first main order of business.

- *Italics denote update from previous edition of Hugovision*
- *A full compendium of the legislation before the House is available on The Hugo Group website, www.thehugogroup.com*

Bills Introduced

Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill*: Introduced June 28. Omnibus bill amending several tax Acts. Confirms annual rates of income tax for the 2018/19 tax year, contains proposals to modernise and improve tax system administration, including secondary tax rules, automatic refunds for many whose only income is from salary, wages, or investment. Clarifies that information collected for one IRD purpose can be used for the dept's other functions. Introduces a short process ruling for binding rules for small businesses. Provides the IR Commissioner new flexibility to correct tax law anomalies. Proposes changes to KiwiSaver, including more choice for employee contribution rates and membership by older NZers. First reading completed July 3 with National opposed despite supporting much of the bill's specifics. Referred to the Finance and Expenditure Committee.*

Trans-Pacific Partnership Agreement (CPTPP) Amendment Bill*: Introduced June 25. Makes changes necessary for NZ to ratify the revised Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Completed first reading June 28 with the Greens opposed. Sent to the Foreign Affairs, Defence and Trade Committee with a report due by Dec 29.*

America's Cup Road Stopping Bill: *Introduced July 2. Supports construction relating to, and the operation of, the 36th America's Cup in Auckland by permanently stopping a portion of Brigham Street on Wynyard Point. First reading completed July 5 with all parties in agreement and referred to the Environment Committee for Sept 3 reportback.*

Health (Drinking Water) Amendment Bill*: Introduced July 5. Amends the drinking water parts of the Health Act following the Government Inquiry into Havelock North Drinking Water.*

Maritime Powers Extension Bill: *Introduced June 27. Allows Customs and other agencies such as Defence to intercept vessels suspected of drug smuggling outside NZ's territorial waters. First reading July 3. Referred to the Foreign Affairs, Defence and Trade Committee.*

Bills in progress

Overseas Investment Amendment Bill: Introduced on Dec 14. The bill class residential and lifestyle housing and land as sensitive under the Overseas Investment Act and only makes it sale possible to non-residents under limited circumstances. *Reported back on June 18 with numerous amendments, including carving out some groups from he ban. This included infrastructure companies and others. Other exceptions were also made for different types of purchase. Unusually, the Speaker ruled one amendment exempting a specific development as out of order as it used a public bill to give private benefit. Second reading completed on June 26.*

Domestic Violence – Victims' Protection Bill: Member's bill from Jan Logie (Gr) drawn from the ballot Dec 1 2016. Enhances legal protections for victims of domestic violence. It places various duties of care on employers for employees who are victims of domestic violence. *Committee stage completed June 27 with amendments prescribing process for applying the new leave provisions and an appeal process. National and ACT remained opposed.*

Insolvency Practitioners Bill: Proposed new rules governing insolvency practitioner regulation. *On June 28, 2018, the bill was discharged and referred to the Economic Development, Science and Innovation Committee for new govt amendments introducing a licensing regime for liquidators, administrators and receivers of failed companies. This would replace a registration regime, which was itself a step up from an initial proposal to exclude incompetent and dishonest practitioners via a negative licensing system.*

Bills passed or discharged

Land Transport Management (Regional Fuel Tax) Amendment Bill: Introduced March 22. Proposes a mechanism under which regional fuel taxes can be established to provide a way for regions to fund transport infrastructure programmes. Committee stage completed on June 20 with the govt using Urgency in the face of filibustering. Amendments inserted around monitoring. The govt indicated officials would be working on a new non-road fuel use rebating system. *Passed third reading on June 26.*

Exclusive Economic Zone and Continental Shelf (Environmental Effects) Amendment Bill: Introduced May 3. Allows recovery from an applicant the actual and reasonable costs incurred in relation to a board of inquiry appointed under the Act to decide a marine consent. Completed first reading on May 8 with the support of all parties and sent to the Environment Committee. A curtailed consideration with a report back date of June 11. Reported back on June 6 with no substantive amendments. *Committee stage completed with minor drafting changes on July 4 and third reading on July 5.*

Friendly Societies and Credit Unions (Regulatory Improvements) Amendment Bill: Member's bill in the name of National MP Stuart Smith drawn from the ballot on April 13. Amends the Friendly Societies and Credit Unions Act 1982 and is intended to remove unnecessary operating and compliance costs for credit unions by promoting greater efficiency, innovation, and accountability. Second reading completed on May 16 with all parties in support. Committee stage completed on June 13. *Third reading completed on June*

Taxation (Neutralising Base Erosion and Profit Sharing) Bill: Introduced Dec 6. The bill seeks to prevent multinationals from using various means of shifting deductible activity into the NZ tax base and taxable activity into other jurisdictions. Second reading completed on May 23 and committee stage interrupted on June 12. *Committee stage completed on June 21 and third reading on June 26. All parties in support.*

PO Box 25120, Featherston Street, Wellington 6146, New Zealand
PHONE 04 385 6249 EMAIL hugo@thehugogroup.com www.thehugogroup.com
THE HUGO GROUP