Events Round-Up

NZ: QSBO business confidence, Q3: -35 vs. -34 prev.
NZ: QSBO domestic trading index, Q3: -11 vs. -5 prev.
JN: Tankan large mfg. index, Q3: 5 vs. 1 exp.
AU: RBA cash rate target (%), Oct: 0.75 vs. 0.75 exp.
UK: Manufacturing PMI, Sep: 48.3 vs. 47 exp.
EC: Core CPI (y/y%), Sep: 1 vs. 1 exp.
NZ: GDT avg winning price ($/mt): 3306 vs. 3303 prev.
CA: GDP (m/m%), Jul: 0 vs. 0.1 exp.
US: ISM manufacturing, Sep: 47.8 vs. 50 exp.
US: ISM new orders, Sep: 47.3 vs. 47.2 prev.
US: ISM employment, Sep: 46.3 vs. 47.4 prev.

Good Morning

There have been big moves in markets overnight after a very weak US ISM manufacturing survey, which fell to its lowest level since the GFC. US rates, which had been trading higher earlier in the day, plunged, while US equities and the USD turned down. The RBA cut its cash rate to 0.75% yesterday, as expected, but its reference to achieving “full employment” in the statement saw a sharp move lower in the AUD. The RBA statement and yesterday’s grim QSBO survey combined to push the NZD to a fresh four year low, but the turn-around in the USD has seen the NZD recover most of its earlier losses.

The US ISM manufacturing survey overnight was much weaker than expected, with the headline index falling further into contractionary territory in September. The 47.8 reading is the lowest since the GFC, although similar to the levels reached in early 2016, when the manufacturing sector was dealing with the fall-out from the oil price shock and weakness in China’s economy. New export orders fell to just 41.8, with softening global growth (as evident in the PMIs released over the past few weeks) and the continued effects on the trade war continuing to depress the manufacturing sector. The employment (46.3 vs 47.4 prev.) and production (47.3 vs 49.5 prev) sub-indices fell in September, with the only (slightly) positive note that new orders edged up (47.3 v 47.2 prev.). The ISM survey contrasts with the lesser-followed Markit PMI manufacturing survey, which rose to 51.1 in September.

The ISM manufacturing data will increase attention on the non-manufacturing equivalent which is released tomorrow night and nonfarm payrolls on Friday. Manufacturing only accounts for around 10% of the US economy and, for now, the larger services sector is continuing to hold up. Were payrolls and the non-manufacturing ISM to weaken, talk of a US recession will undoubtedly start to grow louder. It remains to be seen whether the more tangible signs of weakness in manufacturing influences Trump’s negotiations over a trade deal with China, with high-level talks due to resume next week.

US Treasury yields had increased sharply earlier in the session, with the 10 year yield rising from 1.66% to 1.75%. But the ISM survey put an immediate halt to that, with the 10 year yield falling as much as 14bps, before settling at 1.63% as we write. The curve has bull-steepened, with the 2 year yield falling 8bps on the day and the market increasing its expectations of Fed rate cuts. Market pricing for an October rate cut by the Fed has increased to around 80%, from less than 50% prior to the data, and there are now 80bps of cuts priced-in by the end of 2020.

US equity markets quickly turned down after the ISM survey raised recession fears. The S&P500 is 1.2% lower on the day led by the manufacturing-heavy energy, industrials and materials sectors. Banks, which have a leveraged exposure to the economy, have also fallen sharply; the KBW bank index is down 2% overnight.

In FX markets, the USD fell sharply after the ISM release, consistent with the rise in Fed rate cut expectations. The DXY had earlier made a fresh two-year high prior to the data, but it is now 0.3% lower on the day. The JPY and Swiss franc are the top-performing currencies overnight, both up around 0.4%, amidst the risk backdrop. The rise in the JPY came despite news that the GPIF, Japan’s government pension fund, would reclassify FX-hedged foreign bonds as domestic bonds, which notionally ‘frees up’ limit for GPIF to buy more foreign bonds on an unhedged basis (which would, all else equal, be expected to put some downward pressure on the JPY). The EUR is also up 0.3% and has clawed back above 1.09.

The AUD is the weakest performing currency over the past 24 hours, down 0.75%, and touched its lowest level since 2009 (0.6672) in the wake of a dovish RBA statement. It has since recovered somewhat to around 0.67. The RBA cut its cash rate at its meeting yesterday to 0.75%, as widely expected, and said that “an extended period of low interest rates” was necessary to reach “full employment”, rather than simply a fall in the unemployment rate. With the RBA estimating NAIRU at 4.5% and the unemployment
rate currently sitting at 5.3%, our NAB colleagues see that as a much harder goal to achieve. They expect another 25bp rate cut by December and see the risk of a further 25bp cut next year alongside unconventional policy if fiscal stimulus is not forthcoming. The market prices close to a 50% chance of a November RBA cut and a terminal cash rate around 0.4%. CBA lowered its mortgage rates by 0.13% for owner-occupiers after the RBA cut while NAB lowered owner-occupier mortgage rates by 0.15%.

The NZD reached a fresh four year low against the USD overnight amidst the dovish RBA statement and a grim-looking QSOB business survey yesterday. The NZD fell to 0.6204 before the turn-around in the USD after the ISM survey saw the NZD recover to 0.6245 (~0.3% on the day). The NZD is down on all the major crosses except the AUD, with the NZD/AUD moving back above 0.93.

Yesterday’s QSOB showed a net 30% of firms reported declining profitability, the lowest reading since 2010, and the activity indicators pointed to annual GDP growth, at face value, close to 1%. Additionally, there seemed some signs of weakening demand impacting businesses (alongside capacity constraints), with a net 55% of firms saying demand was the single biggest constraint preventing them from increasing output (up from 42% three quarters ago). The QSOB reinforces our view that growth will fail to live up to the RBNZ’s expectations and further OCR cuts will be forthcoming. We have currently pencilled in two additional cuts in November and February, although we think the balance of risks is towards more easing than this, rather than less (especially if the global economy continues to soften). NZ rates extended their recent decline in the wake of the QSOB, with the 2 year swap falling to 0.91% and the market boosting its chance of a November OCR cut to almost 90%.

Finally, there has been some volatility in the GBP overnight after reports that the EU was considering offering a time limit on the backstop arrangement in the Withdrawal Agreement. This has been one of the major points of contention on the UK side, with pro-Brexit politicians claiming the current backstop arrangements could see the UK ‘locked’ into the EU indefinitely. Later, an EU spokesperson said it was “not considering this option at all” and, in any case, such an option would still need to be agreed to by Ireland. The GBP spiked up from around 1.22 to 1.2340 after the initial report hit the headlines before easing back to 1.2280 as we write. Boris Johnson is expected to produce his detailed plans for a deal with the EU later this week.

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Coming Up

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<th>Period</th>
<th>Cons.</th>
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<tr>
<td>UK Construction PMI</td>
<td>Sep</td>
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<td>US ADP Employment Change</td>
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<td>US New York Fed’s Williams Speaks in San Diego</td>
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Source: Bloomberg, BNZ

Economy Watch

2 October

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