Markets Today

1 October 2018

Events Round-Up

NZ: ANZ consumer confidence, Sep: 117.6 vs. 117.6 prev.

NZ: Building permits (m/m%), Aug: 7.8 vs. -10.8 prev.

JN: Tokyo CPI ex fresh food and energy (y/y%), Sep: 0.7 vs.0.6 exp.

CH: Manufacturing PMI, Sep: 50.8 vs. 51.2 exp.

CH: Caixin manufacturing PMI, Sep: 50 vs. 50.5 exp.

EC: CPI (y/y%), Sep: 2.1 vs. 2.1 exp.

EC: Core CPI (y/y%), Sep: 0.9 vs. 1.1 exp.

CA: GDP (y/y%), Jul: 2.4 vs. 2.2 exp.

US: Core PCE deflator.(y/y%), Aug: 2 vs. 2 exp.

US: Chicago PMI, Sep: 60.4 vs. 62 exp.

Good Morning

Italy is back in the headlines after the populist coalition government announced it was targeting a 2.4% fiscal deficit, setting itself on a collision course with the EU. Italian bond yields moved sharply higher, while European equities and the euro fell. The bout of risk aversion was reasonably contained to Europe though, with little contagion to US equities or US Treasury bonds, both of which were unchanged on the day; the NZD was also unchanged on Friday. Over the weekend, the US and Canada were engaged in last minute talks over a revised NAFTA deal, with the self-imposed deadline being 30th September.

Italian 2 year government bond yields moved 30bps higher on Friday (having been as much as 50bps higher at one point) after the Italian government announced at its Budget that it was targeting a 2.4% fiscal deficit for each of the next three years. The two coalition partners, Five Star and the League, overruled Finance Minister Tria, who had publicly pushed for a 1.6% deficit, in order to push through some of their expensive campaign promises (including a "citizens' income" for the poor, tax cuts, and a rolling back of the retirement age for the state pension). In doing so, they have undermined Tria, who was seen a moderating (and market-friendly) influence within a disjointed and populist coalition.

The scene is now set for a clash with the EU, when Italy formally presents its budget to the European Commission (EC) in mid-October. EC Vice President Dombrovskis said on Friday that the budget "*does not seem to be in line with the stability and growth pact*." The EU wants Italy to show fiscal restraint so the country's debt-to-GDP ratio, which currently sits at over 130%, starts declining towards the EU's target of 60%. In theory, the EC can fine Italy if it breaches the region's fiscal rules.

Despite their steep rise on Friday, Italian short-dated yields remain well below the levels reached earlier this year, when the market started to fret about whether the coalition might contemplate leaving the euro; the Italian 2 year government bond yield is just over 1% at present compared to almost 3% earlier this year. Unlike then, the market is not worried about Italy leaving the euro, but instead gradual fiscal slippage that could ultimately result in Italy being downgraded to high yield (i.e. "junk") status by the major credit rating agencies. Currently, Italy is rated BBB by all three major rating agencies (two notches above junk), but on negative outlook at Fitch and Moody's. If Italy were downgraded to junk, it would drop out of the major global bond benchmarks used by global fund managers, and would see a large amount of 'forced selling.' Given the sheer size of the Italian government bond market (over €1.6tn outstanding), it's uncertain whether there is the depth of investor demand to absorb selling on such a scale (especially given the ECB's QE is due to finish at the end of the year and European regulators are trying to restrict domestic banks from loading up even further on their own government debt).

Risk aversion was evident across European markets from the Italian budget decision, with the Italian stock market down almost 4% (led by bank stocks) and the region-wide EuroStoxx index down almost 1.5%. Encouragingly, there was limited spill-over into other 'periphery' countries bonds though, with only modest upward pressure on Spanish and Portuguese spreads. German bund yields fell by 6bps and the euro dropped to 1.16. The moves lower in European yields and the euro were assisted by a surprise fall in European core inflation to 0.9%. ECB Governing Council member Lane downplayed the core CPI miss however, saying the ECB was "*fairly sure*" core inflation was on an upward path and that wage growth data had been "*increasingly positive*." Either way, ECB rate rises are not on the horizon until September next year, at the earliest.

There wasn't much fall-out in other major markets from Italy on Friday. US equities and bond yields recovered from earlier losses to close almost unchanged on day while the VIX continued to hover around 12. US core PCE inflation, the Fed's preferred inflation metric, was slightly lower than expected in August, but the year-on-year number still rounded up to 2%, right on the Fed's target. New York Fed President John Williams said he expected inflation "*to edge up a bit above 2 percent, but [I] don't see any signs of greater inflationary pressures on the horizon.*" Williams said the Fed was "going to learn a lot along the way" as to whether the US economy could sustain a super low unemployment rate without generating meaningful inflation or financial imbalances, and policy would be need to be increasingly data-dependent going forward.

The USD was slightly stronger on Friday (DXY +0.2%), but that was mainly a by-product of the weakness in European currencies. The NZD was little changed on Friday, ending around 0.6620, but 1% lower over the course of the week. The stand-out performer in FX markets on Friday was the CAD, which was 1% stronger amid renewed hope of Canada signing up to a revised NAFTA agreement. Negotiations are ongoing as we write, with the US and Mexico setting a deadline of midnight on the 30th September (i.e. 10 hours from now). Bloomberg reported that the US and Canada were on the brink of a deal after making progress on several contentious issues.

There was a sizable decline in NZ government bond yields on Friday after a very strong tender for $150m 2025 maturity government bonds. The bid-to-cover ratio was almost 5 times, and the tender cleared 1.5bps through the pre-tender mid-market yields, indicative of very strong demand. Government bond yields fell by between 4 to 6bps at the long-end of the curve, outpacing the 2bp fall in the 10 year swap rate.

It's a busy week ahead. In the US, the ISM surveys are released (manufacturing ISM tonight) with non-farm payrolls on Friday night. Fed Chair Powell speaks on Wednesday morning. Europe will see the final release of the PMI surveys while there will doubtless be Brexit headlines coming out of the UK's Conservative party conference (Theresa May delivers her speech on Wednesday). Domestically, the key focus is the QSBO survey on Tuesday given the importance the RBNZ has placed on business confidence as the key downside risk facing the NZ economy.

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Coming Up

		Period	Cons.	Prev.	NZT
JN	Tankan Large Mfg Index	3Q	22	21	12:50
GE	Germany Manufacturing PMI	Sep F	53.7	53.7	20:55
EC	Eurozone Manufacturing PMI	Sep F	53.3	53.3	21:00
UK	UK PMI Manufacturing	Sep	52.5	52.8	21:30
EC	Unemployment Rate	Aug	8.1	8.2	22:00
GE	Retail Sales (y/y%)	Aug	1.5	0.8	10/04
US	Fed's Bostic Speaks on Economic Development				02:02
US	Markit US Manufacturing PMI	Sep F		55.6	02:45
US	ISM Manufacturing	Sep	60.1	61.3	03:00

Source: Bloomberg, BNZ.

Foreign Exchange

Indicative overnight ranges (*)	Last	% Day	Low	High	Other FX	Last	% Day
NZD	0.6619	+0.0	0.6602	0.6640	CHF	0.9817	+0.5
AUD	0.7224	+0.2	0.7208	0.7241	SEK	8.889	+0.4
EUR	1.1604	-0.3	1.1570	1.1651	NOK	8.154	-0.0
GBP	1.3031	-0.4	1.3001	1.3090	HKD	7.828	+0.2
JPY	113.70	+0.3	113.32	113.67	CNY	6.869	-0.3
CAD	1.2908	-1.0			SGD	1.367	-0.1
NZD/AUD	0.9163	-0.1			IDR	14,903	-0.1
NZD/EUR	0.5704	+0.4			THB	32.32	-0.3
NZD/GBP	0.5079	+0.5			KRW	1,109	-0.3
NZD/JPY	75.26	+0.3			TWD	30.53	-0.1
NZD/CAD	0.8544	-1.0			PHP	54.03	-0.2
NZ TWI	72.25	-0.1					

Equities

Major Indices	Last	% Day	% Year
S&P 500	2,914	-0.0	15.7
Dow	26,458	+0.1	18.1
Nasdaq	8,046	+0.1	23.9
Stoxx 50	3,399	-1.5	-5.4
FTSE	7,510	-0.5	1.9
DAX	12,247	-1.5	-4.5
CAC 40	5,493	-0.9	3.1
Nikkei	24,120	+1.4	18.5
Shanghai	2,821	+1.1	-15.8
ASX 200	6,208	+0.4	9.3
NZX 50	9,351	+0.7	17.9

Commodities**

Price	Last	Net Day
Oil (Brent)	82.73	+1.7
Oil (WTI)	73.25	+1.6
Gold	1196.2	+0.7
HRC steel	830.0	-0.2
CRB	195.2	+0.5
Wheat Chic.	527.3	-0.7
Sugar	11.20	+2.7
Cotton	76.37	-1.7
Coffee	102.5	+3.2
WM powder	2770.0	+0.0
Australian Futures		
3 year bond	97.905	0.03
10 year bond	97.31	0.03

Interest Rates

	Rates Cash	Rates 3Mth	Swap Yields 2 Yr	Swap Yields 10 Yr	Benchmark 10 Yr Bonds	Last	Net Day
USD	2.25	2.40	2.99	3.12	USD	3.06	0.01
AUD	1.50	1.94	2.03	2.86	AUD	2.67	-0.02
NZD	1.75	1.92	2.04	2.90	NZD	2.44	-0.04
EUR	0.00	0.06	-0.11	0.99	GER	0.47	-0.06
GBP	0.75	0.80	1.15	1.66	GBP	1.57	-0.03
JPY	-0.06	-0.05	0.06	0.35	JPY	0.13	0.01
CAD	1.50	1.17	2.55	2.81	CAD	2.43	0.00

NZ Government Bonds	Last	
NZGB 6 05/15/21	1.77	-0.02
NZGB 5 1/2 04/15/23	1.98	-0.03
NZGB 2 3/4 04/15/25	2.24	-0.04
NZGB 4 1/2 04/15/27	2.44	-0.04
NZGB 3 04/20/29	2.61	-0.04
NZGB 3 1/2 04/14/33	2.78	-0.04
NZGB 2 3/4 04/15/37	2.91	-0.06

NZ Swap Yields	Last	
1 year	1.98	0.00
2 year	2.04	0.00
5 year	2.40	-0.01
7 year	2.63	-0.01
10 year	2.90	-0.02
15 year	3.15	-0.02

* These are indicative ranges from 5pm NZT; please confirm rates with your BNZ dealer

** All near futures contracts, except CRB. Metals prices are CME.

Rates are as of New York Close

Source: Bloomberg

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