Events Round-Up

NZ: Manufacturing PMI, Jul: 48.2 vs. 51.1 prev.
US: Housing starts (k), Jul: 1191 vs. 1257 exp.
US: Building permits (k), Jul: 1336 vs. 1270 exp.
US: Uni. Michigan 5-10y inflation expectations, Aug: 2.6 vs. 2.5 prev.

Good Morning

Equities rebounded and long-dated bond yields moved higher after Der Spiegel reported that the German government would relax its fiscal rules in the event of a recession. Still, government bond yields and equities were lower over the course of what was a very volatile week. Fed Chair Powell’s annual address at the Jackson Hole symposium is the highlight for the week ahead.

Risk assets ended what was an extremely volatile week on a positive note. Der Spiegel reported that the German finance ministry was preparing to abandon its balanced budget rule in the event of a German recession. According to the report, the finance ministry wants the automatic stabilisers to kick-in if the economy falls into a recession (as would almost any country), and any shortfall in revenues would be funded by increased government borrowing. That doesn’t seem to suggest that the government is considering a large scale, proactive fiscal easing. Nonetheless, markets took the headlines positively with German government bond yields rising sharply, at least initially, and equity indices extending gains from earlier in the session.

The reaction shows that markets are extremely sensitive to the outlook for fiscal policy, which would take some of the burden off monetary policy in supporting the economy. Global bond yields are at extremely low levels in part because of a global excess of saving over investment, and more activist fiscal policy would help address that balance, in addition to reducing the need for central banks to ease policy as aggressively.

Germany’s 10 year bond yield traded as high as -0.645%, 8bps off its intraday lows, before closing at -0.685% (3bps higher on the day). The US 10 year yield also closed 3bps higher on Friday, at 1.55%, but was still down 20bps on the week. The US 30 year yield increased 6bps, and the curve steepened, after the US Treasury announced that it would reassess investor demand for ultra-long dated (50 and 100 year) US Treasury bonds. A number of European countries have responded to investor demand by issued 50 year bonds over the past few years, with Austria having even issued a 100 year bond.

The short-end of the US curve was weighed down by a disappointing University of Michigan consumer sentiment survey, with the expectations component falling sharply (likely a reflection of recent equity market falls). The 2 year Treasury yield was 2bps lower on Friday, leaving the 2y/10y curve comfortably back in positive territory, at +7bps. The highlight for the US curve this week is Fed Chair Powell’s annual address at the Jackson Hole symposium, entitled “Challenges for monetary policy”, and the market is particularly focused on whether he signals an openness to a more aggressive Fed easing cycle. At the July FOMC meeting, Powell described the 25bp rate cut as a “mid-cycle adjustment” and not necessarily the start of an extended easing cycle, but those comments pre-dated Trump’s latest announcement on tariffs and the ensuing market volatility. The market prices 33bps of rate cuts for the Fed’s September meeting, implying a significant risk of a 50bp move.

The S&P500 closed 1.4% higher on Friday, with around half those gains coming after the headlines of possible German fiscal stimulus. Earlier, European bourses had risen between 1.2% and 1.8%. The steepening of the yield curve helped US bank stocks recover some of their recent losses, with the KBC banking index ending 2.5% higher on the day. General Electric rose 10%, almost entirely reversing its fall from the previous day after a financial analyst had accused the company of fraud on an “Enronesque” scale.

On the trade front, the temporary licence granted to Huawei by the US Commerce department is due to expire today. Reuters reports that the department is expected to extend the licence for another 90 days, which would likely be seen as a positive development by markets. There were also some tentative signs of an easing in the tensions between the two countries, with White House economic advisor Larry Kudlow telling Fox News over the weekend that recent phone calls had produced unspecified “positive news” while, earlier on Friday, Trump said he would have a call with President Xi “very soon.” Kudlow however cautioned that that US was in a “kind of technological war with China” and that the delayed 10% tariffs on some consumer goods were likely to go ahead in mid-December.
In FX markets, the US dollar has broadly unchanged, in index terms, on Friday. On the week, the US dollar was up against all the G10 currencies, with the exception of the British pound, and the USD indices are now trading towards the upper end of recent trading ranges.

The GBP was the top performing currency on Friday, 0.5% higher to 1.2150, and the week, on hopes that MPs could work together to prevent a no-deal Brexit. However, Labour leader Jeremy Corbyn’s hopes of forming an interim government to prevent a no-deal scenario were dealt a blow, with a number of pro-remain Conservative MPs saying they couldn’t support any government led by Corbyn. The betting market odds of a no-deal Brexit have drifted out to above 40% again over the weekend. Boris Johnson will meet European leaders this week, but he is merely expected to say that he intends to leave the EU on the 31st October with or without a deal.

Safe haven currencies underperformed on Friday amidst the risk-on turn in market sentiment while commodity currencies rose against the USD. Unlike the rest of the commodity currency bloc, the NZD fell 0.3% against the USD to 0.6425, making it the worst performer on the G10 leader board. The NZD/AUD cross fell to its lowest level since the end of June, at 0.9485.

The NZD was weighed down by a fall in the PMI to 48.2, indicating contraction in the manufacturing sector for the first time since 2012. A big drop in employment (to 42.6, from 47.2 in June) contributed to the fall in the overall index. July’s PMI is the latest in a number of indicators that suggest NZ GDP growth is starting to struggle and today’s Performance of Services index (PSI) may garner more market attention than usual.

The 10 year NZGB yield broke below 1% on Friday for the first time on record, although it managed to regain that level by the close of trading. Swap rates were down 1 to 2bps across the curve on Friday, with the market finally starting to show some signs of exhaustion after what has been a ginormous rally.

Aside from Jackson Hole on Friday, this week sees the release of the FOMC and RBA minutes and the European flash PMIs.

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Coming Up

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<thead>
<tr>
<th>Period</th>
<th>Cons.</th>
<th>Prev.</th>
<th>NZT</th>
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<tr>
<td>NZ Performance Services Index</td>
<td>Jul</td>
<td>52.7</td>
<td>10.30</td>
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<tr>
<td>EC Core CPI (y/y%)</td>
<td>Jul F</td>
<td>0.9</td>
<td>0.9</td>
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Source: Bloomberg, BNZ

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**Economy Watch**

19 August

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*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