

4 October 2018



Events Round-Up

- EC: Retail sales (y/y%), Aug: 1.8 vs. 1.7 exp.
- UK: UK services PMI, Sep: 53.9 vs. 54 exp.
- UK: UK composite PMI, Sep: 54.1 vs. 53.9 exp.
- US: ADP employment change, Sep: 230k vs. 184k exp.
- US: ISM non-manufacturing index, Sep: 61.6 vs. 58 exp.

Good Morning

The 10 year US Treasury yield moved to its highest level since 2011 after an extremely strong non-manufacturing ISM survey and an upside surprise to the ADP employment report. Expectations are now for a very strong payrolls report on Friday. The USD is stronger across the board on the back of the US data, and this has pushed the NZD back down towards 0.6535.

US Treasury yields have experienced a sharp move higher overnight, with the 10 year yield breaking above its recent highs to 3.15%, a 9bp rise on the day. The 10 year yield is now at its highest level since 2011. The trigger for the move higher in Treasury yields was the release of a super-strong ISM non-manufacturing report. The headline index increased to 61.6, its highest level since 1997, and well above market expectations. The employment component of the report rose sharply as well, to its highest level since the survey's inception in 1997. Separately, the ADP employment report beat expectations as well and helped raise expectations for tomorrow night's payrolls report. The Bloomberg consensus is for a 181k increase in US jobs last month, but the very strong employment components of both ISM surveys and the ADP surprise will undoubtedly see those payrolls estimates revised higher (the ISM non-manufacturing employment index would point to a job gain of over 300k).

Fed rate hike expectations were bolstered by the data surprises, with the market nudging up the probability of a December hike to near 80%, and moving to price slightly more than two full hikes for the 2019 calendar year. Interestingly, the US yield curve steepened over the session, with the 9bp rise in the 10 year yield outpacing the 5bp rise in the 2 year rate – the 2s10s curve is now 29bps, around 10bps steeper than its late-August lows. Chicago Fed President Charles Evans, who has, until recently, been one of the most dovish voices on the committee over recent years noted that *"getting policy up to a slightly restrictive setting -- 3, 3.25 percent -- would be*

consistent with the strong economy and good inflation that we are looking at." The market prices the Fed funds rate to top out close to 3% in the first half of 2020.

The US Treasury move reverberated around other global bond markets, with UK 10 year gilts and German bund yields up 5bps. The move higher in German yields was aided by an easing in concerns around Italy (more below) and some associated unwind of safe-haven buying. NZ swap rates fell across the curve yesterday, with the 10 year rate declining 4.5bps, but those moves should at least partially reverse today, in line with the global moves. NZ-US interest rate spreads continues to move to record levels, with the spread between NZ-US 2 year swap rates now over -100bps and the 10 year differential over -30bps. So far this year, the US 10 year Treasury yield has increased around 75bps while the NZ 10 year swap rate has fallen around 25bps, mainly due to the divergence in monetary policy between the Fed and the RBNZ.

Higher bond yields haven't seemed to dent risk appetite. US equities have moved higher, with the S&P500 up 0.5% to within a whisker of its all-time high. The implication would be that higher bond yields and stock prices reflect a strong US economy, which should be good for corporate earnings. The key for equities is inflation, and the path of Fed policy. As long as the Fed doesn't need to tighten aggressively, the risk of a US recession should remain contained. On that front, the recent steepening in the US yield curve is an encouraging sign.

The USD is unsurprisingly stronger across the board on the back of the stronger US data, which further extended interest rate differentials in the USD's favour. The DXY has moved to 95.70, up 0.2% on the day and 2% higher than a fortnight ago. Against a backdrop of higher US rates and strong risk appetite, USD/JPY has moved above 114 and is close to its highest level since March 2017.

News on Italy has been more positive over the past 24 hours. Prime Minister Conte announced a short while ago that the coalition government had decided to cut its fiscal deficit targets for 2020 and 2021 to 2.1% and 1.8% respectively (lower than the 2.4% previously announced). The coalition was sticking with its deficit target of 2.4% for the 2019 fiscal year. While history would suggest that a lot can change in Italian politics over a three year horizon, so the later year fiscal targets should be taken with a grain of salt, the coalition's decision to make the fiscal adjustments suggest its sensitive to market pressure and the moves should help calm market nerves

in the near-term. Italian 2 year yields fell 27bps on the day. In terms of the EUR, the positive news on Italy has been overshadowed by the US data surprises and strengthening USD. The EUR is 0.3% lower on the day and back near support around 1.15.

The NZD and AUD are the weakest currencies across the G10 over the past 24 hours, both down almost 1%. The NZD moved lower almost in a straight line from 0.6580 at the London open to 0.6535, where it is trading now. The increase in US-NZ interest rate differentials likely played a part in the move. The multi-year lows of 0.6501, set last month, are now within close reach.

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Coming Up

		Period	Cons.	Prev.	NZT
AU	Trade Balance	Aug	1450	1551	14:30
US	Factory Orders	Aug	2.1	-0.8	03:00
US	Durable Goods Orders	Aug F	4.5	4.5	03:00
US	Cap Goods Orders Nondef Ex Air	Aug F		-0.5	03:00

Source: Bloomberg, BNZ.

Foreign Exchange						Equities				Commodities**				
Indicative overnight ranges (*)					Other FX		Major Indices				Price			
	Last	% Day	Low	High		Last	% Day			Last	Net Day			
NZD	0.6538	-0.8	0.6530	0.6583	CHF	0.9893	+0.5	S&P 500	2,935	+0.4	15.8	Oil (Brent)	86.06	+1.7
AUD	0.7129	-0.8	0.7119	0.7186	SEK	9.030	+0.2	Dow	26,911	+0.5	18.9	Oil (WTI)	76.26	+1.7
EUR	1.1525	-0.2	1.1510	1.1593	NOK	8.202	+0.3	Nasdaq	8,045	+0.6	23.2	Gold	1202.8	-0.3
GBP	1.2990	+0.1	1.2963	1.3023	HKD	7.837	+0.0	Stoxx 50	3,405	+0.5	-5.6	HRC steel	830.0	+0.0
JPY	114.35	+0.6	113.65	114.42	CNY	6.869	-0.3	FTSE	7,510	+0.5	0.6	CRB	201.0	+0.5
CAD	1.2827	+0.0			SGD	1.378	+0.4	DAX	12,288	-0.4	-4.8	Wheat Chic.	534.8	-0.6
NZD/AUD	0.9171	-0.0			IDR	15,075	+0.2	CAC 40	5,491	-0.2	2.3	Sugar	12.23	+1.5
NZD/EUR	0.5673	-0.6			THB	32.50	+0.5	Nikkei	24,111	-0.7	16.9	Cotton	76.57	+0.5
NZD/GBP	0.5033	-0.9			KRW	1,118	-0.1	Shanghai	2,821	+1.1	-15.8	Coffee	106.6	-1.0
NZD/JPY	74.76	-0.2			TWD	30.67	+0.0	ASX 200	6,146	+0.3	8.7	WM powder	2750.0	-0.4
NZD/CAD	0.8386	-0.8			PHP	54.28	-0.1	NZX 50	9,294	-0.3	16.9	Australian Futures		
NZ TWI	71.64	-0.6										3 year bond	97.92	0.00
												10 year bond	97.30	-0.02
Interest Rates						NZ Government Bonds				NZ Swap Yields				
	Rates				Benchmark 10 Yr Bonds		NZ Government Bonds				NZ Swap Yields			
	Cash	3Mth	2 Yr	10 Yr	Last	Net Day		Last		Last		Last		
USD	2.25	2.41	3.03	3.20	USD	3.15	0.09	NZGB 6 05/15/21	1.75	-0.02	1 year	1.94	-0.01	
AUD	1.50	1.94	2.01	2.87	AUD	2.64	-0.03	NZGB 5 1/2 04/15/23	1.96	-0.02	2 year	2.01	-0.02	
NZD	1.75	1.90	2.01	2.85	NZD	2.41	-0.03	NZGB 2 3/4 04/15/25	2.21	-0.03	5 year	2.35	-0.04	
EUR	0.00	0.06	-0.10	1.01	GER	0.48	0.05	NZGB 4 1/2 04/15/27	2.41	-0.03	7 year	2.59	-0.04	
GBP	0.75	0.80	1.15	1.67	GBP	1.58	0.05	NZGB 3 04/20/29	2.57	-0.03	10 year	2.85	-0.04	
JPY	-0.06	-0.06	0.06	0.36	JPY	0.14	0.01	NZGB 3 1/2 04/14/33	2.74	-0.03	15 year	3.11	-0.04	
CAD	1.50	1.17	2.64	2.91	CAD	2.53	0.07	NZGB 2 3/4 04/15/37	2.87	-0.04				

* 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: NZT 06:43

Source: Bloomberg

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