2 October 2017

Businesses Don't Like Uncertainty

- **QSBO to be impacted by political shenanigans**
- **Inflation indicators unlikely to be worrying**
- **Economic momentum still positive**
- **Further fiscal easing supported by crown accounts**
- **And commodity price gains furthered**

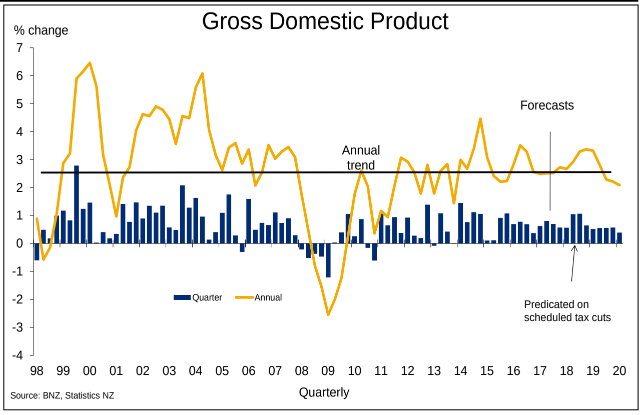
Businesses don't like uncertainty. And that's what they have now, as we await the shape of the new Government. It was an uncertainty that was developing in the run up to the General Election as the polls moved hither and thither. That's why the ANZ's business confidence indicators took a reasonable dip in its September survey. Tuesday we get NZIER's Quarterly Survey of Business Opinion (QSBO). We expect more of the same.

As things stood, activity indicators were already trending lower. This is not surprising as many of the key drivers of the economic expansion appeared to be peaking either because demand growth had peaked or supply constraints had become binding. In particular:

- Net migration growth seems to have peaked;
- Capacity constraints are impacting tourism;
- Building growth is being constrained by credit, capacity and the run-down in Christchurch activity; and
- It's unlikely that commodity prices (especially dairy) can keep forging much higher.

Around six months ago we were forecasting that growth would fall sequentially for the next two to three years. However, we then introduced acceleration in the expansion through calendar 2018 being the period impacted by the substantial tax cuts that the government regulated for. Now, however, those cuts are up in the air. It's not that they are off the agenda. If we get a National-led Government then the plan will stay in place. If Labour, instead, takes the Government benches, we have no

Fiscal stimulus to boost activity



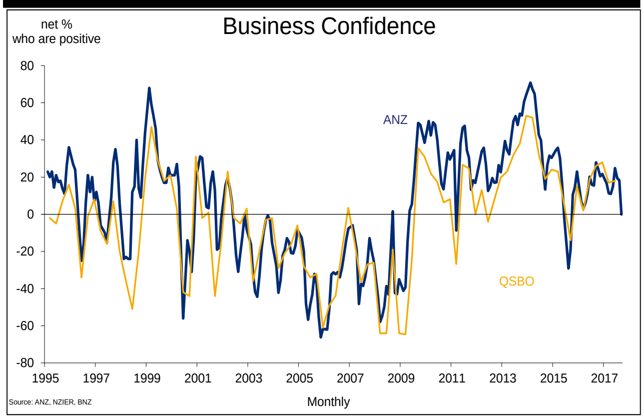
doubt there will be replacement stimulus but we don't yet know its form or magnitude. One way or t'other extra stimulus will be forthcoming but we, and others, now have little confidence as to what. Matters such as this must impact the confidence of retailers and manufacturers alike.

Nonetheless, we still expect that overall confidence readings will remain consistent with the economy continuing to grow at around trend. And, after all, don't forget that economic settings will still drive plenty of momentum:

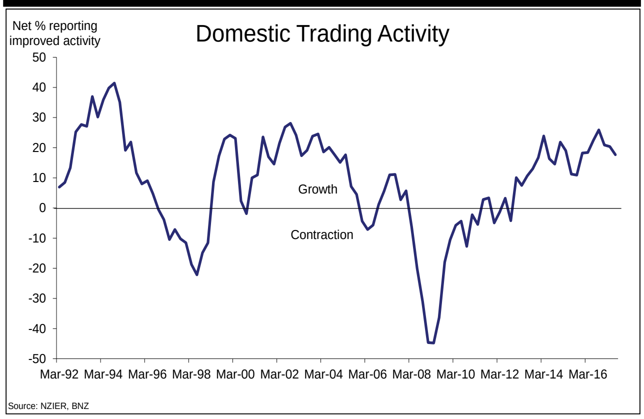
- Monetary policy is very loose and will stay that way;
- Fiscal stimulus is growing and will grow more;
- The global economy is supportive of the external sector; and
- Rural sector earnings will continue to buoy the broader economy

Importantly, we doubt that the QSBO will provide the RBNZ any prod in the direction of raising interest rates any time

Politicians dent confidence



Expectations already drifting lower



soon. Last week's OCR review saw no sign of such and the pricing indicators from the QSBO are not likely to either. We will of course be watching these indicators closely but note that the developed-world over continues to reveal tightening labour markets alongside falling inflation.

The weekend's international data were further evidence of such. In the United States the unemployment rate is dipping down to (or below) the levels considered inflationary yet the core PCE deflator (the one the Fed looks at) rose a lower-than-expected 1.3% for the year. The monthly reading when annualised was just over 1.0% - miles away from the Fed's 2.0% target.

And then in Germany the unemployment rate dropped to 5.6% - a post-unification low. This portends tonight's European unemployment rate dropping to 9.0% - a level considered inflationary in Europe. Yet the annual core CPI came in at 1.1% - again lower than anticipated. Why then should we expect any difference in New Zealand? We do note, nonetheless, that the Fed is already in the midst of a tightening cycle and will likely tighten further in December and the ECB also looks set to remove some stimulus. The RBNZ looks nowhere near doing so.

With regard the fiscal easing, we reiterate that the shape of Government will determine the size, timing and type of extra fiscal stimulus but, whatever the shape, it is, ultimately, likely that the stimulus proves to be more that we, and others, have built into our forecasts. The reason for this is that the Government continues to find itself awash with cash as the economy, particularly its business profitability and pace of employment growth, continues to deliver rising revenue streams. Thursday sees the release of the finalised Government Financial Statements for the year ended June 2017. This will confirm the pace of the gains that we are talking about and highlight the growing options for Government going forward.

The impact of commodity prices on the economy will be highlighted on Wednesday. First up will be the latest dairy auction. Rising dairy futures prices suggest that the GDT auction price could be up as much as three percent. If so, this will put modest upward pressure on Fonterra's recently-confirmed $6.75 payout for the season ahead. The currency's strength will act as a partial offset and we had thought that commodity prices would start to drift lower, especially as grain prices are very weak and the Euro remains relatively soft. However, New Zealand production is being affected by too much rain, Australia's by not enough rain and Chinese production may not live up to expectations. Supply issues, consequently, could yet end up providing more-short term support to prices than we are currently anticipating.

But it will be lamb and aluminium prices that likely feature in Wednesday's ANZ Commodity Price Index for September. We see the world price index being up around 1.0% for the month but NZD returns rising almost double this thanks to the dip in the NZD across the period.

Wednesday is definitely partials-day for NZ. Also out on the day is QVNZ's latest take on the New Zealand housing market and, possibly, Barfoots similar take for Auckland. There has been some talk and anecdotal evidence that the housing market is starting to stabilize after a period of weakness. We will be looking for further signs of such in these data.

Lastly, Wednesday also sees latest job ad figures. These too may be impacted by political uncertainty but we still expect to see trend strength in line with our expectations for an ever-tightening labour market.

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Global Watch

- **RBA likely to sit pat at Tuesday's meeting**
- **Downside for Thursday's Aus retail sales**
- **Hurricanes to crimp Sep US payrolls to +70k**

Australia: It's a busy week in Australia with the RBA Board Meeting on Tuesday the highlight. Datawise, the main pieces are Building Approvals on Tuesday, while Thursday brings the Trade Balance and Retail Sales — note NAB's cashless retail indicator points to downside risks for Retail Sales, though our Online Retail Sales index gave the reverse signal, leading us to reduce our forecast decline somewhat.

First up the RBA Board Meeting. The market unanimously expects the RBA to be on hold. However, recent strength in the labour market has also seen the market reassess its expectations for the cash rate and is now fully pricing an RBA rate hike by August 2018. NAB is similar and is expecting two rate hikes in 2018 – one in August and one in November.

Your scribe expects this same positivity to be reflected in the post-meeting Statement, driven yet again by another stellar jobs print of 54k in August against expectations of 20k. Governor Lowe's recent speech played up this positivity, stating the economy was "on course".

However, the speech also downplayed the likelihood of a near-term rate hike, with Governor Lowe stating "not for some time". Other data out during the period included Q2 GDP figures which were mostly as expected – one weak point though was wages growth. We expect the language around the dollar to be unchanged.

Retail Sales on Thursday is shaping up to be interesting with the market expecting a bounce back to +0.3% m/m from the flat outcome last month. NAB's own Cashless Indicator based on electronic transactions is suggestive of downside risks and is more consistent with a -0.5% m/m outcome. Department store Myer also reported the first six weeks of FY2018 as "below expectations" (from 28 July so most of August), while a warm winter/early spring may have also contributed to weaker winter clearance sales. NAB is consequently forecasting a well- below consensus print of -0.3% m/m, though we have moderated the size of the decline given by the Cashless Indicator because our online retail sales indicator was very strong in the month. [if you would like a copy of NAB's Cashless Indicator please email Tapas.Strickland@nab.com.au]

As for the Trade Balance (also Thursday), the market thinks it will tip further into surplus with NAB and the market tipping a $0.8bn surplus, up from July's $0.5bn.

Better iron ore exports (volumes and prices – at least in August) should add bulk to the trade surplus.

Less controversial are Building Approvals, Tuesday, with the market looking for a 1.0% m/m increase. One notable feature of recent months is the slight upturn in house approvals, while apartment approvals have stabilised after falling sharply earlier in the year.

Chart 2: Better labour market driving RBA positivity

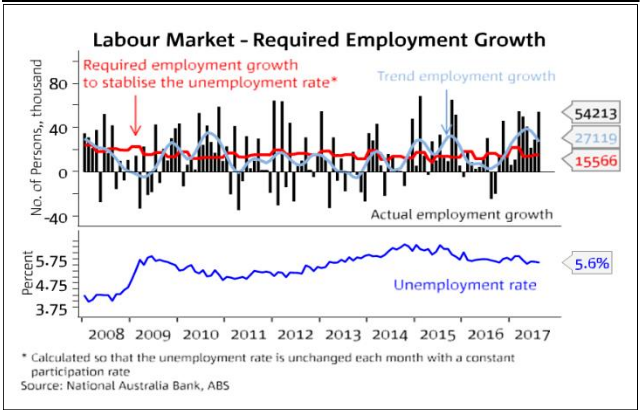


Chart 1: Markets pricing for a higher RBA cash rate

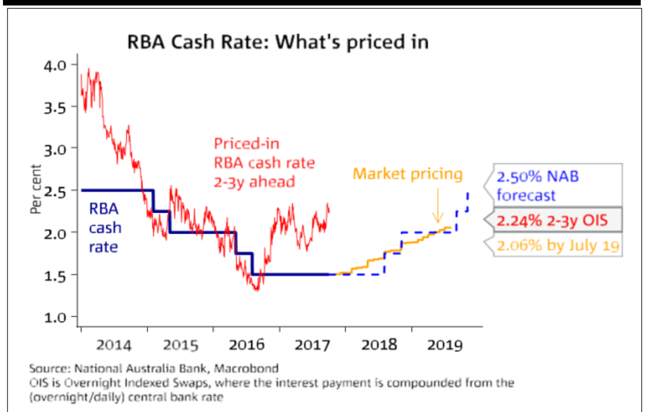
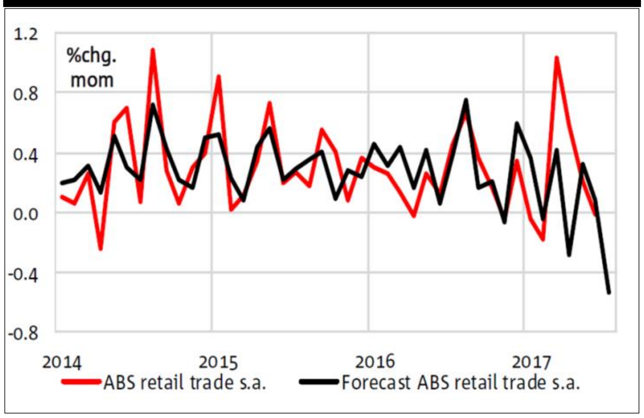


Chart 3: NAB's Cashless Indicator points to weak retail



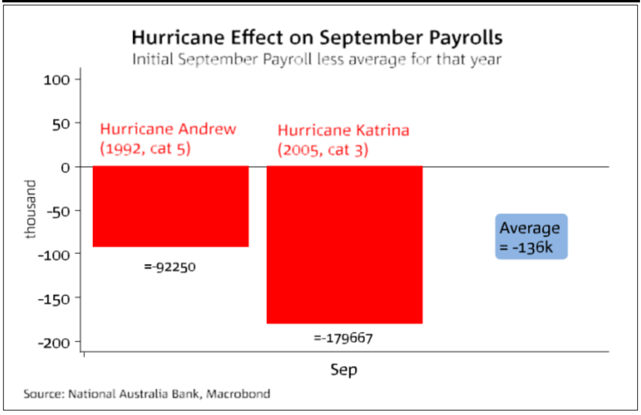
There is also a host of second-tier data including the unofficial MI Inflation Gauge Monday, ANZ Job Ads Tuesday, and the AiG PMIs. Also a reminder that Monday is a public holiday for NSW, QLD, SA and the ACT (but not for Vic, Tas or WA), while daylight savings started Sunday in NSW, VIC, the ACT and Tas.

US: A busy week with the key focus on the Manufacturing ISM Monday, Non-Man ISM Wednesday and Payrolls Friday. It is likely Payrolls will be heavily affected by recent hurricanes. Prior Hurricanes have subtracted on average around 130k from the trend in payrolls for that year (Chart 4). Our models of payrolls excluding hurricane damage are running at around 200k, so taking into account possible damage a print of around 70k could be likely. Other pieces of data include the Trade Balance Thursday. There are also plenty of Fed speakers with Dudley on Friday the one to watch; chair Yellen also speaks but is only giving welcoming remarks.

Japan: A quiet week with only the Tankan Monday and Services PMI Wednesday. Labour cash earnings Friday may also garner some interest.

Eurozone: A quiet week with Retail Sales Wednesday and the ECB Minutes Thursday. The Minutes may garner some attention for details on the "very preliminary" discussions held on tapering last meeting – NAB thinks a taper is likely to be announced at the October meeting.

Chart 4: Hurricanes wipe 130k off payrolls; 70k odds on



UK: It's quiet in the UK with only the Markit PMI on Monday and Services Thursday.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The RBNZ's OCR review came and went last week with little market reaction, as expected. There was a new Acting Governor in charge, Grant Spencer, but there were clear signs of policy continuity, with only minor tweaks from previous statements. Importantly, the language in the final paragraph remained unchanged, with the Bank commenting that "monetary policy will remain accommodative for a considerable period".

In the review, there was no hint that the Bank is looking at beginning the tightening cycle earlier, following the recent lead of the Bank of Canada or Bank of England. Post-election we still don't know the make-up of the next government and it will be some time before the Bank will be able to incorporate any changes to fiscal policy into its projections.

We continue to believe that there is a high hurdle to ease or tighten monetary policy at this juncture. We see policy unlikely to change for some time – certainly not over the next six months. BNZ's official rate call is for a hike in August 2018, slightly ahead of current market expectations. A long period of a stable OCR should help underpin short term wholesale fixed rates close to current levels for the rest of the year. As the first tightening comes into focus, we'd expect to see 2-3 year rates to drift higher, but that's more a story for next year.

Any upside risk this year is likely to come via global forces, with other major central banks moving gradually towards monetary policy normalisation, which means higher rates from historically low levels. As we saw in late-June through to early-July and again from early-mid September these forces can spill over into NZ rates at times.

On current market pricing the first full rate hike is more or less priced by September 2018. This reflects a toss-up between August and November, which is fair in our view. We don't have any argument either with the 2-year swap rate range trading between 2.15-2.25% recently and into year-end. The key local release this week is tomorrow's QSBO, but this shouldn't be market moving. Tomorrow's RBA update should maintain a neutral tone, despite recognition of a slightly better economic outlook.

As usual, the longer end of the curve is more interesting. On Friday, the US 10-year rate closed at its highest level in over two months at 2.33%. The market's confidence in a December Fed rate hike is growing, supported by the language of the FOMC and the Fed Chair. Last week's tax reform plan issued by Trump was designed to get widespread support from his own Republican party. To be sure, some of it will likely get watered down, but the odds of fiscal policy easing from next year have increased, adding to the pressure for the Fed to hike rates further next year, something that the market still well under-prices in our view.

So there has been fundamental support for the marked selloff in US Treasuries over recent weeks and we wouldn't be fighting against that trend. We still see the balance of risks skewed towards higher US rates into year end.

The key data this week is the US employment report at the end of the week. As with most US data releases at present, the series of hurricanes from late August is distorting the data. Employment growth will likely be softer than its recent trend as a consequence. Wage inflation should be less impacted from this force, and is expected to tick higher, helping to support our view that the Fed will be hiking rates again in December.

This dynamic is feeding into the long end of the NZ rates curve. The NZ 5-year swap rate has met some resistance around the 2.80% mark but we wouldn't be surprised to see a test of the 2.9-3.0% level later in the year. For the 10-year swap rate a test of 3.4% has more chance than a retest of 3.1%, in our view.

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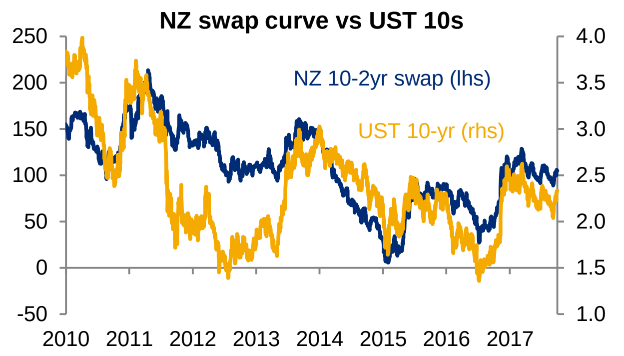
NZ Short-end Underpinned so Curve Driven by USTs



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.96	1.93 - 1.96
NZ 2yr swap (%)	2.21	2.15 - 2.28
NZ 5yr swap (%)	2.75	2.58 - 2.82
NZ 10yr swap (%)	3.26	3.07 - 3.32
2s10s swap curve (bps)	105	92 - 105
NZ 10yr swap-govt (bps)	30	23 - 30
NZ 10yr govt (%)	2.97	2.79 - 3.08
US 10yr govt (%)	2.33	2.12 - 2.36
NZ-US 10yr (bps)	63	63 - 80
NZ-AU 2yr swap (bps)	18	13 - 20
NZ-AU 10yr govt (bps)	13	12 - 23

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

A key theme over recent weeks has been the ascendency of the USD, after falling through much of the year and getting well into "oversold" territory. The USD majors index has recovered 2½% over this time. Last week investors were encouraged by Fed Chair Yellen holding her ground, noting that it would be "imprudent to keep monetary policy on hold until inflation reached 2 percent" and adding to the prospect of a December Fed hike, which now stands at close to a 70% chance. Further supporting the USD was more detail on Trump's tax reform plan, which has been designed to encourage widespread support within the Republican party.

Against a strong USD, NZD/USD slipped 1.7% to close the week around 0.7210. This slippage came at a time when our risk appetite index reached a new high for the year of 84% and the CBA index of NZ export commodity prices showed a strong weekly gain. This sees our short term fair value estimate rise to USD 0.7680, its highest level this year. If we adjust for the average (upward) bias in that model estimate this year, a fairer price for the NZD at this juncture is around USD 0.74.

Saturday saw the release of stronger than expected PMI data for China, which ought to be positive for commodity currencies like the NZD. So as the new week begins, we have some fundamental support underlying the NZD and a currency which looks a little cheap. CFTC data on speculative positioning shows that the extreme long positions that were evident late-July have been steadily cut over the past couple of months to a now-modest level, so positioning is no longer an obstacle for the NZD to recover.

As the final quarter of the year begins, our year-end target for the NZD remains at USD 0.70, but that relies on the USD recovery gaining further momentum, leading to risk appetite falling away and nudging NZ commodity prices lower. For the week(s) ahead, based on supporting fundamentals and our model estimate, we wouldn't be surprised to see the NZD testing short-term resistance around the USD 0.7350 mark.

The key data this week is the US employment report at the end of the week. As with most US data releases at present, the series of hurricanes from late August is distorting the data. Employment growth will likely be softer than its recent trend as a consequence. Wage inflation should be less impacted from this force, and is expected to tick higher, helping to support our view that the Fed will be hiking rates again in December, supporting the USD. In the weeks ahead it will be an interesting battle between positive USD forces and positive NZD forces.

Elsewhere, the RBA is unlikely to deviate from its neutral policy stance at tomorrow's meeting. Our NZD/AUD model suggests that the cross rate is currently fairly priced.

Local data should have little influence on the market, with the key QSBO release taken before the election expected to show a dip in activity indicators.

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Cross Rates and Model Estimates

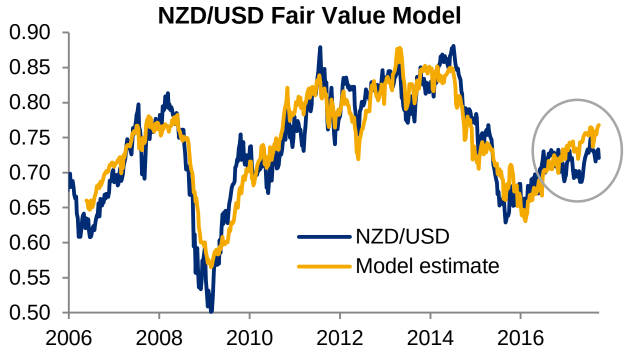
	Current	Last 3-weeks range*
NZD/USD	0.7224	0.7170 - 0.7430
NZD/AUD	0.9214	0.9000 - 0.9240
NZD/GBP	0.5398	0.5340 - 0.5540
NZD/EUR	0.6126	0.6040 - 0.6190
NZD/JPY	81.38	78.90 - 82.80

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

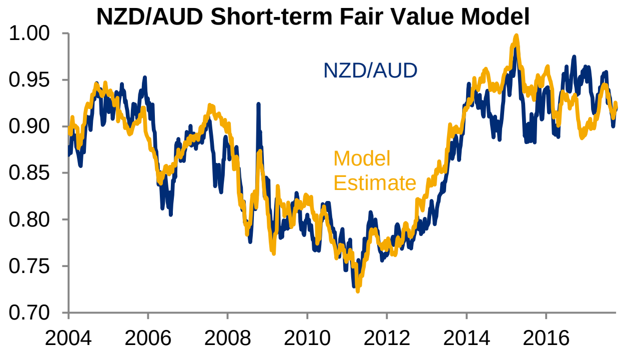
	Model Est.	Actual/FV
NZD/USD	0.7680	-6%
NZD/AUD	0.9210	0%

NZD Model Estimate Up to a Fresh YTD-High



Source: BNZ, Bloomberg

NZD/AUD is Fairly Priced



Source: BNZ, Bloomberg

Technicals

NZD/USD

Outlook: Trading range
ST Resistance: 0.7350 (ahead of 0.7400)
ST Support: 0.7150 (ahead of 0.7100)

We see support around 0.7150-0.72, with the lower estimate being the 200-day moving average. A breach of that would open up significant downside risk. Resistance remains around 0.7350.

NZD/AUD

Outlook: Trading range
ST Resistance: 0.9300 (ahead of 0.9420)
ST Support: 0.9100 (ahead of 0.9075)

Weak resistance is around 0.93, with stronger resistance not really kicking in until just above the 0.94 mark. Initial support around 0.9100.

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NZ 5-year Swap Rate

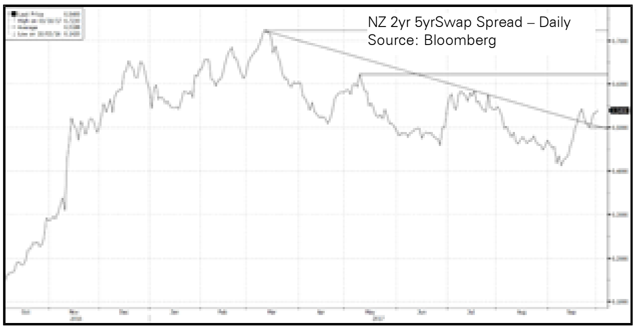
Outlook: Neutral
ST Resistance: 2.83
ST Support: 2.61

Market reached our target of 2.83 and we now expect some consolidation. Await a break to initiate new position.

NZ 2-year - 5-year Swap Spread (yield curve)

Outlook: Steeper
ST Resistance: +62
ST Support: +50

Trendline breached, so expect a move to +62



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Key Upcoming Events

	Forecast	Median	Last
Monday 2 October			
Aus, Manufacturing PMI (AiG), September			59.8
Aus, Inflation Gauge (Melbourne Institute), Sept y/y			+2.6%
Aus, CoreLogic HPI, September			+0.1%
Jpn, Tankan (lge manuf), Q3		+18	+17
Euro, Unemployment Rate, August		9.0%	9.1%
Euro, PMI Manufacturing, Sept 2nd est		58.2	58.2P
UK, Markit/CIPS Manuf Survey, September		56.2	56.9
US, Construction Spending, August		+0.4%	-0.6%
US, ISM Manufacturing, September		58.0	58.8
Tuesday 3 October			
NZ, QSBO, Q3			+18
Aus, Building Approvals, August	+1.7%	+1.0%	-1.7%
Aus, ANZ Job Ads, September			+2.0%
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
Euro, PPI, August y/y		+2.3%	+2.0%
Wednesday 4 October			
NZ, QVNZ House Prices, September y/y			+4.8%
NZ, ANZ Comdty Prices (world), September			-0.8%
NZ, ANZ Job Ads, September			+1.0%
NZ, Dairy Auction, GDT Price Index			+0.9%
Aus, Services PMI (AiG), September			53.0

	Forecast	Median	Last
Wednesday 4 October cont'd			
Euro, Retail Sales, August		+0.3%	-0.3%
Euro, PMI Services, Sept 2nd est		55.6	55.6P
UK, Markit/CIPS Services, September		53.2	53.2
US, ISM Non-Manuf, September		55.5	55.3
US, ADP Employment, September		+143k	+237k
US, Markit PSI, Sept 2nd est		55.1	55.1P
Thursday 5 October			
NZ, Crown Financial Statements, 12m-to-June 2017			
Aus, Retail Trade, August	-0.3%	+0.3%	flat
Aus, International Trade, August	+$0.80b	+$0.87b	+$0.46b
Euro, ECB Minutes, 7 Sept Meeting			
US, Jobless Claims, week ended 30/09		265k	272k
US, Factory Orders, August		+1.0%	-3.3%
US, International Trade, August		-$42.7b	-$43.7b
Friday 6 October			
Germ, Factory Orders, August		+0.7%	-0.7%
US, Unemployment Rate, September		4.4%	4.4%
US, Fed's Dudley Speaks, Monetary Policy			
US, Non-Farm Payrolls, September		+85k	+156k
Saturday 7 October			
NZ, Election Final Vote Count			

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.84	1.83	1.85	2.18
2mth	1.90	1.89	1.90	2.20
3mth	1.96	1.96	1.96	2.21
6mth	1.98	1.98	2.02	2.22
GOVERNMENT STOCK				
03/19	1.91	1.95	1.84	1.91
04/20	2.09	2.12	1.99	1.93
05/21	2.24	2.28	2.13	1.96
04/23	2.54	2.58	2.42	2.06
04/25	2.81	2.85	2.67	2.21
04/27	2.97	2.99	2.83	2.31
04/33	3.31	3.33	3.21	2.63
04/37	3.52	3.54	3.45	2.89
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	73	72	70	103
Nth America 5Y	56	59	57	75
Europe 5Y	57	59	55	74

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.21	2.21	2.16	2.01
3 years	2.41	2.40	2.33	2.03
4 years	2.59	2.57	2.48	2.08
5 years	2.75	2.72	2.61	2.15
10 years	3.26	3.21	3.10	2.49
FOREIGN EXCHANGE				
NZD/USD	0.7214	0.7264	0.7162	0.7275
NZD/AUD	0.9205	0.9153	0.9015	0.9479
NZD/JPY	81.17	81.17	78.58	73.94
NZD/EUR	0.6111	0.6131	0.6021	0.6488
NZD/GBP	0.5390	0.5394	0.5538	0.5665
NZD/CAD	0.9010	0.8987	0.8892	0.9544
TWI	76.2	76.4	75.2	77.4

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