3 April 2017

Monetary Policy Pressures to Evolve Further

- QSBO to portend moderating growth
- But elevated inflationary pressure
- Opposition Finance spokesperson to muse on monetary policy future
- Change in RBNZ Governor will not mean change in RBNZ stance
- Commodity price inflation has peaked

Tomorrow's NZIER Quarterly Survey of Business Opinion (QSBO) is likely to be the domestic talking point of the week. Friday's ANZ Survey painted a picture of a nervous business sector but one which was still quietly confident of the way ahead. At the same time, inflationary pressures keep nudging higher yet not so much as to get the RBNZ hot and bothered. Chances are the QSBO will paint the very same picture but, given the breadth and longevity of the NZIER survey, we will be delivered a clearer picture of the nature and evolution of the current expansion.

In terms of prospective economic activity, the QSBO's trading conditions outcome is the key indicator to watch out for. We would not be in the slightest bit surprised to see this indicator fall further. Its previous (seasonally adjusted) reading of 25 is consistent with annual GDP growth of around 4.0%. This is much higher than the sub 3.0% we expect economic growth to settle at. Trading conditions as low as +10 would be enough to support our view, and we don't expect them to drop that far.

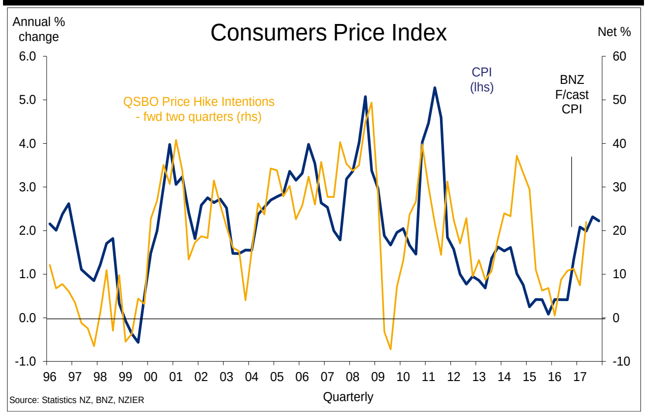
More important, from a market perspective, will be the indicators of inflationary pressure. Last quarter, a net 22% of respondents said they expected selling prices to increase. This was the highest reading since September 24 2014 and consistent with annual consumer price inflation quickly pushing up past the mid-point of the RBNZ's target band. Any further reading near these levels will have us reiterating our concerns that there is more upward pressure on interest rates than the RBNZ cares to accept. We will become even more unequivocal in this view if measures of capacity utilisation and labour market tightness remain at their current levels of elevation.

One area that is providing the RBNZ with some solace on both the monetary and prudential policy front is the recent downturn in housing turnover and house price inflation. Clearly tighter prudential policy has had a circuit-breaker impact on the market (particularly the investor market) in the same way that it did when LVR restrictions were first introduced. The big question is how long the impact will last given that the excess demand for housing remains at a very high level.

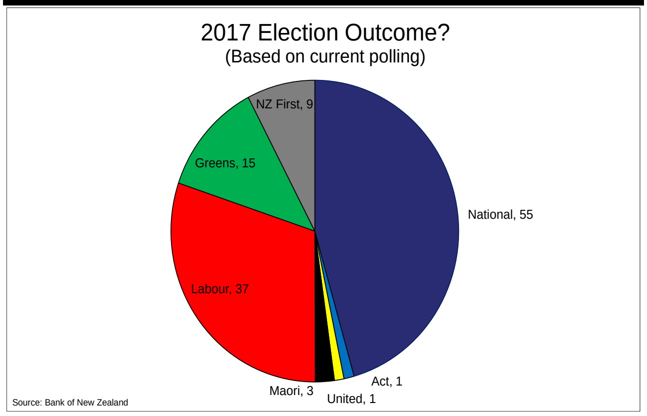
Wednesday's QVNZ monthly house price data are expected to show the moderation in annual house price inflation that other house price measures have already highlighted. Last month's numbers showed annual house price inflation of 13.5%. Something in the order of 12 to 13% can be expected this time around.

Lest we not forget, the September 23 General Election is getting ever closer. To the extent that political polls can be believed (or more accurately, interpreted in any meaningful way), it's going to be a very interesting plebiscite indeed. Based on our three poll moving average, we reckon that if an election was held today National would have 55 seats and a Labour/Greens coalition 52. Neither could rule without the support of NZ First (either formally or informally). Whatever the actual

Inflation Expectations Rising



Getting Interesting



outcome, what we can say definitively at this stage is that the policy pronouncements of all the major players need to be watched with interest - just in case.

With this in mind, be aware that the Labour Party Finance Spokesperson, Grant Robertson, is delivering an address next Monday (April 10) at 12.30pm entitled a Modern Monetary Policy Framework for New Zealand. We're not sure what he will wax lyrical about but it will be worthy of some attention.

What we do know is that Governor Wheeler has been stressing to all who will listen that the effective decision making process within the Bank is now run by a committee of the top four (Graeme Wheeler, Grant Spencer, Geoff Bascand and John McDermott). As such, while the Reserve Bank Act makes the Governor the sole arbiter of the cash rate set, this is not how it's actually working. Grant Robertson's upcoming speech may provide him the platform on which to offer the Bank the opportunity to move formally into the space that it already adopts informally.

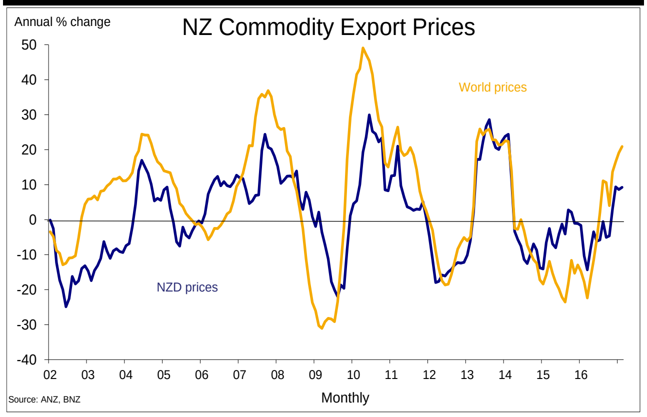
As an aside, note that the effective committee structure ensures that there will be some continuity in the decision making process when Governor Wheeler steps aside and allows Deputy Governor Grant Spencer to take over the reins. Those looking for Spencer to embark on a different way of doing things post the September changeover may well be disappointed. That said, when he too disappears in March, the changing of the guard brought about by a new number one and two in the central bank could see a modest shift in direction. A shift that could, potentially, be that much greater if there was also a change in Government.

Also entering the political debate will be what to do with the increased revenue flows that the Government is finding itself with. An update on this will be delivered on Friday with the release of the Crown Accounts for the eight months ended February. We are expecting the fiscal position to continue its trend strengthening. Here's hoping that in an election year the respective parties can recognise that building up surpluses, where possible, until they are required in a downturn, would be a worthy pastime.

While the fiscal accounts are in good shape, the external accounts, while also fairly robust, are coming under some pressure from a deteriorating trade balance. We will get a further, albeit small, insight into its likely future trajectory with Wednesday's ANZ commodity price release. With dairy prices softening modestly, we are expecting the commodity price index to fall around 2.0% across the month of March. But it's not all bad news for kiwi producers as the currency fell sufficiently during the month to deliver a small positive reading in NZD terms. Moreover, compared to year earlier levels NZD prices will be up over 13% against the backdrop of a 20% increase in world prices.

Wednesday morning's GDT auction will give some insight as to future movements in the commodity price index. The GDT auction price has shown some signs of stabilization of late. We are looking for this week's auction result to show a modest drop in prices which will be consistent with not only the idea that prices are stabilising but also that the peak in prices is now history. With European production ramping up and the EUR relatively weak, we remain wary that the downside risk to future prices is greater than the upside.

Commodity Price Inflation Peaking



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Global Watch

- US focus with Payrolls, ISMs and Fed Minutes
- RBA Meeting and Speeches aplenty
- Will the RBA remark on APRA's macro-pru?
- China's President Xi meets with Trump

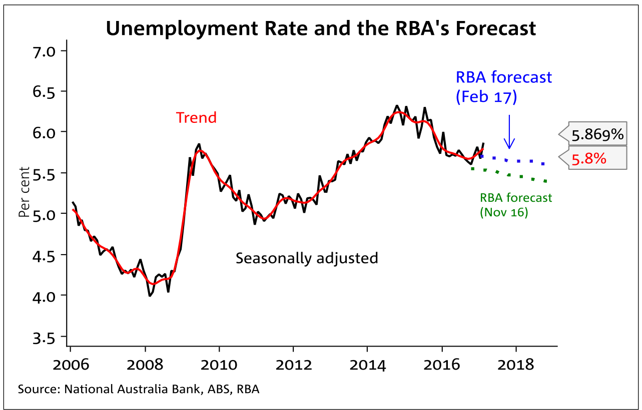
Australia

A busy week ahead. Focus will no doubt be on Tuesday's RBA Board Meeting (unanimously on hold) and whether any references are made to APRA's recent macro-prudential changes. The key data releases are Retail Sales, Monday, and the Trade Balance Tuesday. Finally, there are three RBA speeches with Governor Lowe Tuesday, Heath Wednesday and Deputy Governor Debelle Thursday.

Concerns over household balance sheets have led to a new round of macro-prudential measures being announced by APRA. Tuesday's post meeting statement will be the first clue to whether the RBA feels this is adequate enough and whether this has any implications for the direction of monetary policy.

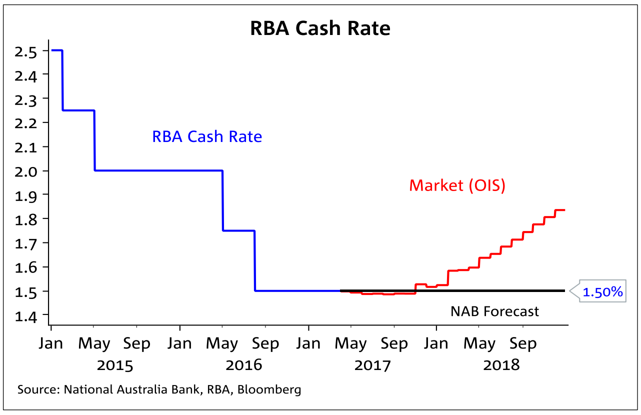
NAB is still of the view that there is a very high bar to further easing even with the latest round of macro-prudential measures. The RBA publically remains skeptical about the effectiveness of such policies.

Chart 1: UR Has Risen Since the Last RBA Meeting



Source: National Australia Bank, ABS, RBA

Chart 2: Markets On Hold in 2017 and a Hike by Sep18



Source: National Australia Bank, RBA, Bloomberg

This was reinforced by RBA Assistant Governor Luci Ellis in a recent RBA research paper: "we are confident that such steps will work in the short to medium term. It is unclear if tighter prudential regulation can permanently offset lower rates in the long term".

The RBA also has become more optimistic on the prospects for the economy, largely based on an improving global outlook, an up-tick in global inflation and the risk of the flow-through from the recent increase in the terms of trade could be larger than currently expected. Against that the labour market remains soft which is likely to keep the RBA on hold.

There are three RBA speeches with the two most important being RBA Governor Lowe Tuesday and Deputy Governor Debelle Thursday. Governor Lowe is speaking at a Board Dinner at 7.15pm AEST while Deputy Governor Debelle is speaking on 'recent trends in Australian capital flows' – potentially of interest to both the FX and rates markets.

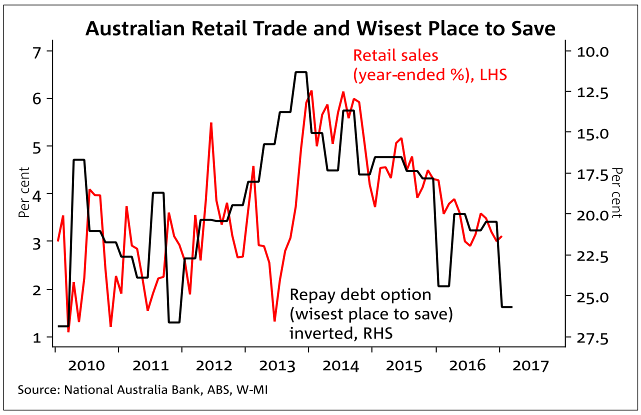
Datawise, the key pieces are Retail Sales and Building Approvals Monday and the Trade Balance Tuesday.

For Retail Sales, NAB and the Market are expecting a 0.3% m/m outcome, around where the trend pace of retail sales growth has been averaging for some time. There is some evidence to suggest that the slow pace of retail sales is due to greater consumer caution, with retail sales growth having a close relationship to the number of people who cite repaying debt as the wisest place to save (Chart 3).

Although building approvals is important, they are extremely volatile on a monthly basis which makes them hard to interpret. The market is expecting a 2% decline and NAB is similar in expecting a flat outcome.

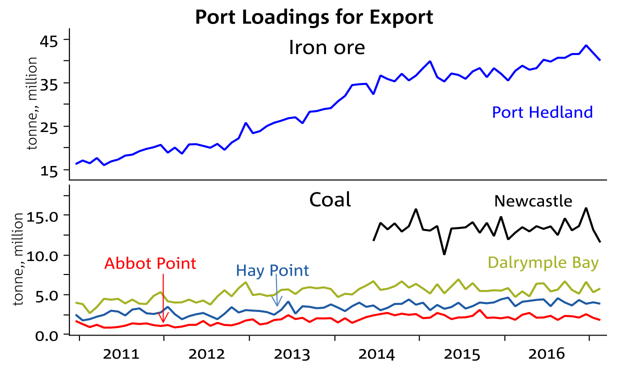
As well as the RBA on Tuesday we also get the Trade Balance on the same day. Market focus will be on whether the trade balance bounces back from its unexpectedly weak read last month (it fell to a $1.3bn surplus from $3.3bn). Our read of loadings at major ports suggests a bounce is unlikely with sharp falls in the amount of coal being loaded in Newcastle. The market consensus currently looks for a $2bn surplus, somewhat above NAB's expectation of a $1.2bn print.

Chart 3: Retail Trade Still Soft; Debt May Be Weighing



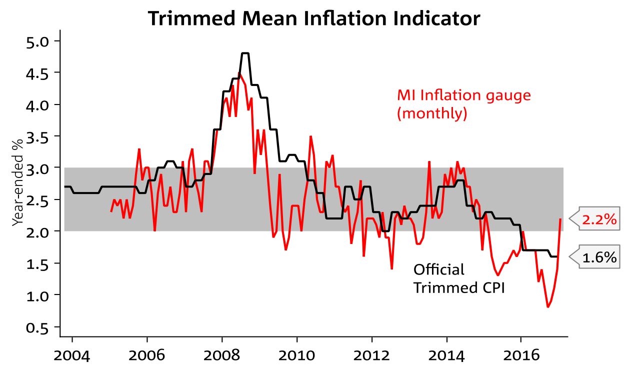
Source: National Australia Bank, ABS, W-MI

Chart 4: Port Loadings Suggests Downside Risks to Trade



Source: National Australia Bank, Bloomberg

Chart 5: The Inflation Gauge Suggests Core Picking Up



Source: National Australia Bank, MI

There is also plenty of second-tier data being released, including the AiG PMIs, the unofficial MI Monthly Inflation Gauge, ANZ Job ads and the RBA Commodity Price Index. The Inflation Gauge is our pick of the second tier data with recent months seeing the pace of its core measure starting to lift – though this does not necessarily have a close relationship with the official core measures.

China

Chinese President Xi meets with Trump for the first time on Thursday. Datawise a quiet week with the Caixin version of the PMIs this Saturday (manufacturing) and Thursday (services) along with Foreign Reserves Friday.

US

A huge week. The Manufacturing ISM is on Monday along with the Non-Manufacturing ISM Wednesday. Wednesday also brings the US Fed Minutes for March and ADP Payrolls. The ADP payrolls survey has become a better indicator of the more important non-farm payrolls recently and is worth watching. Finally, Friday brings the most market moving release in the world, non-farm payrolls which are expected to increase 174k while the unemployment rate is expected to be unchanged at 4.7%. Focus is also likely to be on the average hourly earnings component of the report and whether the tightening labour market is leading to wage pressures – if it is then the US Fed could become even more hawkish than the market is expecting. There are also plenty of Fed speakers.

Japan

The Tankan Monday is an important release in an otherwise quiet data week; the Nikkei Services PMI is also Wednesday.

Eurozone

Potentially an important week with ECB Minutes Thursday – by how far and quickly is the tide turning on accommodative monetary policy? Datawise we get Unemployment Monday and Retail Sales Tuesday.

UK

A busy week with the Markit PMI Monday, Services PMI Wednesday and Industrial Production along with the Trade Balance Thursday.

Canada

Markit PMI and BoC Loan Officer Survey Monday, Labour Market data Friday along with the Ivey PMI.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

It's still hard to get excited about the short end of the curve. During March, the 2-year swap rate traded in an 8bps range of 2.28-2.36% (based on daily closes). With monetary policy expected to be on hold for another 12 months or so, there's a high hurdle to break out.

Until CPI data are released on 20 April, it looks like we'll continue to see the tight range prevail. There's no guarantee the CPI data will excite the market either. At its March OCR review, the RBNZ brushed off the prospect of CPI inflation hitting the mid-point of the target range, not convinced that the rise in inflation will reflect sustainable forces. So it's going to take some time for the RBNZ to move closer to market expectations of a likely rate hike sometime in the first half of next year.

This week's quarterly survey of business opinion, the pick of the local releases, is unlikely to be market moving, even if it continues to show rising pressure on capacity and thereby increasing inflationary pressure.

Australia's short end is also underpinned by expectations that the RBA will not be changing policy anytime soon. Tuesday's policy announcement is likely to see the RBA maintain a neutral policy stance and the market give a collective yawn.

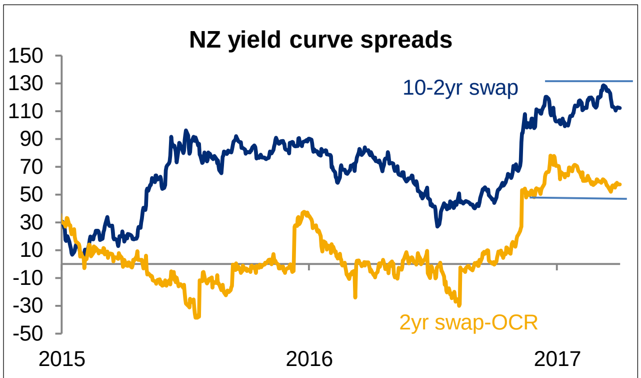
Looking at the long end of the curve, US 10-year Treasuries remain stuck in the circa 2.30-2.60% range that has prevailed all year. Over the past month, short positioning has been significantly curtailed, with CTFC data showing positioning moving from heavily short to only slightly short over that time. The likely driving factors are a Fed that is fairly relaxed about the inflation outlook and gridlock in Washington that reduces the chance of significant fiscal stimulus. This reduces the chance of any additional monetary policy tightening than currently expected by the Fed.

There are lots of key US data releases and events this week, including the ISM manufacturing and non-manufacturing indices, minutes of the Fed's March meeting and the widely anticipated employment report. The latter isn't expected to show any smoking gun on wage inflation so it should remain an open question whether the Fed hikes again as soon as June. Investors are unlikely to make any big positioning changes ahead of that release, so the familiar range is expected to hold.

NZ long rates remain range-bound, reflecting the unchanged local monetary policy outlook and range-trading in US rates. The 5-year swap rate is at the lower end of its 2.89-3.09% range this year, while the 10-year swap rate is at the lower end of its 3.40-3.65% range. We see the near-term risk as a break to the downside, based on risks around US rates, but ultimately we see rates somewhat higher in the second half of the year.

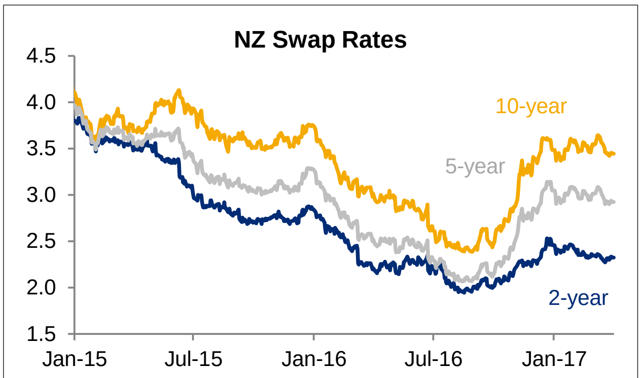
With NZ front end rates well anchored and US 10 year Treasuries potentially holding near the low end of its 2.30-2.60% range, our short term bias is for the NZ curve to flatten further. We can see the NZ 2/10yr curve testing 100bps. Further flattening pressure is a risk on any upside surprise to the Q1 NZ CPI print and/or US 10yrs breaking under 2.30%. Our longer term view is for some steepening, but this rests on US 10yrs trading back up towards 2.60-2.75%, which looks some way off.

Near-term Downside Risk to 10-2yr Swap Spread



Source: BNZ., Bloomberg

Largely Range-Bound for Now



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	2.00	1.95 - 2.00
NZ 2yr swap (%)	2.32	2.27 - 2.35
NZ 5yr swap (%)	2.93	2.89 - 3.08
NZ 10yr swap (%)	3.45	3.41 - 3.64
2s10s swap curve (bps)	112	110 - 127
NZ 10yr swap-govt (bps)	28	23 - 28
NZ 10yr govt (%)	3.17	3.17 - 3.39
US 10yr govt (%)	2.39	2.35 - 2.63
NZ-US 10yr (bps)	78	73 - 81
NZ-AU 2yr swap (bps)	40	27 - 43
NZ-AU 10yr govt (bps)	47	41 - 50

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

Currency markets have been fairly uneventful over the last couple of weeks. However, for the month of March, the NZD fell on all the major cross rates we follow and we're not convinced that poor performance was deserved. Our risk appetite index opened and closed the month at roughly the same (high) level of 75%, so that wasn't a factor. Commodity prices fell, which would normally be NZD-negative, but we didn't see similar falls in AUD and CAD despite oil and iron ore performing as bad, if not worse, than dairy prices.

The RBNZ was unmoved with regards to its neutral policy bias, but that came as no surprise. During the month, market expectations of the next rate hike were slightly shifted out, but not significantly so, as evidenced by the 2-year swap rate trading in a tight range during the month.

We can only pin-point some softer NZ economic data against a backdrop of better global indicators as a possible cause of NZD weakness. But then the Australian economic surprise index showed a similar trend and that didn't impact the AUD.

Based on fundamental drivers, we can only conclude that the NZD begins the new month at a broadly oversold level and particularly so against the AUD. This suggests a low hurdle rate for some sort of recovery over the next month, but much will depend on the global economic backdrop. A fall in risk appetite, which is overdue, would be NZD-negative, but after its recent underperformance, perhaps the NZD could hold its ground even if some of those global factors went against the NZD?

In terms of local data, Q1 CPI data due in a couple of weeks on 20 April are expected to show a further lift in core inflation and headline inflation reaching the 2% mark. Perhaps that could trigger a reversal of sentiment for the NZD?

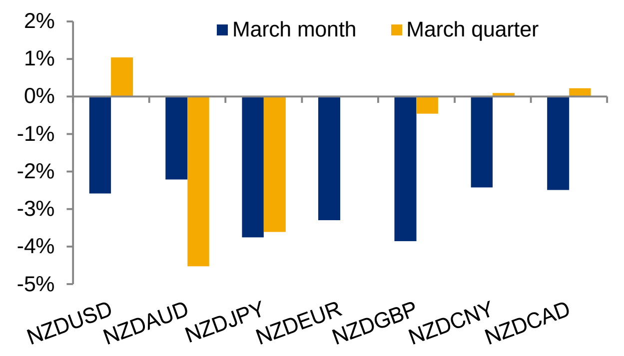
The week ahead sees the NZIER quarterly survey of business opinion on Tuesday. We expect this to show ongoing capacity pressures in the economy, albeit probably with confidence no higher than it has been, as indicated by the ANZ survey last week. After last fortnight's surprisingly positive GDT dairy auction, we expect slightly softer pricing indicators.

In terms of economic releases, US data and events will be the focus, with the ISM manufacturing and non-manufacturing indicators, FOMC minutes and the highly anticipated employment report on Friday night. The latter isn't expected to show any smoking gun on wage inflation so it should remain an open question whether the Fed hikes again as soon as June.

President Trump meets with China's President Xi on Thursday in their first meeting. It'll be interesting to see whether Trump continues his anti-trade stance and agitates about China's currency manipulation or offers a conciliatory tone.

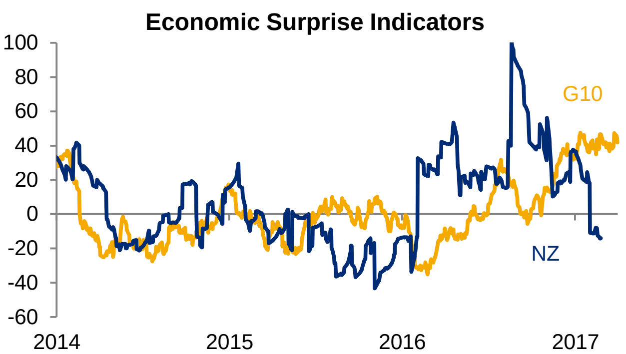
The RBA's policy announcement on Tuesday afternoon should pass without much market reaction. The RBA is likely to keep policy on hold for some time and we could still be some time away before the RBA provides any change in policy bias.

NZD Unloved in March



Source: BNZ, Bloomberg

Softer NZ Data Against a Backdrop of Solid Global Data



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6999	0.6920 - 0.7090
NZD/AUD	0.9165	0.9070 - 0.9280
NZD/GBP	0.5578	0.5580 - 0.5740
NZD/EUR	0.6564	0.6460 - 0.6580
NZD/JPY	78.00	77.50 - 79.90

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7360	-5%
NZD/AUD	0.9140	0%

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Technicals

NZD/USD

Outlook:	Downward channel
ST Resistance:	0.7090 (ahead of 0.7250)
ST Support:	0.6890 (ahead of 0.6860)

The technical picture remains one of a slight downward channel over the past six months. There is decent support just under the 0.69 mark. Short-term resistance levels are a bit more flakey, with more solid resistance not in sight until about 0.7250.

NZD/AUD

Outlook:	Trading range
ST Resistance:	0.9300 (ahead of 0.9400)
ST Support:	0.9100 (ahead of 0.8930)

After a significant fall, it looks like support kicked in around the 0.91 mark. This would need to hold for a few weeks to be sure. Resistance levels are well north of current spot, a reflection of the savage downward break.

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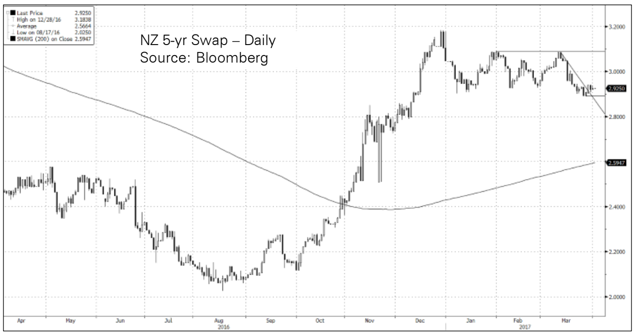
NZ 5-year Swap Rate

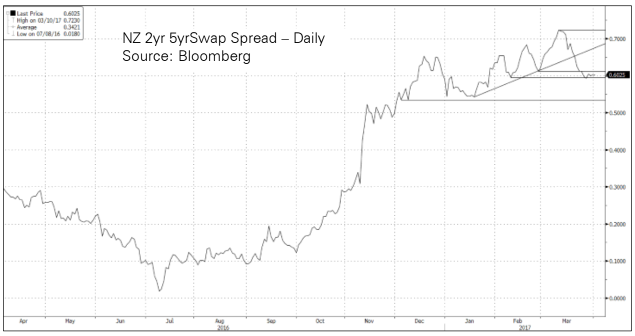
Outlook:	Neutral
ST Resistance:	3.09
ST Support:	2.89



Remain neutral. We went through support at 2.91 briefly last week. Await a breakout to initiate new position.

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

Outlook:	Neutral
ST Resistance:	+72
ST Support:	+53.5



Stopped last week on a move through 61.25. Await a substantive move to initiate new position.

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Key Upcoming Events

	Forecast	Median	Last
Monday 3 April			
Aus, Retail Trade, February	+0.3%	+0.3%	+0.4%
Aus, Building Approvals, February	+0.1%	-1.0%	+1.8%
Aus, CoreLogic HPI, March			+1.4%
Jpn, Tankan (lge manuf), Q1		+14	+10
UK, Markit/CIPS Manuf Survey, March		55.0	54.6
US, Construction Spending, February		+1.0%	-1.0%
US, ISM Manufacturing, March		57.2	57.7
US, Fed's Dudley/Harker Speak			
Tuesday 4 April			
NZ, QSBO, Q1			+28
Aus, International Trade, February	+$1.20b	+$1.80b	+$1.30b
Aus, Lowe Speaks, RBA Board Dinner			
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
Euro, Retail Sales, February		+0.5%	-0.1%
US, Factory Orders, February		+1.0%	+1.2%
US, International Trade, February		-$44.5b	-$48.5b
US, Fed's Tarullo Speaks			
Wednesday 5 April			
NZ, Dairy Auction, GDT Price Index			+1.7%

	Forecast	Median	Last
Wednesday 5 April cont'd…			
NZ, ANZ Comdty Prices (world), March			+2.0%
NZ, Credit Aggregates (new format/series), February			
NZ, QVNZ House Prices, March			+13.5%
Aus, RBA's Heath Speaks, Bloomberg Panel			
UK, Markit/CIPS Services, March		53.4	53.3
US, ISM Non-Manuf, March		57.0	57.6
US, Markit PSI, March 2nd est			52.9P
US, ADP Employment, March		+195k	+298k
US, FOMC Minutes, 14/15 Mar meeting			
Thursday 6 April			
NZ, Crown Financial Statements, 8m-to-February 2017			
Aus, RBA's Debelle Speaks, Capital Flows			
China, Services PMI (Caixin), March			52.6
Euro, ECB Minutes, 9 Mar Meeting			
Germ, Factory Orders, February		+4.0%	-7.4%
Friday 7 April			
Germ, Industrial Production, February		-0.2%	+2.8%
UK, Industrial Production, February		+0.2%	-0.4%
US, Non-Farm Payrolls, March		+175k	+235k

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.91	1.85	1.84	2.30
2mth	1.95	1.90	1.92	2.32
3mth	2.00	1.98	2.00	2.35
6mth	2.04	2.01	2.03	2.34
GOVERNMENT STOCK				
12/17	1.84	1.85	1.87	2.05
03/19	2.12	2.12	2.16	2.13
04/20	2.31	2.34	2.41	2.27
05/21	2.45	2.51	2.57	2.38
04/23	2.76	2.79	2.82	2.63
04/25	3.06	3.09	3.12	0.00
04/27	3.17	3.19	3.23	3.04
04/33	3.52	3.55	3.60	3.38
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	84.25	88.11	84.69	143.55
N. AMERICA 5Y	66.19	67.04	62.65	79.38
EUROPE 5Y	73.64	75.14	75.01	76.55

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.32	2.32	2.32	2.26
3 years	2.56	2.56	2.55	2.34
5 years	2.93	2.93	2.93	2.58
10 years	3.45	3.45	3.43	3.08
FOREIGN EXCHANGE				
NZD/USD	0.70	0.7039	0.7197	0.6725
NZD/AUD	0.9173	0.9219	0.9378	0.8918
NZD/JPY	77.9800	78.110	80.745	76.330
NZD/EUR	0.66	0.6498	0.6815	0.6009
NZD/GBP	0.5582	0.5634	0.5775	0.4720
NZD/CAD	0.9329	0.9399	0.9435	0.8873
TWI	75.98	76.26	78.28	71.75

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