3 July 2017

Leading From the Front

- BCA reckons RBNZ in the group to hike next
- Which tomorrow's QSBO is likely to reinforce
- Especially with its messages of capacity constraint
- But the RBNZ looks set to keep OCR at record low
- Credit, QVNZ, commodity prices, Crown accounts due
- But also watch for Barfoot's June housing results

With central banks stirring towards stimulus removal, the Reserve Bank of New Zealand should be at the forefront, not the back, of the pack. After all, the NZ economy is already much more stretched than most, and has strong momentum, as tomorrow's NZIER Quarterly Survey of Business Opinion (QSBO) will surely show. Granted, New Zealand's cash rate is not near zero. But it's still at a record low on its own account. Nevertheless, the Reserve Bank looks unconvinced of the need for lifting its Official Cash Rate any time soon.

So there is some market tension building. As much as the RBNZ looks set in a holding pattern, we have the likes of heavyweight research house, BCA, putting the NZ central bank in the group most likely to hike next. While this doesn't infer any immediate move, it is a collective that includes the Bank of Canada, which is now (rather suddenly) expected by the market to hike later this month. While we have a lot of sympathy with the BCA view – and representative, as it is, of some global views currently affecting NZ markets – we just as surely point out that the RBNZ would appear unconvinced.

Yet we also expect tomorrow's QSBO to question the wisdom of persevering with a historically low policy rate. This is principally because of the capacity constraints it will show the economy is running into, as growth remains robust.

In this there is nothing particularly new. Rather it's something that has built up over recent quarters. And last quarter, the QSBO upped the ante with lofty pricing intentions, as its capacity utilisation measure (CUBO) hit a record high and labour shortages intensified.

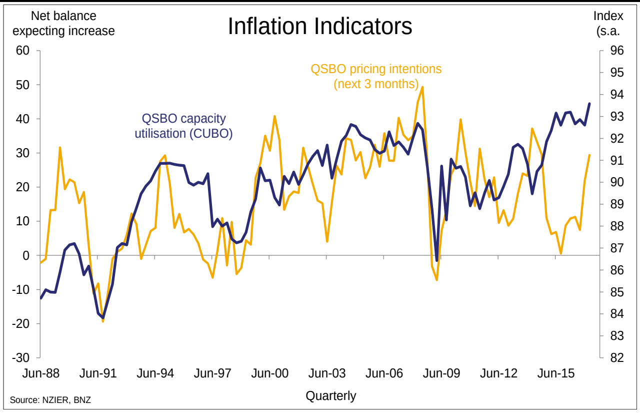
We haven't seen anything to query these broad themes. Last week's ANZ business survey certainly kept the ball rolling with respect to business confidence and expectations. Just bear in mind that it will have captured a good deal of stimulus now coming via commodity income, whereas the QSBO doesn't directly survey farmers.

All that tomorrow's QSBO really needs to do, then, is stay about as strong as it was three months ago. And it was pretty strong then. Of course, as it turned out, this didn't translate into Q1 GDP. But that is no reason to ignore the general thrust of the NZIER survey, which tends to be reflected in GDP in broad respect.

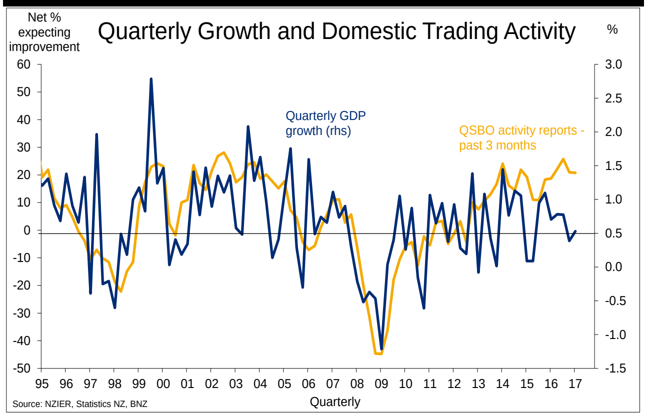
Outside of the QSBO, the rest of the week's NZ data are second-tier in nature. May's credit aggregates are due later on tomorrow (3:00pm). We wouldn't be surprised to see annual growth in (the stock of) housing credit cool a bit further, from April's 8.2% pace, given the moderation in the new residential lending statistics for May. We'll also be interested to see if consumer and business annual credit growth has pushed any higher from their April rates of 7.6% and 5.5% respectively. Agriculture's annual credit expansion will be lined up against April's restrained 2.7%.

Related to household credit, Quotable Value NZ is scheduled to release its June results on Wednesday (5:00am). Its annual house price inflation measure looks set to subside further from its May read of 9.7%. This is with Auckland's inflation rapidly dissipating to nought, but with most other areas exhibiting relative robustness.

Pressure Showing



Mind the Gap



For more on Auckland's housing market, in particular, keep an eye out for Barfoot and Thompson's results for the month of June. These are due any day now. We sense that sale prices are struggling to become any more extreme than they already are.

For Wednesday's early morning dairy auction, indicators suggest another small decline in price is possible.

As for commodity export price performance, more generally, for the month of June, the ANZ indices are due Wednesday (1:00pm). We expect a circa 2% lift in its world price index, as increases in dairy, meat and forestry products offset declines in wool and aluminium. However, strong and widespread strength in the NZD in the month will likely see the NZ dollar price index edge back a touch.

The 0.6% dip in May's ANZ job ads followed a very long and strong run. So even another small decline in June, in figures due Wednesday (10:00am), wouldn't deny a still-strong trend, necessarily. Whatever the result, the employment intentions series in tomorrow's QSBO should hold court.

The final scheduled report for the week, locally, is Thursday's (10:00am) Crown Financial Statements for May. April's surplus surpassed the new Budget baselines by a whopping $1.55b. This mostly reflected a spike in corporate tax, which the Treasury expects to time out. Even so, we get the impression that the fiscal balance is tracking at least as well as the Budget expected.

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Global Watch

- Fed, ECB speakers to monitor as central banks stir
- Fed minutes Wednesday; ECB minutes Thrusday
- US Monetary Policy Report to Congress on Friday
- RBA expected to sit pat Tuesday
- US ISM, payrolls headline data week
- PMIs due in China, Japan, EU, UK, Canada

Australia

The RBA meeting Tuesday is the clear highlight. Markets will be focused on whether the language in the post-meeting Statement follows the seemingly coordinated hawkish comments by central banks recently. In our view the RBA is unlikely to be hawkish given still elevated labour market slack and subdued inflation. Nevertheless, the Statement could well read more positively given last month's stellar labour market figures and the market might well infer a hawkish tilt even if it isn't! It's a conundrum for the RBA which wants to avoid a stronger currency. Data wise the main pieces will be Building Approvals Monday, Retail Sales Tuesday and the Trade Balance Thursday. There is also plenty of second tier data including the AiG Surveys, ANZ Job Ads and the MI Monthly Inflation Gauge.

Chart 1: Hawkish Statements Have Seen Markets Reprice

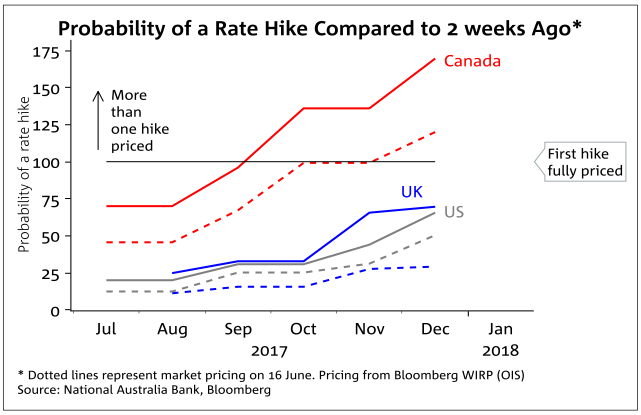
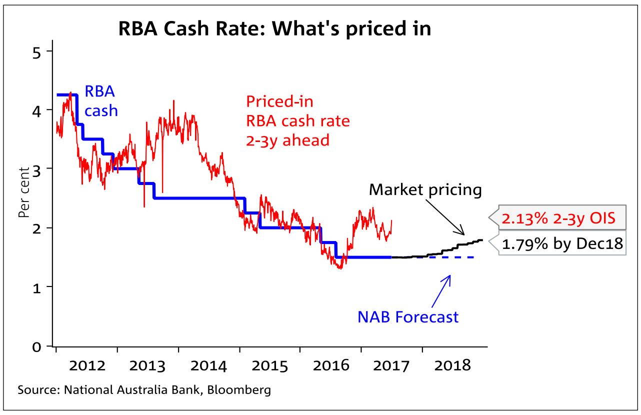


Chart 2: Markets Fully Pricing an RBA Hike by Nov 2018



All eyes will be on the RBA Tuesday. While no rate change is unanimously expected, the market will be parsing the post-meeting Statement for any changes in view in light of the more hawkish central bank commentary globally and improving local data. The key question for markets is, how close is Australia to joining the party?

NAB's view is that Australia will lag the rest of the world in normalising rates given still elevated spare capacity in the labour market and subdued inflation. It is unlikely the RBA would want to come across as hawkish, but a more positive assessment on the domestic economy is still likely given last month's stellar labour market figures — that saw the unemployment rate fall to 5.5%, below the RBA's latest forecasts for the economy.

The RBA will also be mindful that any positive change is likely to be interpreted hawkishly by the market, if only because of the hawkish sentiment coming from central banks globally (e.g. Euro area, England, Canada and Norway).

The data starts with Building approvals on Monday. The data are volatile on a monthly basis and the market looks for some retracement of last month's growth and looks for a -1.3% m/m outcome which translates into a 14.1% y/y outcome. NAB looks for a -1.7% m/m decline.

Retail sales are expected by the consensus pick to rise 0.2% m/m after last month's stellar 1.0% rise. It's likely seasonal adjustment problems affected last month's print (note the shift of Easter from March to April this year) and the figures for May should be closer to the recent trend pace of growth. Nevertheless, NAB thinks there may be slight upside to the consensus due to retailers bringing forward their half-year sales and we look for growth of 0.4% m/m.

The Trade balance Thursday could prove to be a surprise for markets. The current consensus looks for a surplus of $1bn with a wide range of expectations from $0.8bn to +$3.5bn. The divergence likely reflects the strong rebound in coal export loadings in May which would, all things being equal, argue for a higher trade surplus. However, NAB thinks this could be more than offset by lower commodity prices in recent months, along with a likely

Chart 3: Labour Market Improves Over Past 3 Months

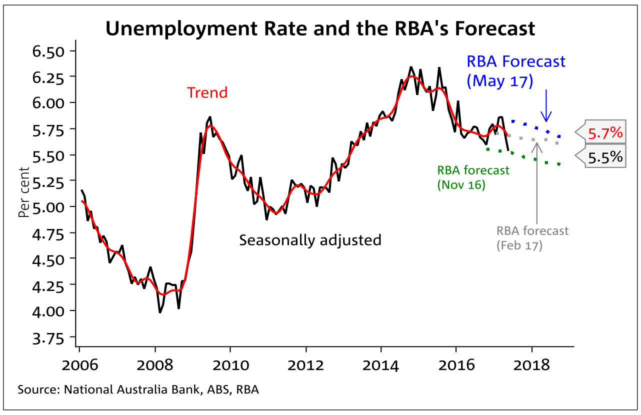


Chart 4: Retail Sales Likely to Slow After Last Month

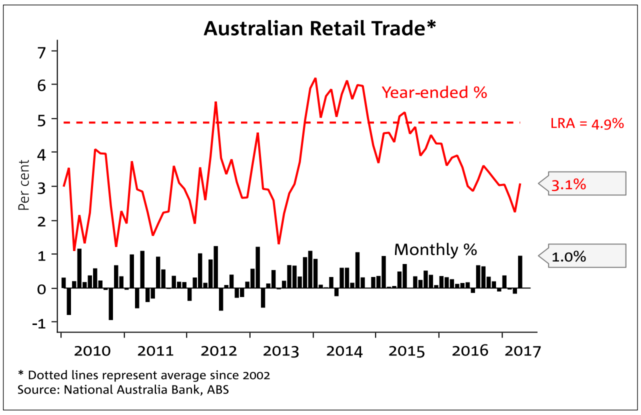
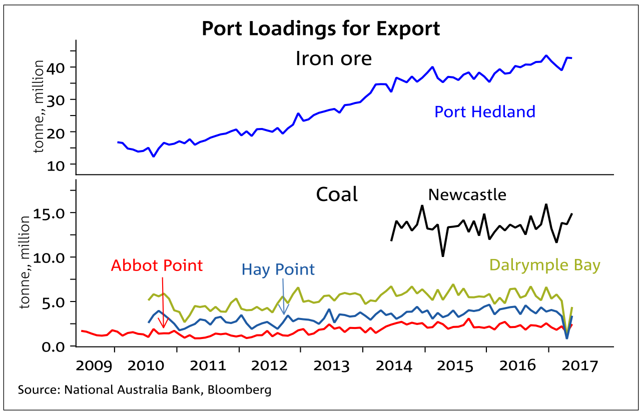


Chart 5: Ports Indicate Coal Exports Will Recover In May



large capital import for the Ichthys LNG project (more on that below). NAB accordingly forecasts a $0.2bn deficit with downside risks, and if this eventuated it would be the first deficit since October 2016.

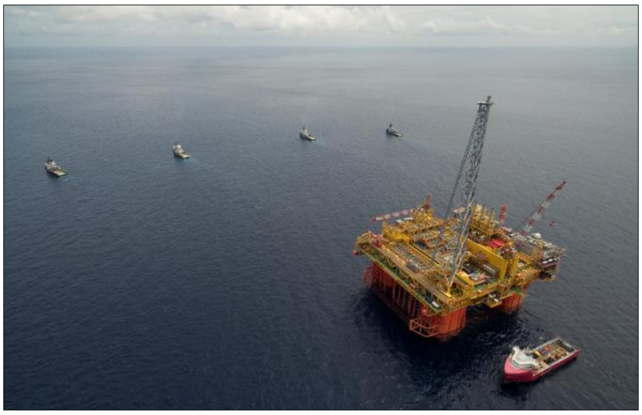
The likely large capital import is the Central Processing Facility (CPF) for the Ichthys LNG project. The CPF sailed across the border in May and public documents reveal the facility was worth some $2.7bn back in 2013. It is unclear what import amount will be shown in the trade balance this month with uncertainty to when the Statistician included progress payments on the facility as an "import" when it was under construction in South Korea. We have only included a small import amount in our expectation and the risk is that it could be larger if it's all in this month's totals.

Amongst the second-tier data, the Monthly Inflation Gauge from the Melbourne Institute will be watched closely for signs of inflation with the Statistician's official quarterly CPI figures due on 26 July.

China

The market will be looking to the Caixin Manufacturing PMI Monday and Services PMI Wednesday for further confirmation of improvement in the official PMI's seen last week.

Chart 6: Ichthys CPF is a Large Capital Import for May



US

A huge week ahead for the US. The ISM Manufacturing Survey Monday will capture early attention – the market looking for a similarly solid if unspectacular 55.0 print, a repeat of last month's 54.9. The FOMC Meeting Minutes Wednesday will be dissected for any more clues/nuances on the inflation outlook. ADP Payrolls will get some attention ahead of the official Non-farm Payrolls Friday. The market looks for +179k payrolls in June and an unchanged unemployment rate at 4.3%. Fed speak continues with Fed Vice-chair Fischer the one to watch (others include Bullard and Powell). The Fed releases its July Monetary Policy Report to Congress on Friday.

Canada

More than usual focus is likely going to be placed on Canada given Governor Poloz's statements this week strongly hinting at removing accommodation at upcoming meetings. Datawise we get Employment figures Friday along with the Ivey PMI which could prove pivotal to whether rates are raised the following week.

Japan

A business survey dominated week with the Tankan Monday along with the Nikkei PMIs (final Manufacturing Monday and Services Wednesday). Labor cash earnings Friday may also garner some attention given the wages-inflation link.

Eurozone

Focus will likely be on ECB speakers given Draghi's comments last week along with the ECB Minutes Thursday. Scheduled so far is Weidmann and Nowotny speaking on the Future of the Euro on Thursday. The main data points are the final version of Euro PMIs Monday, Retail Sales Wednesday and German IP Friday.

UK

Focus goes back on the data with the Markit PMI Monday then the Construction PMI Tuesday and Services PMI Wednesday. Industrial Production and the Trade Balance is Friday.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

We've noted upside risk to global bond rates for a while now and have been somewhat surprised by the grind lower in rates over the past couple of months. That changed last week, with a significant sell-off across the world.

This was led by Europe, with ECB President Draghi in the driving seat. In what seems a deliberate strategy, he openly indicated that the strength of the euro area economic recovery would ultimately allow some removal of policy accommodation. BoE Governor Carney chimed in, suggesting he had a hawkish bias, and this followed a similar change in recent tone from the Bank of Canada and Norges Bank. A coordinated central bank approach to reset rates towards a more normal level seems underway, with the only question now being one of timing.

Noteworthy is the week's gains in 10-year government bond rates across various markets: US +17bps, Canada +30bps, UK +25bps, Germany +22bps, Australia +22bps, and NZ +25bps. If rates continue to climb, we'll look back on last week as a watershed week, a major inflexion point in central bank guidance.

The global bond market sell-off – led by Europe – has had a significant impact on the NZ rates curve, even as the RBNZ hasn't joined in. Indeed, it was only a little over a week ago that the Bank reiterated its clear "neutral" policy guidance. OIS pricing now shows a full rate hike is priced in by May 2018, some three months earlier than the market had priced in earlier in the week, and some 18 months earlier than the RBNZ has guided. The 2-year swap rate ended up rising over 12bps for the week to 2.33%, its highest close since the day before the shocking May MPS.

If the RBNZ's view hasn't changed, then this represents an over-reaction. Indeed, we don't see the RBNZ budging anytime soon. Its May projections already showed inflation falling from over 2% down to 1.1% by March 2018. A stronger NZD and lower oil prices since that update suggests an even lower path for inflation ahead. To be sure, there are positive offsetting factors such as stronger terms of trade and easier fiscal policy ahead. And surveys point to rising capacity utilisation and rising inflationary pressure – we expect tomorrow's quarterly survey of business opinion to show this, but it isn't a new theme. The Bank is probably content to maintain its neutral policy bias for some time yet.

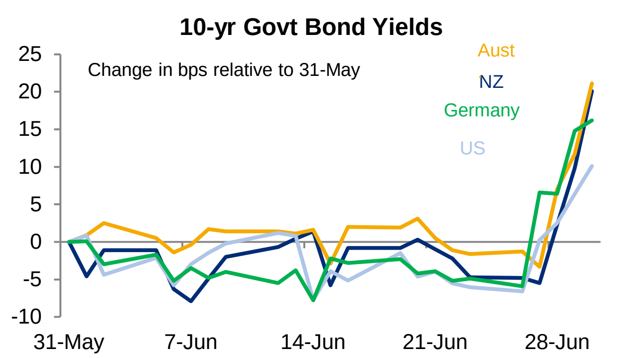
A 2-year swap rate around 2.35-2.40% represents a reasonable level to receive, in our view in anticipation of some push-back by the RBNZ on future rate hikes. But after the vicious sell-off last week, traders will probably be hesitant to rush in, and rightly so, as the risks point to still-upside risk to global rates in our view.

It has been a one-sided market for much of the week and NZ remains at the whim of offshore market sentiment. The next 25bps increase in NZ long-term rates won't happen in a straight line, but that's where we see the balance of risk lying over the coming quarter.

This view is based on, but not limited to (1) significant upside potential to German10-year rates. Indeed, rates need to rise by 100bps just to get real rates back to zero, (2) spillover risk of higher Germany rates onto NZ and US rates, (3) a positive global economic backdrop that supports the case for higher rates, (4) the Fed beginning to reduce the size of its balance sheet within a few months, that puts upside pressure on US bond rates, and (5) positioning remains net long in US long rates.

The air of complacency around the bond market should finally be put to rest and a more volatile period for the rates market could well prevail over coming months. Brace for impact. We wouldn't be counting on any quick reversal of last week's move.

Late-Month Turmoil in the Global Rates Market



Source: BNZ, Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.98	1.93 - 1.98
NZ 2yr swap (%)	2.36	2.16 - 2.36
NZ 5yr swap (%)	2.91	2.64 - 2.91
NZ 10yr swap (%)	3.40	3.10 - 3.40
2s10s swap curve (bps)	104	91 - 104
NZ 10yr swap-govt (bps)	39	37 - 41
NZ 10yr govt (%)	3.01	2.71 - 3.01
US 10yr govt (%)	2.30	2.10 - 2.31
NZ-US 10yr (bps)	70	57 - 71
NZ-AU 2yr swap (bps)	42	33 - 42
NZ-AU 10yr govt (bps)	41	34 - 41

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

It was a mixed bag for the NZD last week, up against the USD and JPY and down against the AUD, EUR, GBP and CAD. What was expected to be a quiet week turned out to be one that possibly defines how the rest of the year progresses. The most important development was ECB President Draghi's refreshed policy guidance. In what seems a deliberate strategy, he openly indicated that the strength of the euro area economic recovery would ultimately allow some removal of policy accommodation.

This less dovish ECB outlook coincides with firmer policy guidance from the Bank of Canada, Bank of England and Norges Bank, alongside the US Fed, which is well into a tightening cycle and continues to guide higher rates ahead.

The key loser amongst all this is the USD, where firmer policy has been long expected. Currency traders have bid up the CAD and European currencies, with less policy accommodation seen to be fresh news. The NZD has been indirectly swept up in all this, as traders contemplate when the RBNZ will blink and adopt a tightening bias. This explains NZD/USD strength but the softer crosses.

We don't see the RBNZ budging anytime soon. Its May projections already showed inflation falling from over 2% down to 1.1% by March 2018. A stronger NZD and lower oil prices since that update suggests an even lower path for inflation ahead. To be sure, there are positive offsetting factors such as stronger terms of trade and easier fiscal policy ahead. And surveys point to rising capacity utilisation and rising inflationary pressure. But the Bank is probably content to maintain its neutral policy bias. We see NZ monetary policy as a negative force for the NZD over the second half.

NZ's 2-year swap rate rose by over 12bps for the week, swept up by the global rates sell-off, but if the RBNZ's view hasn't changed, then this represents an over-reaction. The key local release in the week ahead is tomorrow's quarterly survey of business opinion. We expect the survey to show further signs of stretched capacity and higher inflationary pressure, but this theme is not new.

In Australia, we'll be watching the RBA policy update tomorrow afternoon but, like the RBNZ, we don't see that central bank joining the chorus for firmer monetary policy. A neutral stance might disappoint traders who have re-priced the AUD and rates, reflecting the risk of a firmer tone.

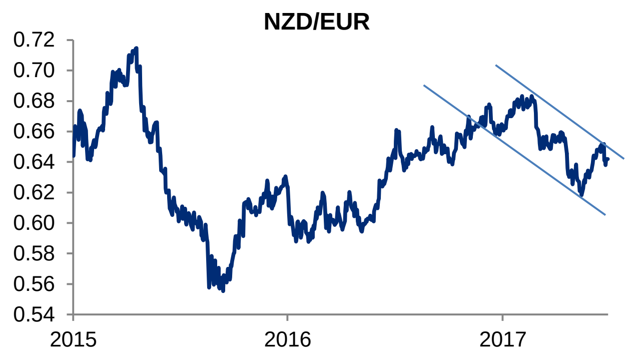
In the US the key potential market-moving release will be Friday night's payrolls report. Employment should rebound after the lull in May, and wage inflation should also be stronger.

However, with Europe in the driving seat, investors should probably be paying more attention to developments on the other side of the Atlantic, with a couple of ECB speakers due late in the week.

After a tumultuous week in the rates market, led by Europe our core views on the NZD haven't changed. NZD/USD remains well supported on fundamentals, with our short-term fair value estimate still with a 0.75 handle. But the charts point to strong technical resistance around the current level through to 0.74 and net speculative positioning has nudged even longer, making the NZD vulnerable to the downside on any negative news.

Our highest conviction view is that NZD/EUR still has significant downside risk, with a move sub-60 in sight over coming quarters. The ECB will have to tread carefully to avoid a taper-tantrum, as it guides towards a less accommodative stance. But a EUR-supportive shift higher in euro-area rates might be unavoidable.

Downside Channel for NZD/EUR, We Believe



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7283	0.7130 - 0.7320
NZD/AUD	0.9630	0.9480 - 0.9640
NZD/GBP	0.5717	0.5520 - 0.5750
NZD/EUR	0.6503	0.6330 - 0.6530
NZD/JPY	80.99	78.40 - 81.20

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7540	-3%
NZD/AUD	0.9460	2%

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Technicals

NZD/USD

Outlook:	Downward channel
ST Resistance:	0.7350 (ahead of 0.7400)
ST Support:	0.7170 (ahead of 0.7100)

The NZD has edged up further and is trading close to technical resistance around the top of the downward channel that has been in place for the past nine months. The 0.7350-0.74 area represents a key level of resistance. The first area of support is 0.7170, ahead of the 200-day moving average around 0.7100.

NZD/AUD

Outlook:	Trading range
ST Resistance:	0.9650 (ahead of 0.9700)
ST Support:	0.9470 (ahead of 0.9400)

Over the past month the cross has traded within a higher trading range, within a larger trading range that has been in play for some time. It's not a particularly clear technical picture, but we'll settle for 0.9470-0.9650 as the current near-term support and resistance levels.

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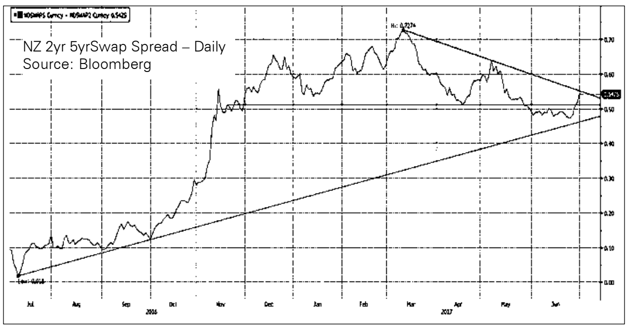
NZ 5-year Swap Rate

Outlook:	Neutral
ST Resistance:	2.92
ST Support:	2.64

Bounced off ST support at 2.64. Now testing ST resistance at 2.92, after breaking back through the 200 day. Higher.

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

Outlook:	Neutral
ST Resistance:	+56.5
ST Support:	+45.5



Bounced close to support at 45.5. Testing ST resistance at 56.5. Neutral.

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Key Upcoming Events

	Forecast	Median	Last
Monday 3 July			
Aus, Inflation Gauge (Melbourne Institute), June y/y			+2.8%
Aus, Building Approvals, May		-1.3%	+4.4%
Aus, CoreLogic HPI, June			-1.1%
China, PMI (Caixin), June		49.8	49.6
Jpn, Tankan (lge manuf), Q2			+12
Euro, PMI Manufacturing, June 2nd est		57.3	57.3P
UK, Markit/CIPS Manuf Survey, June		56.3	56.7
UK, Carney Speaks, FSB Work			
US, Construction Spending, May		+0.3%	-1.4%
US, ISM Manufacturing, June		55.2	54.9
Tuesday 4 July			
NZ, Credit Aggregates (new format/series),			
NZ, QSBO, Q2			+17
Aus, Retail Trade, May		+0.2%	+1.0%
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
US, Holiday, Independence Day			
Wednesday 5 July			
NZ, QVNZ House Prices, June			+9.7%
NZ, Dairy Auction, GDT Price Index			-0.8%
NZ, ANZ Job Ads, June			-0.6%
NZ, ANZ Comdty Prices (world), June			+3.2%

	Forecast	Median	Last
Wednesday 5 July cont'd…			
China, Services PMI (Caixin), June			52.8
Euro, Retail Sales, May		+0.3%	+0.1%
UK, Markit/CIPS Services, June		53.5	53.8
US, FOMC Minutes, 13/14 June meeting			
US, Factory Orders, May		-0.5%	-0.2%
Thursday 6 July			
NZ, Crown Financial Statements, 11m-to-May 2017			
Aus, International Trade, May		+$1.10b	+$0.55b
Euro, ECB Minutes, 8 Jun Meeting			
Germ, Factory Orders, May		+1.8%	-2.1%
US, Fed's Powell Speaks, Housing Finance			
US, ISM Non-Manuf, June		56.5	56.9
US, ADP Employment, June		+190k	+253k
US, International Trade, May		-$46.3b	-$47.6b
US, Fed's Fischer Speaks			
Friday 7 July			
Germ, Industrial Production, May		+0.2%	+0.8%
UK, Industrial Production, May		+0.4%	+0.2%
UK, Trade Balance, May		-GBP2.5b	-GBP2.0b
US, Non-Farm Payrolls, June		+177k	+138k
US, Fed Monetary Policy Report			

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.86	1.84	1.86	2.31
2mth	1.93	1.90	1.91	2.33
3mth	1.99	1.96	1.97	2.34
6mth	2.02	1.99	2.00	2.36
GOVERNMENT STOCK				
12/17	1.81	1.80	1.80	2.19
03/19	2.10	1.94	1.93	2.20
04/20	2.30	2.10	2.10	2.24
05/21	2.42	2.19	2.21	2.26
04/23	2.71	2.45	2.49	2.32
04/25	2.92	2.63	2.69	2.49
04/27	3.03	2.72	2.81	2.63
04/33	3.37	3.05	3.10	2.96
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	83.81	84	85	138
N.AMERICA 5Y	60.46	60	62	87
EUROPE 5Y	56.15	53	61	95

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.37	2.21	2.23	2.20
3 years	2.59	2.39	2.42	2.22
5 years	2.92	2.68	2.73	2.33
10 years	3.42	3.14	3.22	2.68
FOREIGN EXCHANGE				
NZD/USD	0.7343	0.7284	0.7050	0.7101
NZD/AUD	0.9550	0.9625	0.9470	0.9553
NZD/JPY	82.49	81.02	78.45	72.53
NZD/EUR	0.6429	0.6505	0.6309	0.6414
NZD/GBP	0.5643	0.5716	0.5503	0.5279
NZD/CAD	0.9527	0.9662	0.9484	0.9250
TWI	78.76	78.72	76.45	76.08

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Sydney

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Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891