4 September 2017

Economy Chugging into Political Fog

- Q2 GDP growth to exceed 1%?
- Nominal GDP growth pushing 8% y/y
- Commodity prices consolidating recent strength
- Election permutations multiplying poll by poll

As the election campaigning cranks up further this week, we'll also get insight into New Zealand's Q2 GDP growth as well as the latest on commodity export prices. The election night permutations, if anything, look to be multiplying, as the polls jockey for position. However, the messages from the economy are pretty uniform; chugging forth at a robust rate, thanks very much.

For the election night coverage on Saturday 23 September, we'd recommend a well-stocked chippie bowl. It could well be like watching the recent rugby test series between the All Blacks and the British and Irish Lions. It really could go any which way (including a controversial draw, after all the officiating?). Far from making things clear, recent polls have arguably increased the range of permutations for the next government's shape. We remain alert to any more twists and turns.

Still, the economy doesn't seem to be put off one little bit. Last week's ANZ business survey didn't miss a beat. As such, it suggested above-trend GDP growth remains in prospect. The surprise was the moderation in its inflation pointers, although these were still at levels consistent with annual CPI inflation around the middle of the Reserve Bank's 1.0 to 3.0% target band.

With respect to recent GDP performance that thread begins with tomorrow's Building Work Put in Place report for the June quarter. We expect a decent bounce-back in real terms, after a 3.5% fall in the March quarter that we judged as mainly technical/timing rather than the start of any rot. Still, we wouldn't want to push the Q2 rebound story too far, as the construction sector is running headlong into severe capacity constraints. Big promises are clashing with on-site reality.

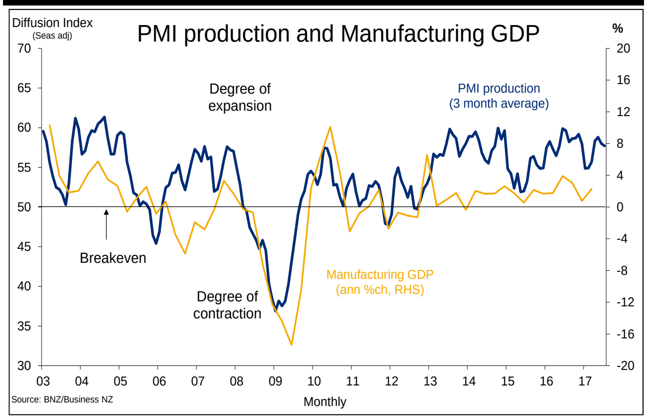
For Thursday's June quarter Wholesale Trade we are looking for its nominal sales to increase in the region of 2% (seasonally adjusted). This would infer a 1.0% expansion in volume, which is what we are working with for the wholesale component of GDP.

We anticipate Friday's manufacturing sales and inventory data will infer a 1.5% expansion in the industry's production for Q2. Food processing should aid this. Also in support is the fact the Performance of Manufacturing Index was strongly expansive throughout the June quarter.

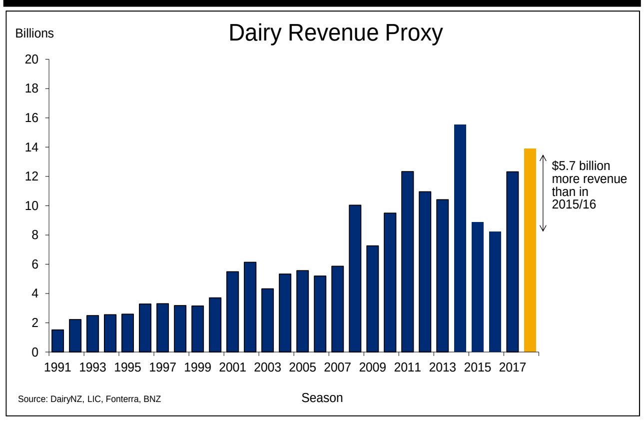
Going into this week's trifecta of Q2 GDP indicators, we estimate a production-based increase of 0.9% (2.6% y/y). As it happens, this is also what the Reserve Bank, in its August Monetary Policy Statement (MPS), expected, as did Treasury in its pre-election Economic and Fiscal Update. That said, we sense Q2 GDP growth could quite conceivably be 1.0% or more (our expenditure-GDP growth estimate for Q2 is presently +1.4%, as a cross-check).

As for the June quarter GDP report, it's due 21 September, so two days before the General Election. While this is likely to register decent growth in real terms, nominal GDP growth will probably be running especially fast we reckon, near 8% at an annual rate. This captures the flush of income coming through the commodity

Expansive



Flush



export sector, as was writ large in last week's June quarter Overseas Trade Indexes.

Regarding the latest in commodity export prices, the ANZ indices for August are due tomorrow. The world-price total looks biased to register a slight fall, but when translated into local currency a fractional increase.

This picks up on the fact the exchange rate was on a moderating path last month. Indeed, the TWI eased 5.0%, to now be about 3.5% below what the August MPS assumed as a Q3 average level. This should not be lost sight of with respect to inflation and thus OCR thoughts.

Very early Wednesday morning plays host to the latest Global Dairy Trade auction. We figure a slight upward bias in the weighted price, but nothing obvious. But the wider story around international dairy prices is already well set. They have rebounded substantially off their lows of late-2015/early 2016. This has meant for an increase in dairy farm income of around $5.7b (2.1% of nominal GDP) for this season, compared to the low point of 2015/16.

Wednesday also, by the way, delivers August's ANZ job ads. Over prior months they looked to have a lost a bit of momentum, although with annual growth in the region of 10%.

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Global Watch

- Central banks in focus: ECB, RBA, BoC
- Many Fed speakers too
- US non-manufacturing ISM, Chinese services due
- Q2 GDP feature of heavy AU data week

Australia: The large data download begins Monday, pre-GDP Q2 partials with Company Profits, Inventories, and then the Current Account (including net exports and the terms of trade) and Government Spending Tuesday before the RBA Board Meeting. Odds on that rates will be left on hold but the RBA will still express anxiety over household leverage. RBA Governor Lowe's address Tuesday evening offers a further opportunity to outline the Bank's views further. As for GDP Wednesday, we look for 0.6% q/q. Thursday's Retail sales/ International trade double to reveal tepid 0.1% growth in retail, but a larger $1,500m trade surplus. (Warning: should the ABS unexpectedly include the large LNG facility in imports, a multi-billion deficit would result, but be offset in GDP by investment.)

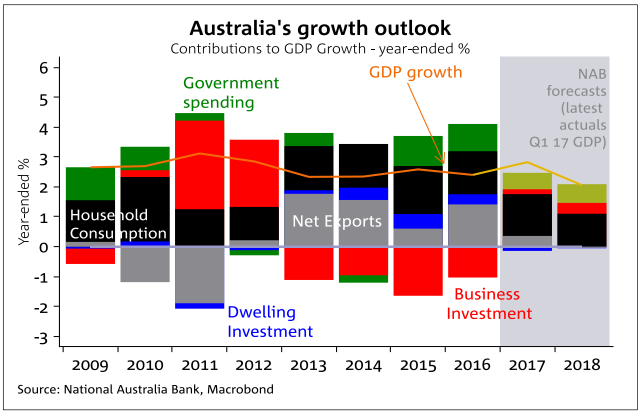
Australia's economic growth and monetary policy will both be at the centre of the market's attention. The RBA is expected to leave the cash rate on hold again, but to recognise that the near term growth momentum of the economy continues to improve. Speaking at a RBA Board dinner on Tuesday night, RBA Governor Lowe will get the opportunity to expand on the Bank's latest thinking on the local economy and outlook. Alex Heath, RBA Head of its Economic Analysis Department is speaking at lunchtime on Wednesday to the Economic Society in Tasmania, RBA Deputy Governor Debelle is on a panel at a Regulators Conference on Thursday, while Governor Lowe is delivering some "brief remarks" also on Thursday at a Bank of China 75th Anniversary Celebration Dinner.

NAB looks for the Australian economy's growth rate to have stepped up in the June quarter to 0.6% from 0.3% in the March quarter. Annual growth that is likely virtually steady at 1.6% after 1.7% to Q1. Pre-GDP partials on Monday and Tuesday will indicate whether that estimate remains on track or not.

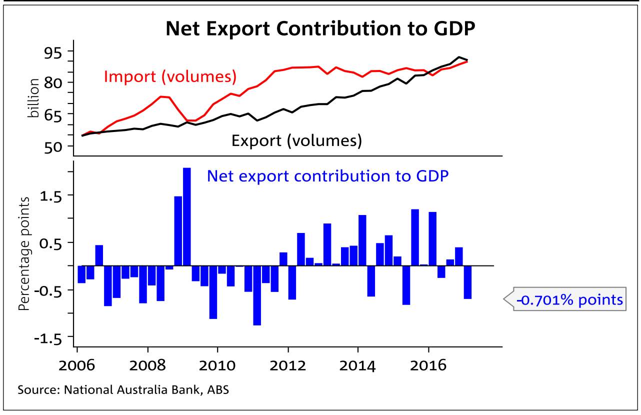
Ahead of GDP, Monday sees the release of the June quarter Statistician's Business Indicators report containing estimates of Company Operating Profits, Non-farm inventories, aggregate wages growth, and Company Sales, all providing clues on various parts of the GDP income, expenditure, and production jigsaw. NAB and the market look for some growth in inventories (0.4-0.5%) but a quarterly pull back in operating profits of 3%, led by somewhat lower profits from Mining after a large boost to earnings (+13%) in Q1.

Tuesday's Balance of Payments for the June quarter is expected to reveal a net zero contribution to growth.

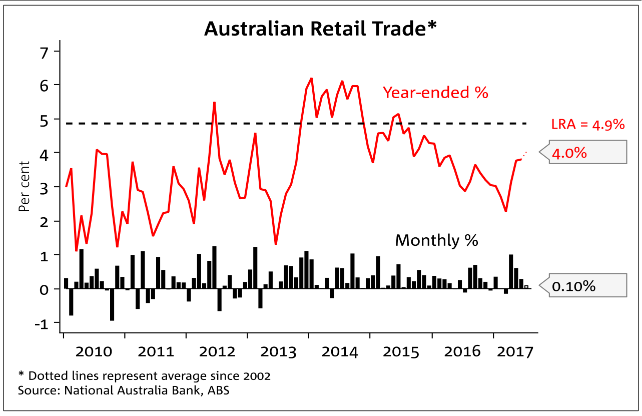
The evolving growth outlook



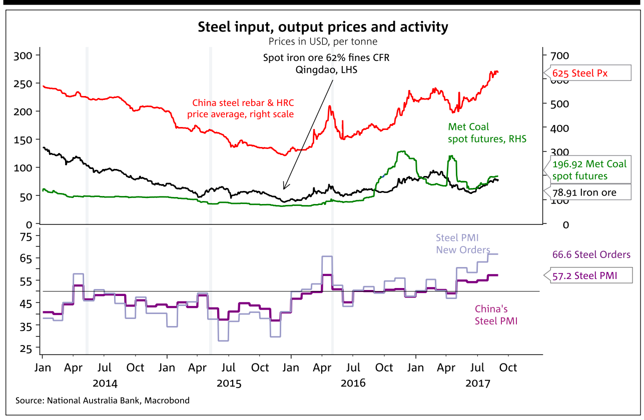
Export volumes temporarily soft in Q1



The ups and downs of retailing



Higher bulk export commodity prices



The release will likely reveal a larger current account deficit in Q2, partly reflecting the interruption to coal rail infrastructure constraining Queensland coal exports for several weeks, since rectified. Also be aware that just as Engineering Construction was bloated in the June quarter by the Ichthys LNG Central Process Facility sailing into Australian waters in May, this may also be included in the Balance of Payment report. There would be a net zero impact on GDP, with any import offset on the investment side of the accounts.

Also out Tuesday is the June quarter Government Financial estimates that will provide the Statistician's estimate of government spending on consumption (mainly public service wages) and public capital investment. The ramp up in state infrastructure investment offers the prospect that it will become more of a growth engine in coming quarters, if not in the June quarter estimate.

We are alert to the possibility that Thursday's International Trade report could conceivably include the large Prelude LNG production platform in July, though confidentiality considerations might preclude its inclusion in this monthly trade statistics by virtue of its large value. Aside from this potential statistical impact, NAB looks for a larger trade surplus in July, a $1,500m surplus in prospect, bulk resource commodities benefiting from higher prices, spillover from solid Chinese demand.

Thursday's Retail trade is forecast to reveal tepid 0.1% growth, subdued growth also suggested by Business Conditions in the NAB Business Survey.

Friday sees release of Housing Finance for July, with the monthly CPI gauge for August, ANZ Job Ads, Services and Construction PMIs, and the weekly ANZ-Roy Morgan Consumer Confidence also due.

China: Caixin Services PMI Tues, Trade Thursday and CPI/PPI Saturday.

US: Factory orders on Tuesday comes before a likely stronger ISM Non-manufacturing report on Wednesday, then Productivity/Unit Labour Costs on Thursday. The Fed's Beige Book is out Wednesday. Seven Fed speakers include the influential Brainard Tuesday and Dudley Friday morning. Political debate around the debt ceiling will also heat up with Congress sitting from Tuesday.

Japan: The Services PMI, Labour earnings and second estimate of Q2 GDP are due.

Eurozone: "Sources" suggest tapering will be discussed by the ECB this week, but are uncertain whether an announcement to taper will be made this week or in October, or even as late as December.

UK: House prices, industrial production, construction, and trade all under focus.

Canada: The BoC is expected to pass at Wednesday's meeting but the market is looking for guidance that a second hike in October still looks likely.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The short end of the curve remains tightly range-bound, with the 2-year swap rate trading consistently between 2.15-2.20% over the past four weeks.

A number of NZ economic indicators this week are expected to confirm that the production-based measure of Q2 GDP will show a decent 0.9% q/q increase, while the expenditure-based measure could well come in north of 1%. But even a decent growth rebound is unlikely to rattle the short-end of the curve, with the focus firmly on inflation rather than economic activity.

As we approach NZ's general election some traders will be looking to punt on the implications of the result for NZ monetary policy. While fiscal policy is clearly going to be easier under a Labour-led government than a National-led government, that doesn't automatically imply tighter monetary policy. Not only do the details of fiscal policy matter, but we also don't know who the next Governor of the RBNZ will be or what the new Policy Targets Agreement will look like. We see any possible knee-jerk reaction to election prospects as an opportunity "to take the other side" in anticipation of a reversal. Economics should prevail over politics.

With NZ's short end rates underpinned by expectations of unchanged monetary policy for an extended period, the shape of the yield curve remains at the whim of US rates.

Are we at a turning point in US 10-year Treasury yields? We might well be. Over the last couple of weeks the 2.10% level (or just under) has been tested and firmly rejected, with not even a soft US payrolls report managing to support rates at that level. The pricing of the Fed Funds curve shows very little further tightening priced in – just 8bps for the rest of 2017 and another 17bps through 2018.

Speculative positioning in US10-year futures remains significantly long, meaning traders are not positioned for higher rates. Skewed positioning limits the downside potential for rates and adds to the chance of a greater move up in rates when sentiment changes.

As the week begins, traders who are long will be happy to see US-North Korea tensions back in the spotlight, inducing a bit of a risk-off move. But we see actual military conflict as a low probability event, with the consequences of a first-move too devastating to imagine. As we've seen in the past, North Korean headlines that cause a market reaction should be seen as a transitory event.

Global data take a back seat this week, with central banks in the spotlight, including meetings from the RBA, Bank of Canada, and ECB. We'll be watching the Fed speakers closely to see how much push-back they give with regards to current market pricing. Dudley has the best chance to shift market expectations, if he chooses to. If he signals that rate hikes remain firmly on the agenda and that the market under-prices this risk, then the risk would be for US rates to lift.

The ECB will be trying hard to avoid a taper-tantrum as it looks to unwind its QE policy. The tapering of its asset purchase programme is almost guaranteed to begin in January, we're just waiting for the ECB to outline the plan. Sources report that the ECB might look to delay any announcement for as long as possible to avoid undesired strength in the euro.

NZ long end rates have recently faced opposing forces, with lower US rates and higher Australian rates, the latter in the face of a surge in metal prices and a better-than-expected economic outlook. This has kept NZ's 5-year swap rate tightly range bound between 2.6-2.7%. We don't expect this week's RBA Statement to rock the boat, keeping policy unchanged and a neutral policy bias, while acknowledging the improvement in global and Australian economic indicators.

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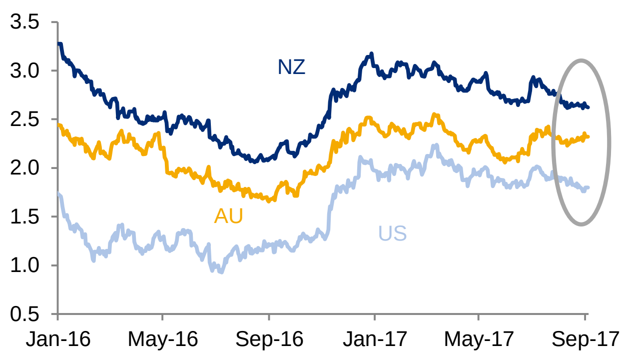
NZ 5 – Year Swap Rate Facing Opposing Forces



Source: BNZ, Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.95	1.94 - 1.97
NZ 2yr swap (%)	2.16	2.16 - 2.20
NZ 5yr swap (%)	2.62	2.61 - 2.67
NZ 10yr swap (%)	3.11	3.08 - 3.18
2s10s swap curve (bps)	95	92 - 99
NZ 10yr swap-govt (bps)	26	23 - 30
NZ 10yr govt (%)	2.85	2.82 - 2.95
US 10yr govt (%)	2.17	2.08 - 2.28
NZ-US 10yr (bps)	68	62 - 77
NZ-AU 2yr swap (bps)	22	22 - 28
NZ-AU 10yr govt (bps)	22	19 - 27

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

Another poor week for the NZD saw it fall on all the major crosses and fresh year-to-date (or longer) lows for NZD/AUD, NZD/EUR, NZD/CAD and NZD/CNY. We can't point to any specific factor driving the weakness. Our risk appetite index ended the week back above the 80% mark, suggesting that recent NZD weakness has gone against fundamental forces. At a short term fair value level of over USD 0.75, the valuation gap has extended to over 5%. That model estimate has been consistently above the spot rate all year, so we don't expect a return to that level, but it's a reminder that the hurdle rate for the NZD to continue to fall further is rising by the day. Some consolidation is now due.

The NZ TWI has fully unwound its May-July strength, seeing it trade below its 5-year average. This is quite a milestone, considering the terms of trade index reached its highest level since 1973 (and if not for revisions, would have been a record high spanning 150 years of data).

CFTC data continue to show an unwinding of NZD longs, although net long positioning still remains well above average. Much of this reflects the general distaste for the USD. The same dataset shows net long positioning in the AUD moving to its highest level in over four years. The AUD and CAD are clearly the commodity currencies of choice at the moment, to the detriment of the NZD.

NZD/AUD at sub-0.90 is starting to look interesting. The nadir is still potentially another 1-2 cents lower, or more if industrial commodity prices continue to rise at their spectacular rate (up over 21% the last couple of months). But we don't expect that driving force to be in play for much longer. The bigger risk as China heads into winter towards the end of the year is factory shutdowns to ease environmental concerns and a reversal of some of the speculative forces driving those hard metal prices at present. Our current spot NZD/AUD fair value estimate sits in a 0.90-0.91 range.

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7155	0.7130 - 0.7340
NZD/AUD	0.8999	0.8970 - 0.9300
NZD/GBP	0.5523	0.5520 - 0.5710
NZD/EUR	0.6024	0.6000 - 0.6250
NZD/JPY	78.48	78.30 - 80.60

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7590	-6%
NZD/AUD	0.9090	-1%

In the week ahead the focus will turn to central banks, with policy decisions by the RBA, Bank of Canada and ECB, while a number of FOMC members are on the speaking circuit, including NY Fed President Dudley.

The RBA's expected no change/no bias policy decision should have little impact on the AUD, with any policy tightening still in the distant future. Wednesday's Q2 GDP data and partial indicators ahead of that release have more scope to move the AUD.

The Bank of Canada's rate decision is seen to be a line-ball call between a September or October tightening. NZD/CAD has been on a significant downward trend, and there's still a big gap down to our long-term fair value (PPP) estimate of CAD 0.82. The BoC's policy cycle is well ahead of the RBNZ and Canada's economy looks to be growing well above trend, suggesting that the path of least resistance for the cross remains to the downside over the medium term.

The ECB's meeting on Thursday night has been on the radar for some time. Last week a Reuters report suggested that the ECB will use the meeting to formally discuss the pace of asset purchases going forward, but it was "highly unlikely" that any decision would be made. We might even have to wait until December. The ECB will have a tough time to getting the messaging right and there will be some focus on how recent EUR strength changes the policy outlook. Everyone knows the ECB will taper asset purchases from next year and significant long positions in EUR have been entered into in anticipation of the ECB giving the eventual nod. But market reaction is unpredictable and we see significant event risk on the day, with much depending on the language ECB President uses at his press conference.

We'll be watching the Fed speakers closely to see how much push-back they give with regards to current market pricing, which implies little prospect for further hikes over the next 18 months. Dudley has the best chance to shift market expectations, if he chooses to. If he signals that rate hikes remain firmly on the agenda and that the market under-prices this risk, the USD would be well supported.

Finally, US-North Korean tensions look likely to remain a key swing factor for the NZD. These headlines that drive the NZD lower are an opportunity to buy in our view as we see actual military conflict as a low probability event, with the consequences of a first-move too devastating to imagine. NZ data this week are likely to cement in prospects for a strong Q2 GDP release (due 21 Sept.)

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Technicals

NZD/USD

Outlook:	Down
ST Resistance:	0.7350 (ahead of 0.7400)
ST Support:	0.7130 (ahead of 0.7000)

Support levels have been tested and broken on the way down. The 200-day moving average of 0.7130 is one of the few support levels left before a big gap opens up to the downside. Decent resistance doesn't kick in until 0.7350.

NZD/AUD

Outlook:	Down
ST Resistance:	0.9160 (ahead of 0.9400)
ST Support	0.8875 (ahead of 0.8800)

Various (weak) support levels have been broken one by one on the way down. The move sub-0.90 opens up a lot of downside potential, with the next level of support 0.8875. The steady move down suggests resistance levels are not particularly relevant at present.

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NZ 5-year Swap Rate

Outlook:	Neutral
ST Resistance:	2.68
ST Support:	2.61

Trade a break, below 2.61 opens up 2.51%. Above 2.68 opens up 2.85

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

Outlook:	Steeper
ST Resistance:	+58
ST Support:	+45

Still expect move steeper stop on break of +45.

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Key Upcoming Events

	Forecast	Median	Last
Monday 4 September			
Aus, Company Profits, Q2	-3.0%	-4.0%	+6.0%
US, Holiday, Labor Day			
Tuesday 5 September			
NZ, Building Work Put In Place,Q2 vol	+2.0%		-3.5%
NZ, ANZ Comdty Prices (world), August			-0.8%
Aus, BOP Goods and Services, Q2	0.0ppts	0.0ppts	-0.7ppts
Aus, Lowe Speaks, RBA Board Dinner			
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
China, Services PMI (Caixin), August			51.5
Euro, GDP, Q2 3rd estimate		+0.6%	+0.6%P
Euro, Retail Sales, July		-0.3%	+0.5%
UK, Markit/CIPS Services, August		53.5	53.8
US, Fed's Brainard/Kaplan Speak			
US, Factory Orders, July		-3.3%	+3.0%
Wednesday 6 September			
NZ, Dairy Auction, GDT Price Index			-0.4%
NZ, ANZ Job Ads, August			-1.0%
Aus, GDP, Q2	+0.6%	+0.8%	+0.3%
Aus, RBA's Heath Speaks			
Germ, Factory Orders, July		+0.2%	+1.0%
US, ISM Non-Manuf, August		55.5	53.9

	Forecast	Median	Last
Wednesday 6 September cont'd			
US, International Trade, July		-$44.6b	-$43.6b
US, Beige Book			
Can, BOC Policy Announcement		0.75%	0.75%
Thursday 7 September			
NZ, Wholesale Trade, Q2 ($) s.a.	+2.0%		+2.1%
Aus, International Trade, July	+$1.50b	+$0.95b	+$0.86b
Aus, Retail Trade, July	+0.1%	+0.2%	+0.3%
Euro, ECB Policy Announcement, Refi	0.00%	0.00%	0.00%
Germ, Industrial Production, July		+0.6%	-1.1%
US, Fed's Dudley Speaks, Economic Outlook			
Friday 8 September			
NZ, Manufacturing Sales, Q2 vol s.a.			-0.3%
Aus, Housing Finance, July	+1.8%	+1.0%	+0.5%
Aus, Lowe Speaks, Bank of China			
China, Trade Balance, August			+CNY321b
Jpn, GDP, Q2 2nd est		+0.7%	+1.0%P
Germ, Trade Balance, July		+€21.0b	+€22.3b
UK, Industrial Production, July		+0.2%	+0.5%
UK, Trade Balance, July		-£3.2b	-£4.6b
Saturday 9 September			
China, PPI, August y/y		+5.4%	+5.5%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.84	1.81	1.83	2.08
2mth	1.9	1.88	1.89	2.16
3mth	1.95	1.94	1.95	2.25
6mth	2.01	1.99	2.00	2.24
GOVERNMENT STOCK				
12/17	1.78	1.79	1.77	1.79
03/19	1.85	1.87	1.93	1.82
04/20	2.00	2.01	2.11	1.83
05/21	2.15	2.14	2.26	1.85
04/23	2.44	2.43	2.58	1.98
04/25	2.70	2.70	2.83	2.17
04/27	2.85	2.84	2.99	2.29
04/33	3.23	3.22	3.34	2.62
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	68.3	77	77	99
N. AMERICA 5Y	57.16	62	58	72
EUROPE 5Y	53.55	59	52	67
SWAP RATES				
2 years	2.16	2.18	2.22	2.00

	Today	Week Ago	Month Ago	Year Ago
3 years	2.34	2.34	2.42	2.01
5 years	2.63	2.65	2.77	2.11
10 years	3.12	3.14	3.29	2.44
FOREIGN EXCHANGE				
NZD/USD	0.7169	0.7309	0.7516	0.7230
NZD/AUD	0.9006	0.9221	0.9413	0.9570
NZD/JPY	78.75	79.89	83.09	73.70
NZD/EUR	0.603	0.6218	0.6396	0.6458
NZD/GBP	0.553	0.5678	0.5719	0.5506
NZD/CAD	0.888	0.9202	0.9360	0.9408
TWI	75.18	77.20	79.31	77.13

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