4 December 2017

New Zealand in Hot Water

- **NZ sea temperatures unusually high**
- **Spencer's talk on low inflation a scene setter**
- **Partials to test our 0.7% view on Q3 GDP**
- **Data to show housing stabilising?**
- **Commodity price updates also due this week**

There is a fair bit of NZ data on offer this week, including a few to inform on Q3 GDP. However, the most scene-setting news for the markets could well be in tomorrow's speech about low inflation by RBNZ Acting Governor Grant Spencer. But that's not to overlook, either, the further evidence of the potential for extreme weather to engulf the country – this time in the form of unusually high sea temperatures.

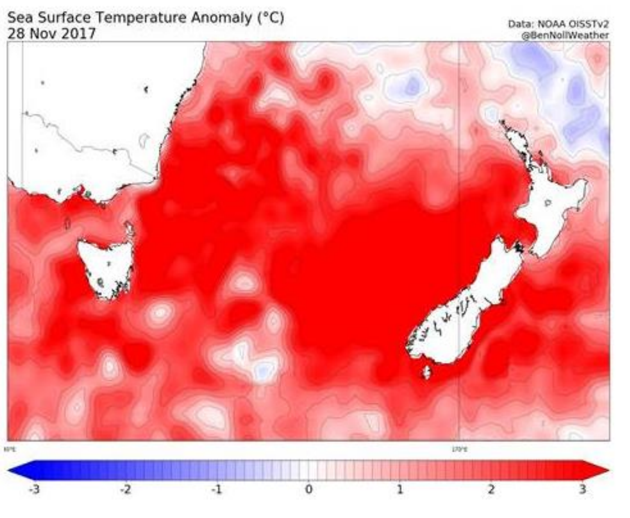
Just on the climate – following up on our NZ drought risk note from the other day – NIWA says ocean temperatures around New Zealand are 2 degrees Celsius warmer than usual for this time of year, and up to 6 degrees warmer off the West Coast. In some cases sea temperatures are even above historical ranges. It's difficult to know what this means for the weather ahead, and thus the potential implications for the economy at large. But this further evidence of extreme weather seems important to acknowledge, and think through.

Grant Spencer's speech tomorrow, entitled "Low inflation and its implications for monetary policy", also promises to be important, one way or another. In particular, it lends itself to an issue we've long been mulling. That is, there is reason to believe global inflation is being suppressed by structural, as distinct from cyclical, factors, which central banks have little to no influence over. Accepting this, is it prudent for central banks to keep aiming for the same old CPI inflation targets?

Central banks are certainly talking more and more about this issue, the world over. However, many of them seem to be coming down on the side of needing to generate stronger domestic (cyclical) inflation (in order to achieve existing inflation targets), rather than accepting that consumer price inflation will naturally run a bit lower than "normal" for as long as the structural factors continue to make their presence felt.

In this vein, we note that November's Monetary Policy Statement forecast a sustained pick-up in non-tradables CPI inflation over the coming few years. This offsets a renewed sag in tradables inflation that the RBNZ

Trouble Brewing?

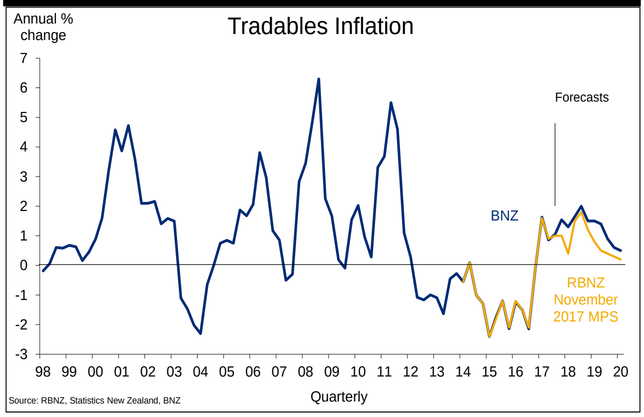


forecasts, such that annual CPI inflation of close to 2% was still achieved over the medium term.

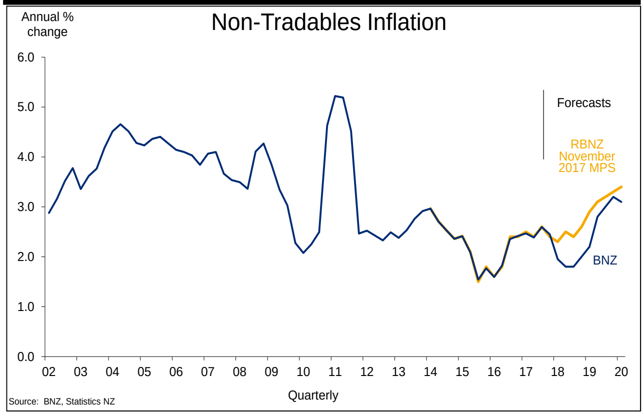
Having said this, Grant Spencer has shown his willingness to openly debate the issues, and make any changes he sees fit to do. We detected a bit of this in the Bank's commitment last week to a relaxation in the loan-to value ratio restrictions. However slight they were, we have to wonder if we would have seen the same shift, this early, had Graeme Wheeler still been at the helm. And so we will be most interested in what Spencer has to say about the supposed low-inflation conundrum tomorrow.

With respect to this week's local economic data, by the end of it we will have at least finalised our NZ Q3 GDP growth expectation. Currently it sits at 0.7% (2.5% y/y), but is subject to the upcoming "partials".

Weak



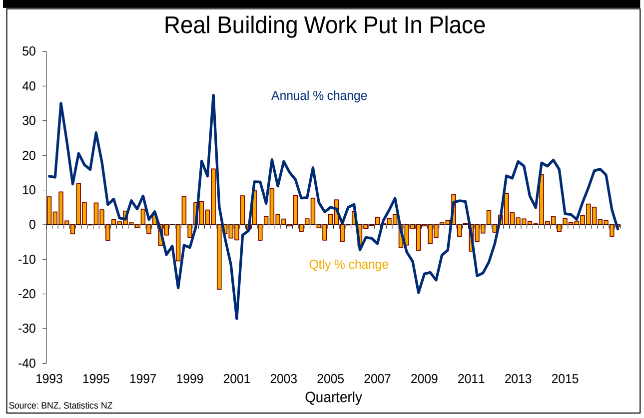
Strong



For Tuesday's Q3 Building Work Put in Place, we are looking for a moderate bounce in real terms, after it contracted almost 4% over the first half of the year. September quarter Wholesale Trade is due Thursday and we are looking for an increase in its sales value of around 1.0%, seasonally adjusted. This would infer a volume gain of a similar order. Friday completes the partials with the quarterly Economic Survey of Manufacturing. We expect its sales and inventory figures to imply a moderate expansion in the industry's production, albeit with a likely drag from the food processing sectors.

For reference, the RBNZ expects Q3 real GDP growth of 0.7% and the Treasury 0.9%.

Time for a Rebound



Of course, the bigger issue with the Treasury's forecasts is how its Half-year Economic and Fiscal Update is going to look. This has been confirmed for a 14 December release. Tomorrow's Crown Financial Statements for the four months to October will be a taster to the starting point on the fiscal balance, the government's debt position, as well as showing October's tax revenue.

For more on how the local economy has been going more recently, Wednesday's ANZ Job Ads, being for November, will be perused for any sign of caution post the announcement of what the new government is going to look like. Up to October they were pretty stout.

There will also be some housing data to chew on this week. Quotable Value NZ is due to publish its November results early on Thursday morning. Its house price index seems biased to slow further in its annual pace. However, we'll be more interested in the QVNZ commentary, to get a feel for sentiment in the NZ housing market, post government formation and the various housing policy announcements.

Also, there is a good chance we'll see the November residential results of Auckland-based realtor Barfoot and Thompson before the week is out.

There is also some commodity price news on offer this week (following on from the record high merchandise terms of trade reported last week for the September quarter). Regarding Tuesday's ANZ Commodity Export Prices, we anticipate its world price index to fall by around 1% for November, while prices in NZ dollar terms lift about 0.5% (courtesy of the weakened NZD through the month).

Further commodity news comes in the form of Wednesday's early morning (NZ time) dairy auction on the Global Dairy Trade platform. Early indicators suggest some price stabilisation at this event. But they suggested that last time only for the GDT Price Index to fall 3.4%, making for a cumulative 10% decline since September. European milk production, SMP stockpiles, and proposed changes to the EU intervention scheme remain headwinds. On the other hand, spreading dry conditions in NZ may bring some silver lining to dairy export prices.

craig_ebert@bnz.co.nz

Global Watch

- **US payrolls on Friday the data highlight this week**
- **China's CPI/PPI on Saturday important too**
- **Brexit talks remain a focus in Europe**
- **Australian annual GDP growth back to 3%?**
- **Market not unanimous for BoC meeting Wednesday**

Australia: The early part of the week sees the release of the remaining partial indicators of Q3 GDP: Business Indicators on Monday should see profits +0.2% (restrained by another fall in the terms of trade) and inventories -0.2% (for a contribution of 0.1 percentage points to GDP).

Tuesday has the Balance of Payments, which we expect to show net exports contributing 0.3 percentage points to growth, while government spending has also been running relatively strongly in recent quarters, boosted by strong infrastructure spending, especially in NSW.

Taken together this has NAB's models looking for a 0.7-0.8% q/q Q3 GDP outcome, which is a little stronger than the RBA's 0.6% q/q pick. This will see annual growth printing close to 3%. More importantly, the RBA has been growing more confident in its view and forecast that the Australian economy will strengthen over the next few years. Such a GDP print would help with that confidence as will the upgrade evident in capex spending expectations data released this week.

This confidence in the growth outlook should be evident in the final RBA Board meeting for 2017 tomorrow (the next meeting is February after the Q4 CPI), though question marks will remain about the course of inflation, given still relatively slow wages growth. The Bank will want to see some further reduction in spare capacity in the labour market to be more confident that wages growth will pick up, something that we expect to be evident in the first half of next year.

The other main interest in Australia will be October retail sales, following a run of very weak retail figures over the past few months – and a number of retail names entering administration this week. The market and NAB are looking for a modest bounce of 0.3% m/m. Our cashless retail sales index suggests the ABS data may have been understating retail spending a little in recent months, so a somewhat larger print may be the risk, especially given weakness in WA, NT and iPhone sales last month.

Other less market moving releases include Housing Finance on Friday. The ABA data were much weaker in the month, but missed badly last month, so we are looking for another 2.5% decline rather than the near double digit decline suggested by the ABA. The trade surplus is expected to shrink to a still-healthy $1.35bn, with lower iron ore volumes and prices plus Qantas's first Dreamliner outweighing higher coal exports and increased oil prices.

China: Trade numbers on Friday and PPI/CPI on Saturday will be the key focus.

US: At the end of the week, November non-farm payrolls should provide a hurricane-free read on employment, with significant focus also on the unemployment rate, which fell to a cycle low of 4.1% in October.

Japan and Eurozone: Quiet.

UK: Industrial production data on Friday will be the key statistic, though markets will also be interested in Theresa May and Jean-Claude Juncker's meeting later today.

Canada: The Bank of Canada's latest interest rate decision occurs on Wednesday. An unchanged (1%) rate is mostly expected, though a small number of reputable houses are forecasting a rate rise.

ivan.colhoun@nab.com.au

Chart 1: Q3 GDP expected at +0.7% q/q and 3% y/y

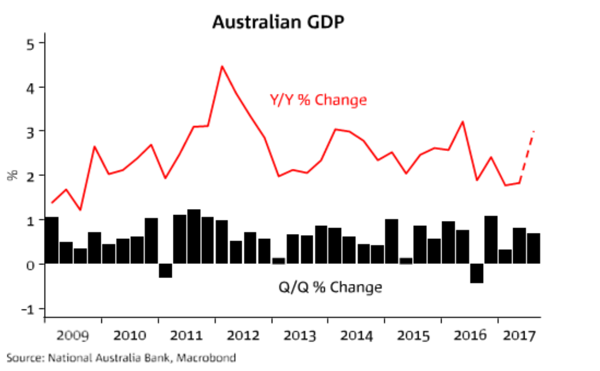
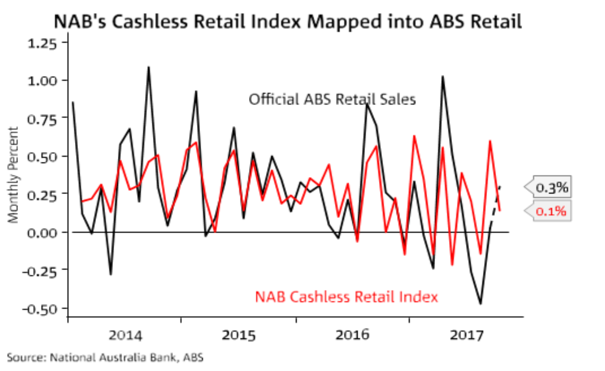


Chart 2: Retail sales to bounce 0.3% m/m (or more)



Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

NZ's 2-year swap rate has been marked down to 2.13% this morning, back to the low seen in early September. As we've noted over the past couple of weeks, the domestic banking system is flush with cash, with banks sitting on over-funded positions amidst a backdrop of softening credit growth. This is keeping downward pressure on money market rates, with a spillover impact onto the short end of the curve. These conditions are likely to linger for a while yet.

At this juncture there is still more risk of rates falling slightly further over the near-term than any threat of a move back up. The next RBNZ MPS is not due until early February, some time away. The range for the 2-year swap rate looks like 2.10-2.20% for now.

Last week the RBNZ signalled an easing of macro-prudential policy, with the move to ease LVR restrictions surprising some. It seemed like a sensible move to us, with house price inflation now moderate, softer credit growth and the banking system much better placed to handle a shock. We expect further relaxation of restrictions over the next year or two, with Acting Governor Spencer indicating that macro prudential policy would be reviewed on a quarterly basis.

More support for the housing market helps grease the wheels for an eventual tightening in monetary policy late next year in our view. But the market has ignored the policy move at this stage, with still slight downward pressure on the rates curve.

Last week's ANZ survey showed a slump in business confidence, not surprising in the context of usually much weaker confidence under Labour-led governments. There is usually no follow through for real economic activity. The inflation indicators perked up, consistent with our view that one thing we can be reasonably confident about with the change of government is that the current policies on offer will lead to higher inflation. For now, it is a risk that the market isn't willing to trade on, but this is expected to be a developing theme through the next year.

With only second-tier local data out this week, the most interesting event on the calendar is RBNZ Acting Governor Spencer's speech tomorrow with the title, "Low inflation and its implications for monetary policy". Many central banks have been grappling on why inflation hasn't picked up this cycle so far and NZ finds itself in the same position. The question is whether new structural forces are in play this cycle which changes the policy reaction function. It's an interesting debate which the Governor will be wading into.

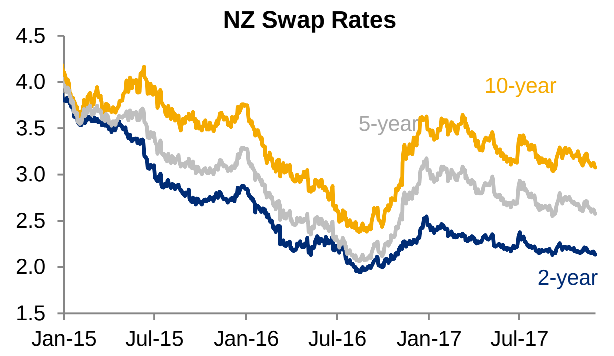
NZ 5 and 10-year swap and government rates are within spitting distance of making fresh lows for the year. This reflects the market's current lack of concern about the inflation outlook, downward pressure on the short end of the curve and a global backdrop which still shows long term rates well contained.

There doesn't seem anything imminent for rates to break out to the upside but we still see the balance of risk skewed towards higher, rather than lower rates over the next few months.

The US Senate's passing of a tax reform bill now means that over the next week or two the House and Senate versions need to be reconciled. Once passed, which we see as likely this year, we can add easier US fiscal policy into the mix which the Fed will have to consider at a time when the economy is fully employed. Alongside a higher US fiscal deficit and borrowing programme it adds to the probability of upside pressure to rates next year. The key global data release this week is the US employment report on Friday night, which is expected to show another solid increase in employment and a rise in average hourly earnings. We haven't seen anything recently to deviate from our view of another Fed hike mid-December and three more hikes next year.

jason.k.wong@bnz.co.nz

Rates Near Year-to-Date Lows



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.90	1.90 - 1.92
NZ 2yr swap (%)	2.14	2.12 - 2.21
NZ 5yr swap (%)	2.58	2.56 - 2.73
NZ 10yr swap (%)	3.08	3.06 - 3.24
2s10s swap curve (bps)	95	94 - 103
NZ 10yr swap-govt (bps)	34	28 - 37
NZ 10yr govt (%)	2.74	2.72 - 2.96
US 10yr govt (%)	2.36	2.31 - 2.43
NZ-US 10yr (bps)	38	31 - 54
NZ-AU 2yr swap (bps)	22	22 - 29
NZ-AU 10yr govt (bps)	19	19 - 30

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD was flat to slightly higher last week on most of the major exchange rates we follow. The biggest movement (down) came after the headline shock of a plunge in business confidence to an 8-year low. The reaction was undeserving as it is typical for business confidence to shift down to an enduring lower plane under a Labour-led government, with no real implications for the economy. Once the dust settled, the NZD showed a broadly based recovery into the end of the week.

Looking at the charts, the NZD has spent most of the last six weeks aimlessly trading within a USD 0.68-0.70 range against a backdrop where our model estimate has drifted down by about 1½ cents to 0.7160 – driven by slightly softer risk appetite, slightly softer NZ commodity prices and slightly narrower NZ-US short term rates. This leaves the NZD still on the cheap side of fair value, but not significantly so.

Seasonal factors are normally kinder for the NZD heading into year end. The NZD has now fallen in 9 of the last 10 Novembers but has risen in 7 of the last 10 Decembers.

In the week ahead, political forces are in play for the USD. The USD came under pressure at the end of last week after Trump's dealings with the Russians during the Presidential campaign came under the spotlight again, while on the positive side the US Senate voted in favour of the tax reform bill. Those factors remain in play this week, with suspicion around Trump's dealings with Russia pre-election unlikely to disappear in a hurry, while some common ground needs to be found between the House and Senate versions of the tax bill. Expect some noise around a possible government shutdown as well. Overall, a fairly messy picture for the USD.

On the economic front, the US employment report at the end of the week is the key focus, which is expected to show another solid increase in employment, while average hourly earnings lifts from 2.4% to 2.7% y/y. Alongside tax reform, this supports the Fed continuing to tighten monetary policy.

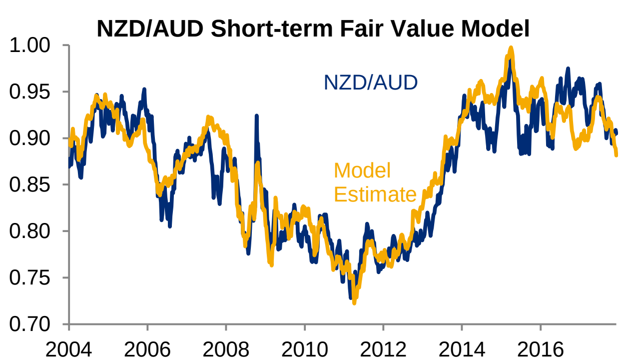
Only second-tier economic data are released in NZ. The biggest potential market mover from local forces is RBNZ Acting Governor Spencer's speech tomorrow with the title, "Low inflation and its implications for monetary policy". In this week's GDT dairy auction we might see an end to the run of falling prices. The odds slightly favour an increase in average prices after falling in each of the past four auctions.

NZD/AUD has settled in an AUD 0.90-0.91 range after temporarily going sub 0.89 towards the end of October. Our model estimate continues to fall, as NZ commodity prices underperform Australian commodities, and as Australian business confidence has risen, NZ confidence has fallen. Both of these forces might only be temporary, but as long as they linger, they represent a headwind for the cross. The RBA is expected to maintain its neutral policy bias tomorrow, while GDP figures are expected to show annual growth of 3.0%, helped by base effects.

GBP has had a good run in anticipation of Brexit talks moving forward. If the Irish border issue can be resolved then it is likely that trade talks can soon begin. Being long GBP, the market is well positioned for this development so the currency would be vulnerable to any bad news on Brexit developments.

jason.k.wong@bnz.co.nz

NZD/AUD Model Estimate Slipping



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6880	0.6780 - 0.6950
NZD/AUD	0.9057	0.8980 - 0.9130
NZD/GBP	0.5116	0.5040 - 0.5260
NZD/EUR	0.5799	0.5720 - 0.5920
NZD/JPY	77.67	76.10 - 78.50

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7160	-4%
NZD/AUD	0.8810	3%

Technicals

NZD/USD

Outlook:	Downside risk
ST Resistance:	0.7050 (ahead of 0.7200)
ST Support:	0.6780 (ahead of 0.6675)

The NZD has spent much of the last six weeks hovering in a 0.68-70 range, with support and resistance just outside of that range. Vulnerability to the downside remains the biggest threat on the charts.

NZD/AUD

Outlook:	Downside risk
ST Resistance:	0.9170 (ahead of 0.9230)
ST Support:	0.8975 (ahead of 0.8875)

The 0.8975 level remains a weak level of support ahead of 0.8875. Resistance is well north of spot, around 0.9170.

NZ 5-year Swap Rate

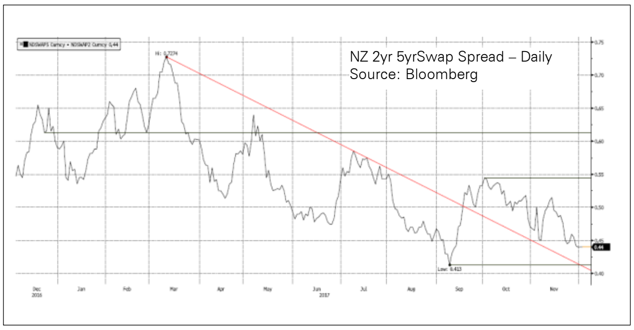
Outlook:	Neutral
ST Resistance:	2.79
ST Support:	2.545

Ranges holding at present so initiate a paid position around 2.58 and put a stop through 2.545.

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

Outlook:	Neutral
ST Resistance:	+54
ST Support:	+41

Ranges holding. Trade +54/+41 range with tight stops.



pete_mason@bnz.co.nz

Key Upcoming Events

	Forecast	Median	Last
Monday 4 December			
Aus, Company Profits, Q3	+0.2%	+0.1%	-4.5%
Aus, ANZ Job Ads, November			+1.4%
US, Factory Orders, October		-0.4%	+1.4%
Tuesday 5 December			
NZ, ANZ Comdty Prices (world), November			-0.3%
NZ, RBNZ Acting Governor Spencer Speaks, Low Inflation			
NZ, Building Work Put In Place, Q3 vol s.a.	+1.0%		-0.5%
NZ, Crown Financial Statements, 4m-to-Oct 2017			
Aus, BOP Goods and Services, Q3prelim	+0.3ppts	+0.3ppts	+0.3ppts
Aus, Retail Trade, October	+0.3%	+0.3%	flat
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
China, Services PMI (Caixin), November			51.2
Euro, Retail Sales, October		-0.7%	+0.7%
Euro, GDP, Q3 3rd estimate		+0.6%	+0.6%
UK, Markit/CIPS Services, November		55.0	55.6
US, International Trade, October		-$47.4b	-$43.5b
US, ISM Non-Manuf, November		59.0	60.1
Wednesday 6 December			
NZ, ANZ Job Ads, November			+0.9%
NZ, Dairy Auction, GDT Price Index			-3.4%
Aus, GDP, Q3	+0.7%	+0.7%	+0.8%

	Forecast	Median	Last
Wednesday 6 December cont'd			
Germ, Factory Orders, October		-0.2%	+1.0%
US, ADP Employment, November		+190k	+235k
Can, BOC Policy Announcement		1.00%	1.00%
Thursday 7 December			
NZ, QVNZ House Prices, November y/y			+3.9%
NZ, Wholesale Trade, Q3 ($) s.a.			+1.7%
Aus, International Trade, October	+$1.3b	+$1.4b	+$1.7b
Germ, Industrial Production, October		+1.0%	-1.6%
Friday 8 December			
NZ, Manufacturing Sales, Q3 vol s.a.			+1.0%
Aus, Housing Finance, October	-2.5%	-2.0%	-2.3%
China, Trade Balance, November			+CNY254b
Jpn, GDP, Q3 2nd est		+0.4%	+0.3%P
Germ, Trade Balance, November		+€21.9b	+€24.1b
UK, Industrial Production, October		flat	+0.7%
UK, Trade Balance, October		-£3.0b	-£2.8b
US, Mich Cons Confidence, December 1st est		99.0	98.5
US, Non-Farm Payrolls, November		+199k	+261k
Saturday 9 December			
China, CPI/PPI, November y/y		+1.8%/+5.8%	+1.9%/+6.9%

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	1.75
1mth	1.77	1.77	1.78	1.89
2mth	1.84	1.84	1.86	1.97
3mth	1.91	1.92	1.94	2.04
6mth	1.93	1.94	1.97	2.10
GOVERNMENT STOCK				
03/19	1.79	1.84	1.85	2.16
04/20	1.90	1.96	1.94	2.36
05/21	2.03	2.10	2.06	2.53
04/23	2.31	2.39	2.33	2.81
04/25	2.58	2.66	2.59	3.07
04/27	2.72	2.81	2.75	3.21
04/33	3.08	3.17	3.08	3.58
04/37	3.31	3.40	3.27	3.84
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	64	66	66	109
Nth America 5Y	52	54	53	72
Europe 5Y	49	50	50	78

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.14	2.17	2.17	2.27
3 years	2.29	2.33	2.32	2.46
4 years	2.44	2.48	2.47	2.64
5 years	2.58	2.63	2.60	2.81
10 years	3.08	3.13	3.10	3.34
FOREIGN EXCHANGE				
NZD/USD	0.6865	0.6912	0.6945	0.7141
NZD/AUD	0.9038	0.9093	0.9030	0.9558
NZD/JPY	77.49	76.79	78.97	81.29
NZD/EUR	0.5787	0.5810	0.5982	0.6635
NZD/GBP	0.5109	0.5190	0.5272	0.5610
NZD/CAD	0.8719	0.8826	0.8823	0.9478
TWI	72.7	72.8	73.4	78.1

Contact Details

Stephen Toplis
Head of Research
+64 4 474 6905

Craig Ebert
Senior Economist
+64 4 474 6799

Doug Steel
Senior Economist
+64 4 474 6923

Jason Wong
Senior Markets Strategist
+64 4 924 7652

Main Offices

Wellington
Level 4, Spark Central
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Toll Free: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Toll Free: 0800 283 269

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+61 2 9237 1406

Alan Oster
Group Chief Economist
+61 3 8634 2927

Ray Attrill
Head of FX Strategy
+61 2 9237 1848

Skye Masters
Head of Fixed Income Research
+61 2 9295 1196

Wellington
Foreign Exchange +800 642 222
Fixed Income/Derivatives +800 283 269

Sydney
Foreign Exchange +61 2 9295 1100
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