6 November 2017

Time for Normalisation?

- **Time to drop policy neutrality**
- **Inflationary pressures are rising**
- **NZD weakness key**
- **Potential PTA and RBNZ Act changes no cause for inaction**
- **But general level of policy uncertainty a credible excuse**

It is our strong view that the RBNZ needs to adopt a formal tightening bias when it releases its November Monetary Policy Statement this Thursday. It should probably back this up by moving its first published tightening forward from December 2019 to earlier in the year. But while we would strongly recommend this course of action we would not be especially critical of the Bank if it, instead, hid behind the wall of confusion that currently surrounds it for a while longer.

To us the confusion lies with the detail of upcoming policy changes that the new government will implement. We all know the broad thrust of the changes but, at this stage, need a bit more detail on timing and specifics before including such change into our models. Moreover, incorporating change can take a fair few person-hours of analysis and the folk at the RBNZ really haven't had that much time available to them.

While the lack of detail may add to forecast confusion, the Bank does know the broad thrust of policy and will be keen to take a stab at its implications as soon as possible so don't be surprised if some effort is made to either explicitly include some policy changes or, at the least, talk of the risks of such to the Bank's central forecasts.

We do not buy, however, the argument that the RBNZ would sit on its hands because it doesn't yet know the exact detail of the future Policy Targets Agreement or, indeed the Reserve Bank Act. Sure, there is some uncertainty about the detail but, equally, there is a great deal of certainty too.

- Employment will enter the equation. But if it does so, it is highly unlikely to prevent the RBNZ from becoming more hawkish as the unemployment rate looks set to sit near to, or perhaps even below, the NAIRU.

- If the Reserve Bank was to stand pat until the new RBNZ Act is finalised it might have to do and say nothing for another 18 months. This would be completely inappropriate.

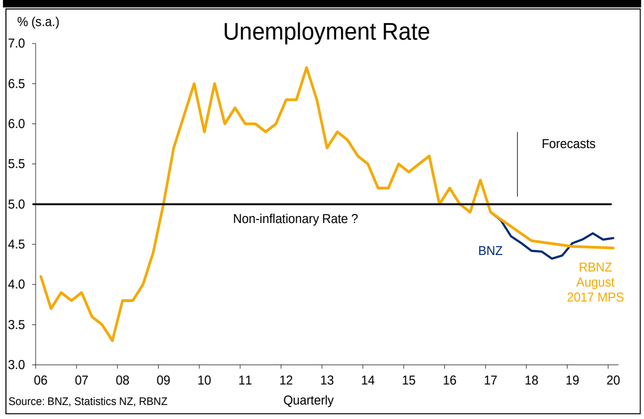
- CPI inflation will remain a key, probably THE key, focus of the RBNZ Act so the Bank will still want to respond to inflation developments.

On this basis, if the Bank concludes that inflation is not an issue then it might well reiterate its previous statement but it won't do this simply because of uncertainty around prospective changes to its objectives.

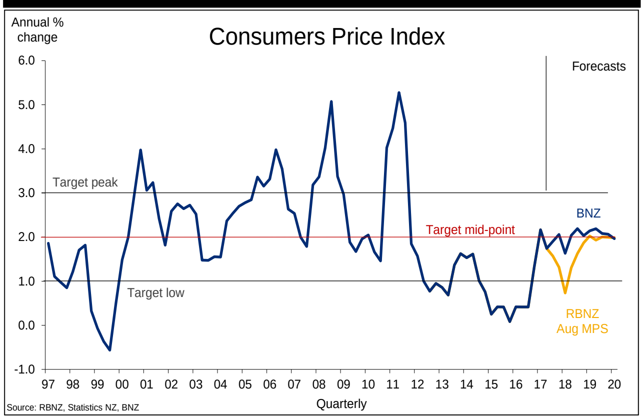
Moreover, don't fall into the misapprehension that Acting Governor Grant Spencer will do nothing because of the temporary nature of his role. If he, and his fellow "committee" members, see reason to respond they will do so.

For the record, we expect that the new finance minister will wait for the new Governor to be installed and then sign a new PTA with an employment consideration in it in March of next year. In this interim way, employment would technically be a secondary objective subservient to inflation. After a full review of the RBNZ Act is completed, which is likely to take a

Unemployment no barrier to tightening



Inflation to rise



year or so, employment is likely to be given equal status to inflation in the Act but, because there is unlikely to be a set labour market target, inflation objectives will still tend to dominate settings at the margin.

While we have significant doubt over what the RBNZ will do with its monetary policy guidance this week, we have little doubt it will revise its CPI inflation forecasts higher. The biggest influence in this regard will be the currency. When the RBNZ put together its August MPS it assumed that the NZD TWI would average 77.9 through the December quarter of this year and 77.6 for March 2018. Its assumed value for the TWI at the September quarter 2020 end-point of its forecast track was 75.4. Right now the TWI sits at 73.6! If the RBNZ doesn't assume the TWI will appreciate from here, which seems likely, then its current level should add around 0.5% to its year-ahead CPI forecasts taking the forecast of annual inflation to around the 2.0% mark.

Moreover, the starting point for the Bank's inflation forecasts is raised with September quarter CPI inflation coming in 0.3% up on the Bank's expectations and the December quarter is looking to be equivalently above forecast. In some ways, these overshoots don't matter much, especially if the Bank sees them as transitory but to the extent that they feed into inflation expectations and wage-setting behaviour they become more permanent in nature.

We also believe that, on balance, the policy suite of the new government will be seen as more inflationary than its predecessor. We have discussed this in length previously but in short:

- the substantial moves in minimum wage must push overall wage growth higher;

- lower net migration inflows will further put pressure on a tight labour market;

- the regional petrol tax in Auckland will push the CPI higher;

- increased construction demands will push the cost of construction upwards;

- rents will rise as the cost of construction increases, more students look for rental accommodation and the rental warrant of fitness bites;

- the overall fiscal impulse will be greater;

- redistribution of income from those with a low marginal propensity to consume to those with a high MPC will push up aggregate demand.

There are offsets but they will only be partial in nature.

As already noted, the Bank will not have the level of detail optimal but it can't just put its head in the sand and ignore these factors.

To cap things off:

- expectations for global growth are strengthening;

- central banks elsewhere are either reducing, or talking about reducing, current monetary stimulus;

- bond yields are edging higher.

This is not to deny that there are factors pushing the RBNZ in the opposite direction.

Heading the list is the fact that "longer-term inflation expectations remain well anchored at around 2 percent", and the RBNZ's preferred measure of core inflation – the sectoral factor model – sits well below the mid-point of the RBNZ's target range.

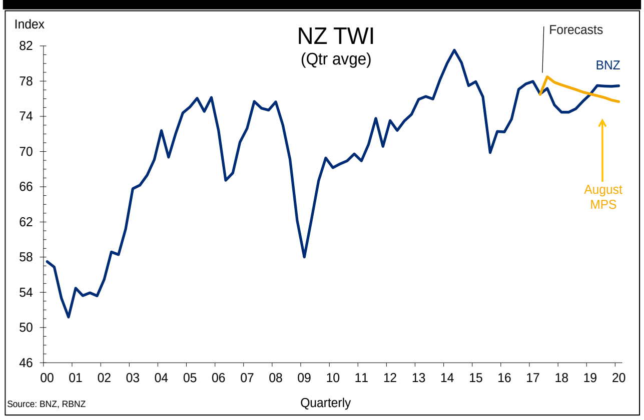
Additionally, the housing market is a tad-weaker than expected and construction is similarly softer. Indeed, we think the general growth outlook for New Zealand will be softer than the RBNZ has previously projected. In part because net migration is declining faster than anticipated and business confidence is under pressure.

But, on balance, we still think that the rising inflation story dominates.

Accordingly, we think the time is ripe for the RBNZ to talk about policy normalisation in much the same way as

Minimum wage up

Currency weaker than expected



central banks such as the Federal Reserve (which, incidentally, has an employment objective too) are doing. This is not so much an argument that interest rates NEED to rise to choke off inflation. It is more an argument that interest rates don't need to be at emergency-low settings when inflation appears to be returning to target.

We think there is now an air of inevitability about this transition. And we think, if pushed, the central bank will be hard pressed, at this juncture, to repeat its previous mantra that the chances of an easing are the same as the chances of a tightening. The worm, in our view, has most definitely turned. However, we do acknowledge the extremely difficult operating environment in which the RBNZ is operating and would not be completely surprised if it displayed a degree of caution in its attempt to come to grips with this transitional phase.

The RBNZ's Monetary Policy Statement will dwarf all the other releases due this week but, for the record.

- The RBNZ's Survey of Inflation Expectations is released 3.00pm on Monday (today). We are looking for two year inflation expectations hanging above the 2.0% mark. We see this as being consistent with the RBNZ moving to a tightening bias but the Bank has largely dismissed this survey as having less importance, than it did previously.

- Tuesday we get the Crown Financial Statements for the three months to September 2017 which will, hopefully from the new Government's perspective, show that revenue flows are continuing at a pace that will fund future fiscal spending.

- Wednesday morning we get the latest GDT (dairy) auction. We are expecting a further drop in this series which in turn will put more downward pressure on Fonterra's expected payout and, in turn the NZD. Additionally, it may add to any downside risk perceptions that the RBNZ sees for the local economy.

- Parliament also opens on Wednesday and we may get a bit more detail on the new government's policies when the speech from the throne is delivered. Having said that, such speeches tend to be more about general policy thrust than specifics.

- On Friday, we get Electronic Card Transactions for October. This series has been disappointing of late and is beginning to question the strength that we, and others, have built into our forecasts for private consumption. We are looking for a modest bounce in October. If this fails to eventuate, we may have to take another look at our near term domestic demand forecasts.

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Global Watch

- **RBA rate decision and quarterly statement**
- **US data light but some Fed speakers to note**
- **China trade due Wednesday**

Australia: It's RBA week, the Board meeting on Tuesday followed by the quarterly Statement on Monetary Policy on Friday. All 27 economists polled in the latest Bloomberg survey expect the RBA to remain on hold with no change picked until the first meeting next year where one analyst is looking for a cut and two for a hike. (NAB expects no change through the first half of next year, a steady for now rates view given more force by the last CPI report and Friday's softer than expected Retail Sales report, even allowing for the somewhat distorting impact from the launch of the new iPhone which affected sales last July before bouncing strongly in August and September. This effect should show up in October and November data this year.)

For Friday's Statement on Monetary Policy, there will be particular interest in the refreshed inflation forecasts in light of the Q3 CPI, likely coming with at least a slight lowering of the year-ended inflation forecast for December 2017. That said, the unemployment forecast will also need to be lowered.

On the data front, the Melbourne Institute's monthly CPI gauge is released on Monday (L: 0.3/2.5), along with ANZ Job Ads (L: 0.0%), both October readings. The risk on job ads is another strong print. Tuesday sees the AiG PCI Construction Index (also October; L: 54.7) coming with the weekly ANZ-Roy Morgan Consumer Confidence reading. Completing the data week is Housing Finance Approvals for September. Our expectation is that headline Owner-Occupier Approval loan numbers rose at a faster 3.4% rate after August's 1.0% rise. There'll be interest in what the report says about finance to construct or purchase new dwellings as well as investor finance approvals that have shown a degree of resilience of late, up 4.3% in value terms in August.

China: Trade on Wednesday and CPI/PPI on Thursday come ahead of key activity reports the week after. Lending data are due any day from Friday.

Chart 1: A degree of resilience in residential building

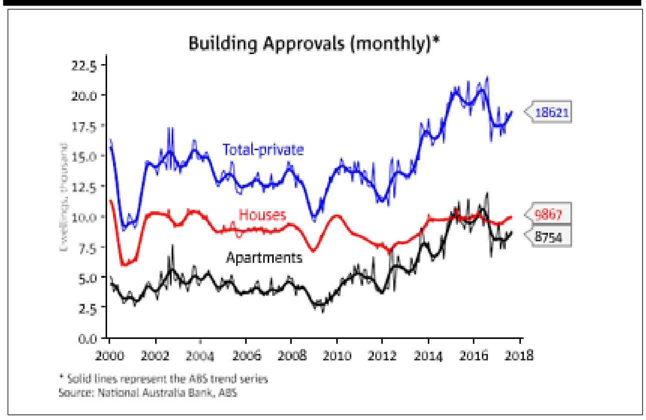
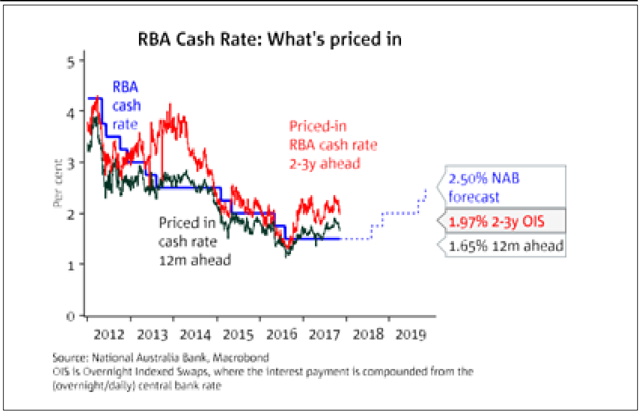


Chart 2: RBA pricing eased back last week



US: It's a very light week for the calendar ahead. Tuesday's Job Openings and Friday's first reading of Consumer Sentiment are the highlights. There'll be interest in what the NY Fed's Potter (closed to media; text only), his boss Dudley, newly-minted Fed Governor Quarles, and outgoing Chair Yellen have to say, though Yellen is receiving an award, so possibly not an occasion for a speech.

Japan: A light calendar week is in store with some interest in the Leading Index, Core Machine Orders and the Tertiary Industry Index.

Eurozone: Tuesday's Retail Sales will be the main data interest. Draghi (with Lautenschlaeger, Nuoy, and Angeloni) speaks at an ECB Forum on Banking Supervision on Tuesday; Banque de France Governor de Galhau and Bundesbank President Weidmann speak on Thursday.

UK: UK-EC Brexit talks resume this Friday. Industrial production, Construction Output and Trade might offer some insights into economic activity.

Canada: The IVEY PMI is out, along with Housing Starts, Building Permits and New House Prices. Governor Poloz speaks on Tuesday.

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Chart 3: iPhone sales likely distorted Retail Sales

Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The key local release this week is the RBNZ Monetary Policy Statement on Thursday. The way the market has been behaving, a number of traders out there must be expecting the Bank to either reaffirm its neutral policy tone or come across more dovish. In our view, the risk is skewed in the opposite direction.

Since the RBNZ's August and September updates, the market has pushed out the projected first full tightening to February 2019 and the 2-year swap rate has nudged lower to 2.16%, near the bottom of the range over the past six months. Rates moved decisively lower after the formation of the new government. In the eyes of the market, the RBNZ can afford to take a more relaxed policy stance, driven by reform of the RBNZ Act.

It's a view we struggle to accept, with the expected modifications to the RBNZ Act unlikely to change much the RBNZ's reaction function, in our view. Furthermore, inflation pressures are building and the Bank's inflation forecasts must surely be higher than in August.

We see the RBNZ upgrading its inflation forecasts reflecting the higher starting point (Q3 CPI was 0.3 percentage points higher than the RBNZ forecast), higher oil prices, the much weaker NZD, a tighter labour market, and a much higher track for the minimum wage. The RBNZ will be well aware that fiscal policy will be much easier under the new government, but the lack of detail suggests that this is more of an upside risk factor for inflation than something the Bank can include in its forecasts.

Offsetting those upward forces for inflation, a possibly weaker growth path and weaker housing market can be added into the mix. Net migration is more of an unknown quantity. We've seen higher net migration help keep inflation contained as supply-side forces have overwhelmed demand-side forces. Weaker net migration, isn't necessarily a negative force for inflation.

A higher inflation track could lead the Bank to build in a projected earlier beginning to the tightening cycle. Or the Bank could simply underline the skewed risks to inflation, without wanting to make a judgement at this stage as to the outlook for rates. Whatever, the tone should come across as more hawkish (or less neutral) than the previous statement. We see the 2-year swap rate struggling to fall much further from here and the risks skewed to slightly higher rates before the end of the week. We're talking a fairly restrained sell-off, as rate hikes remain a distant prospect (August 2018 according to BNZ economists), and we still don't actually know who the RBNZ Governor will be, a key "unknown" in the mix.

The September-October sell-off in 10-year US Treasury yields looks done for now. Market conviction in the Fed hiking rates in December and through 2018 has increased as well as an improved prospect of some sort of tax reform package seeing the light of day. Despite all that, we've seen the US yield curve flattening, with the 2s10s spread narrowing to 72bps, the flattest since 2007, driven by lower 10-year rates. Debate rages on whether this is a sign of slower economic growth ahead or simply a reflection of the unusual low global rates backdrop that keeps demand for US long-dated Treasuries underpinned.

It is hard to see what the catalyst is over the near term to take the US 10-year rate beyond the 2.40% level. We probably need to see higher than expected inflation indicators, a complete turnaround from the trend over the past six months.

A higher inflation track and less neutral RBNZ might see some upward pressure on the NZ 5-year swap rate, which currently sits at 2.61%, near the lower end of its range this year. But against a backdrop of well-contained global rates, any sell-off this week should be modest.

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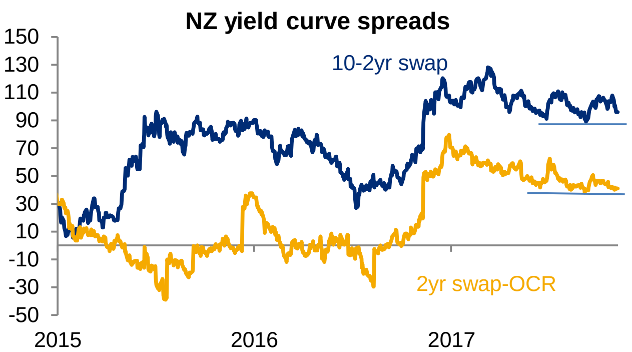
Curve Flattening Remains in Vogue



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.94	1.93 - 1.95
NZ 2yr swap (%)	2.16	2.15 - 2.22
NZ 5yr swap (%)	2.61	2.60 - 2.73
NZ 10yr swap (%)	3.12	3.11 - 3.26
2s10s swap curve (bps)	96	96 - 108
NZ 10yr swap-govt (bps)	27	20 - 28
NZ 10yr govt (%)	2.85	2.83 - 3.04
US 10yr govt (%)	2.33	2.29 - 2.48
NZ-US 10yr (bps)	52	50 - 64
NZ-AU 2yr swap (bps)	29	15 - 29
NZ-AU 10yr govt (bps)	28	16 - 28

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD showed signs of mild recovery last week, with gains around 0.5-1% on the key major crosses. Selling pressure brought on by domestic political fears now appears to be largely exhausted and fundamental forces might now be back in play.

CFTC net speculative positioning data showed the first net short positions in the NZD since June. Speculative accounts have been active sellers of the NZD over the past few months and the short positioning suggests a reduced hurdle for the currency to recover further. The NZD still looks modestly oversold to us on a short-term view.

We wouldn't rule out a return to a USD0.70 handle this week. The key local release will be Thursday's Monetary Policy Statement. Since the formation of the new government, the market has priced in a softer stance of NZ monetary policy, reflected in a pushing out of the first rate hike this cycle to February 2019, lower short-dated swap rates and a sell-down of the NZD. On that basis, there will be some traders out there expecting a more dovish stance from the RBNZ, a view we strongly disagree with.

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Elsewhere, the RBA is expected to maintain its neutral policy bias tomorrow, while Friday's Statement on Monetary Policy could see slightly lower near-term inflation forecasts. The contrast between the RBNZ and RBA statement should be helpful for the NZD/AUD cross to recover further.

The US data calendar is light, but there will be interest in how negotiations around the widely-anticipated tax bill proceed and Trump's trip across Asia will be widely reported.

Last week's announcement that Powell will replace Yellen as the Fed Chair was seen to be the "continuity" appointment, with no significant implication for the USD. The market is pricing a December Fed rate hike as almost a done-deal, despite soft inflation indicators, as the labour market continues to tighten, the economic data flow remains solid and financial market conditions remain easy. Over the past month, the Fed Funds market has been more willing to price in further hikes through 2018, which has helped support the USD, while some sort of tax reform also seems to be priced into the market. To the extent that USD pricing reflects these factors, the hurdle rate for further NZD/USD gains has been reduced.

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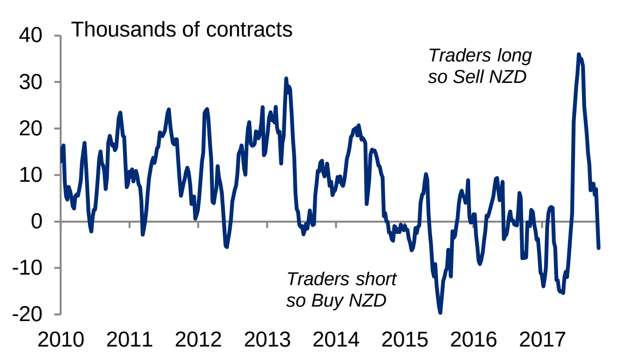
Speculators Now Net-Short NZD



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6911	0.6820 - 0.7180
NZD/AUD	0.9026	0.8860 - 0.9170
NZD/GBP	0.5281	0.5150 - 0.5450
NZD/EUR	0.5949	0.5810 - 0.6110
NZD/JPY	78.82	77.40 - 81.00

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7210	-4%
NZD/AUD	0.9120	-1%

Technicals

NZD/USD

Outlook:	Downside risk
ST Resistance:	0.7050 (ahead of 0.7200)
ST Support:	0.6820 (ahead of 0.6670)

While the long-term upward trend support line has been broken, the NZD has failed to break the support line around 0.6820, so this is a key level to watch. Initial resistance sits around 0.7050.

NZD/AUD

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

The currency has bounced off the key support level of 0.8875 nicely, a positive sign for now but too early to suggest a turning point. Initial resistance around 0.9170.

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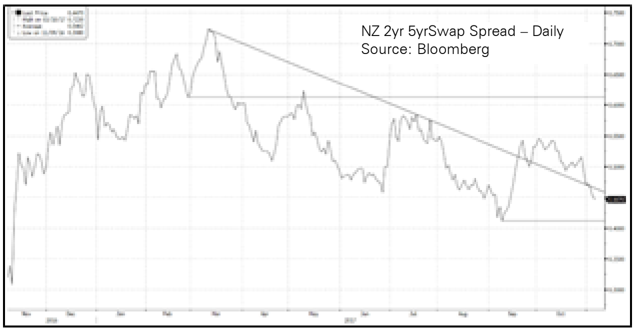
NZ 5-year Swap Rate

Outlook:	Neutral
ST Resistance:	2.83
ST Support:	2.61

Testing support at 2.61 should this be breached next level is 2.54

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

Outlook:	Neutral
ST Resistance:	+62
ST Support:	+41



Stopped out of steeper on a break of +48.5. Support now at +41 should hold near term.

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Key Upcoming Events

	Forecast	Median	Last
Monday 6 November			
NZ, ANZ Commodity Prices (world), October			+0.8%
NZ, RBNZ 2yr Inflation Expectations, Q4			+2.09%
Aus, ANZ Job Ads, October			flat
Aus, Inflation Gauge (Melbourne Institute), Oct y/y			+2.5%
Jpn, BOJ Minutes, 20/21 Sept. Meeting			
Euro, PMI Services, Oct 2nd est		54.9	54.9P
Euro, PPI, September y/y		+2.7%	+2.5%
Germ, Factory Orders, September		-1.1%	+3.6%
US, Fed's Dudley Speaks, Econ Club NY			
Tuesday 7 November			
NZ, Crown Financial Statements, 3m-to-Sept 2017			
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
Euro, Retail Sales, September		+0.6%	-0.5%
Germ, Industrial Production, September		-0.8%	+2.6%
US, JOLTS Job Openings, September		6,053	6,082
Wednesday 8 November			
NZ, NZ Parliament Opens			
NZ, Dairy Auction, GDT Price Index			-1.0%
China, Trade Balance, October		+CNY274b	+CNY193b

	Forecast	Median	Last
Thursday 9 November			
NZ, RBNZ MPS	1.75%	1.75%	1.75%
Aus, Housing Finance, September	+3.4%	+2.0%	+1.0%
China, CPI, October y/y		+1.7%	+1.6%
China, PPI, October y/y		+6.6%	+6.9%
Jpn, BOJ Summary of Latest Meeting, 30/31 Oct. Meeting			
Jpn, Machinery Orders, September		-2.0%	+3.4%
Jpn, Eco Watchers Survey (outlook), Oct		51.2	51.0
Euro, ECB Economic Bulletin			
Euro, EC GDP Forecasts			
Germ, Trade Balance, September		+€22.0b	+€20.0b
UK, Industrial Production, September		+0.3%	+0.2%
UK, RICS Housing Survey, October		+4%	+6%
UK, Trade Balance, September		-£4.6b	-£5.6b
US, Jobless Claims, week ended 04/11			229k
Friday 10 November			
NZ, Electronic Card Transactions, Oct	+0.4%	+0.5%	-0.1%
Aus, Qtly Monetary Statement			
Jpn, Tertiary Industry Index, September			-0.2%
US, Mich Cons Confidence, November 1st est		100.6	100.7

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.78	1.79	1.83	2.04
2mth	1.86	1.86	1.88	2.08
3mth	1.94	1.95	1.94	2.13
6mth	1.97	1.98	2.00	2.13
GOVERNMENT STOCK				
03/19	1.86	1.87	1.92	2.08
04/20	1.96	2.02	2.10	2.22
05/21	2.09	2.17	2.27	2.32
04/23	2.38	2.48	2.57	2.52
04/25	2.65	2.77	2.84	2.69
04/27	2.84	2.98	2.99	2.78
04/33	3.19	3.33	3.34	3.10
04/37	3.38	3.52	3.55	3.37
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	66	65	70	106
Nth America 5Y	53	53	54	76
Europe 5Y	49	51	57	74

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.16	2.16	2.21	2.23
3 years	2.32	2.33	2.41	2.35
4 years	2.47	2.50	2.59	2.45
5 years	2.61	2.66	2.75	2.55
10 years	3.12	3.20	3.26	2.92
FOREIGN EXCHANGE				
NZD/USD	0.6907	0.6876	0.7064	0.7344
NZD/AUD	0.9032	0.8944	0.9111	0.9504
NZD/JPY	78.76	77.83	79.61	76.71
NZD/EUR	0.5946	0.5902	0.6017	0.6651
NZD/GBP	0.5283	0.5207	0.5376	0.5924
NZD/CAD	0.8808	0.8824	0.8866	0.9816
TWI	73.6	73.0	75.1	78.7

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