7 August 2017

RBNZ To Hold

- RBNZ expected to hold OCR steady on Thursday
- Amid generally softer than expected data
- We contemplate pushing out our rate hike call
- ECT, PMI, food price and maybe REINZ housing data out this week

Thursday's RBNZ Monetary Policy Statement (MPS) sits head and shoulders above anything else on the local calendar in the coming week. We expect no change in the OCR, but there is a lot to consider.

Given all that has occurred since the May MPS, we see broad downward pressure coming on the Reserve Bank's inflation forecasts. In the first instance, this stems from a new, lower, starting point needing to be included as Q2 CPI undershot expectations. Recall that annual CPI inflation came in at 1.7% in Q2, below RBNZ forecasts of 2.1%. Core inflation measures also slipped a bit. Secondly, more downward pressure on RBNZ inflation forecasts will result when the stronger-than-expected NZD feeds into the projections. The TWI is currently tracking more than 3% above previous RBNZ projections.

Meanwhile, the housing market has been cooling under LVR restrictions and mortgage rates have been increasing independent of the OCR. For the latest on the housing market, keep an eye out for July's REINZ housing report that might see the light of day before the week is out and, if so, will probably reinforce the recent cooling tendencies. To date, the RBNZ has been more wary of a recharge in the housing market than showing any concern about the market potentially cooling more than anticipated.

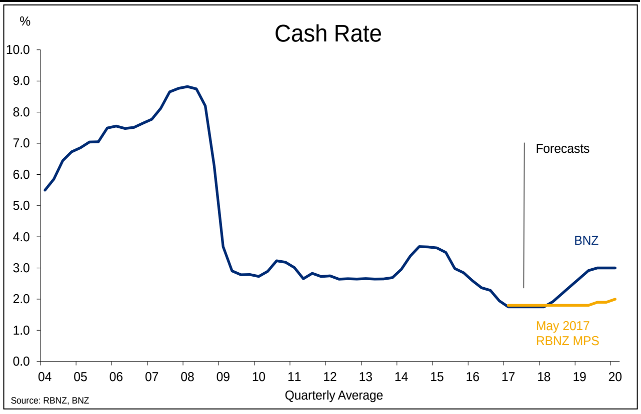
Last week's information played with the grain of being on the softer side of RBNZ forecasts. The balance of the Q2 labour market data was marginally weaker than RBNZ expectations, courtesy of private sector annual wage inflation not rising as fast as the Bank anticipated. This all pushes in the direction of a cut. Meanwhile, focus on domestic political uncertainty has intensified as the 23 September election looms.

There have been some positives too. Fonterra has lifted its milk price forecast on the back of solid offshore prices. This is one component of a positive outlook for the terms of trade, which, in part, justifies the strength in the currency. And there is the prospect of much easier fiscal policy than previously anticipated to factor in. Oil prices have recouped losses to be back at levels prevailing at the time of the MPS.

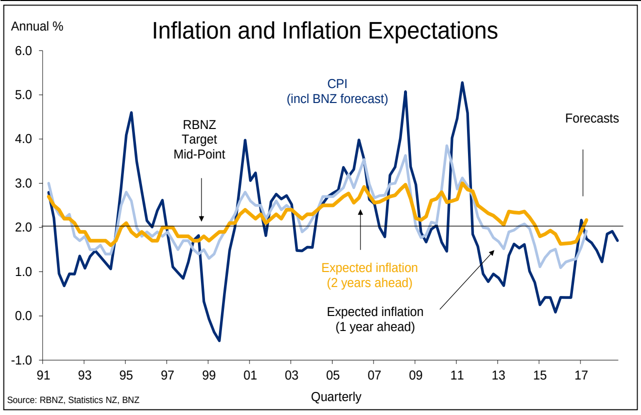
Overall, the chance of a mid-2018 hike is diminishing. At the very least, the balance of information suggests it is highly unlikely that the RBNZ would move to a hawkish stance from its firmly neutral position in May (and maintained in June). Indeed, it's almost certain we will push out our own May 2018 rate hike call but will wait for Thursday's MPS before making a final decision on that

We don't think the RBNZ will cut. There was no clear sense of material movement away from the Bank's neutral stance in a recent speech by RBNZ Assistant Governor and Head of Economics, John McDermott. While the Bank might feel the need to respond to the recent information flow with an easing bias – and there is a risk it does – we believe it will prefer to stick with its on-hold message for the meantime. So we shouldn't expect much, if any, change to the Bank's central cash rate projections, which, recall, were dead flat out to mid-2019 in the May Statement. We wouldn't be surprised to see previous guidance being maintained 'Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly'. The risk, however, is for something that

Rates On Hold



Will These Pullback?



looks a bit more dovish. But as stated, the current guidance would keep the Bank's future options open. Note it is RBNZ Governor Graeme Wheeler's final MPS before his term ends on 26 September

Turning to the data for the week, this afternoon's Q3 RBNZ Survey of Expectations will be mostly watched to see what 2-year-ahead inflation expectations does post its lift to 2.17% in Q2. It is a fair move higher from Q1's 1.92% and Q4's 1.68%. It was the biggest six month lift in this series since 1990. We wonder if it might ease back a touch this quarter following the dip in actual Q2 CPI inflation and push higher in the NZD. An edge lower would play to the idea of the RBNZ sounding cautious on Thursday, but recall that the Bank has been downplaying the reliability, and hence relevance, of this indicator of late.

After the MPS on Thursday we get July's electronic card . transactions. There is a lot to think about with these, including the hangover from the Lions rugby tour as well as lower petrol prices in the month. With such things in mind, we are going for just a 0.3% increase in July's transaction values; matching market expectations. This would see the annual expansion holding at around 4%. It would be enough to keep our solid expectations for Q3 real retail sales growth intact, following would looks to have been a moderate gain off around 0.6% in Q2 (the latter data due next Monday).

Friday's Performance of Manufacturing Index for July will be lined up against a run of robust readings including June's 56.2, while July's Food Prices release on the same day are expected to dip slightly as part of our calculations for Q3 CPI that currently sit at +0.2% q/q and +1.7% y/y. The latter currently sits 0.4% below the RBNZ's 2.1% forecast for Q3 2017 CPI inflation pending Thursday's updated MPS forecasts.

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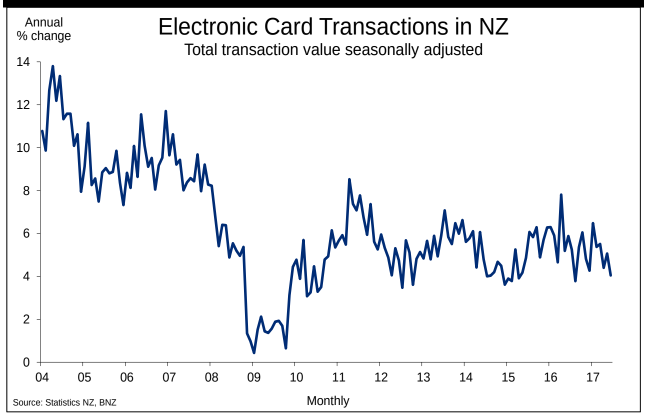
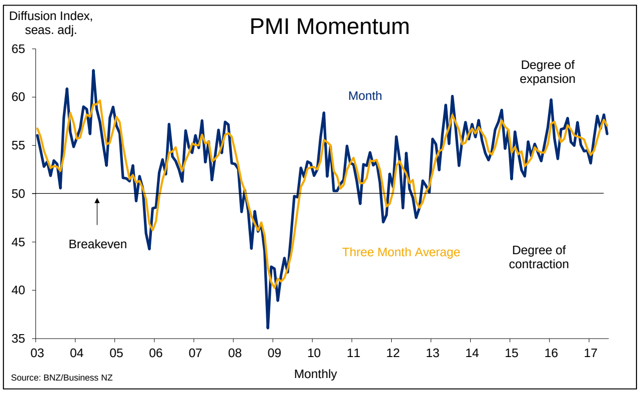
Spending Growing At Around 4% pa



Positive



Global Watch

- US CPI on Friday looks the feature in a quiet week.
- China releases trade on Tuesday; CPI, PPI on Wednesday.
- RBA Governor Lowe's testimony, confidence indicates the AU focus.
- Limited data out elsewhere.

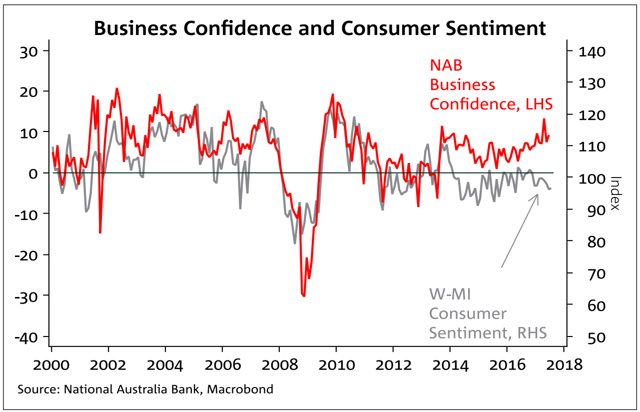
Australia: It's a combination of focus on the business-consumer divide this week as well as the RBA again with Governor Lowe's Semi-Annual testimony to the House Economics Committee on Friday, in Melbourne. (NB: Today is a bank holiday in Sydney.)

Initial focus for the week gets underway with the NAB Business Survey for July released tomorrow. Not only have Business Conditions been pushing higher to June, but Business Confidence has also risen to above average levels, in contrast to the more cautious spirits of the consumer, the Westpac-Melbourne Institute measure of Consumer Sentiment (out Wednesday) is running somewhat below its long term average.

The NAB Business Survey has also been reporting a broader-based uplift in business activity, with trend increases in trading, profitability, and employment. The latter has been pointing to continued rises in prospective employment, the July ABS Labour Force report not due until the week after. Also out on Wednesday is the Housing Finance report for June, a report that tends to draw only limited market interest at most, following as it does the RBA credit report.

Friday's House testimony from RBA Governor Lowe will be a focus for the week, offering as it does the opportunity for Committee MPs to quiz the Governor and his team on the economy and monetary policy. The Governor's Opening

Chart 1: Mind the gap –The business-consumer divide



Statement will be a potted summary of the refreshed assessment and outlook outlined in last week's post-Board Media Release and Statement on Monetary Policy (SoMP).

While the SoMP offered little in terms of material changes to the Bank's forecasts for growth, inflation, and unemployment, it's the risks around those forecasts that will likely draw interest. Most recently, it's been the higher AUD that's drawn the market's attention and the 59 words that the Media Release devoted to outlining some of the economic growth and inflation impacts. No doubt he'll be quizzed and pressed further on this and what the policy consequences might be. The state of housing markets across the country, the labour market, international events, geopolitics, and the growth journey of the Chinese economy could be further topics of interest. And how confident is the RBA getting inflation back into the 2-3% band on a sustainable basis?

RBA Assistant Governor (Financial Markets) Chris Kent is also speaking next week, on Wednesday morning at a Bloomberg conference

China: The July Trade (Tuesday) and CPI/PPI (Wednesday) will be the main interest ahead of the key July activity reports the week after. The July money supply, new lending and aggregate financing reports are due any day from Thursday.

US: The highlight in market interest will undoubtedly be Friday's July CPI report, the market looking (again) for a one tenth step up in core CPI to 0.2% m/m. Wednesday's Q2 Productivity/Unit Labour costs are a watch point for the Fed if not the market. Fed speeches populate the calendar a little more, with speeches from Bullard (Monday), Kashkari (twice, Monday, Friday), Dudley (Thursday, opening remarks only at a press briefing), and Kaplan (Friday).

Japan: A quiet data week with Machine Tool Orders (Wednesday) and Machine Orders (Thursday) the picks among a smattering of releases.

Eurozone: Germany's June Industrial production (Monday) should reflect strong business conditions; France's own is out on Thursday.

UK: Further focus on the economy's condition with Industrial Production, Construction Output, and Trade on Thursday, all after the watched RICS House Price Balance report for July on Thursday.

Canada: Housing Starts (Tuesday) and Building Permits (Wednesday) the picks in a quiet week.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

Monetary policy remains clearly on hold in NZ, the only question is for how much longer. According to market pricing, any hike remains a distant prospect (over a year away) and according to the RBNZ, the first rate hike for the cycle will be even further away. One just needs to bear this in mind when reading through this Thursday's Monetary Policy Statement. Throw in two changes in leadership at the RBNZ by March 2018 and the (medium-term) forward guidance by the RBNZ will need to be taken with a smaller grain of salt than usual.

We expect the key final paragraph in the press statement to remain unchanged. "Monetary policy will remain accommodative for a considerable period. Numerous uncertainties remain and policy may need to adjust accordingly". The underlying message will be that the RBNZ is in no hurry to join some other major central banks in looking to remove policy accommodation. In fact, we expect inflation forecasts to be reduced a little, reflecting the strength of the NZD more than offsetting any possible inflationary impulse from stronger terms of trade and the lower starting point for the forecasts given the downside surprise to Q2 CPI.

At the margin, the tone of the Statement and Governor Wheeler's press conference could come across as slightly more dovish than the May Statement. But this shouldn't surprise the market, with some anticipation of that tone leading up to the Statement. This has led the market to push out the first full tightening to September 2018, while the 2-year swap rate is trading at the bottom end of its range this year. It's hard to argue with market pricing and we expect the RBNZ's tone to support current (low) short-end rates. We see the post MPS reaction for rates as slightly skewed to the downside, with more chance of a dovish than hawkish surprise. But the Bank is likely to be fairly content with market pricing at this juncture, which has seen market pricing for hikes pushed out into the distant future.

Apart from the RBNZ's MPS, there are few other highlights this week. Across the Tasman, RBA Governor Lowe delivers his semi-annual testimony to lawmakers on Friday. On paper, there shouldn't be any surprises as it follows last Friday's Statement on Monetary Policy, but there is the risk of market over-reaction to comments around the AUD and the RBA's (neutral) policy outlook. The Australian short end rate curve is even flatter than NZ, with the first full rate hike not priced in until early 2019.

There is only one other release of note this week worth highlighting and that is Friday night's US CPI release. After four months of surprising to the downside, the risk is growing of a positive surprise and that would deal a blow to the US Treasury market, coming hot on the heels of last Friday's strong employment report. There remains a degree of scepticism about the future path of US policy tightening, with less than a full rate hike priced for the next 12 months. We think that before the end of the year, we'll see evidence of inflation ticking back higher alongside a strong labour market, providing the Fed some cover to raise rates again in December.

The US 10-year Treasury rate is trading near the bottom end of its 2.20-2.40% trading range for the past month and speculative positioning data still shows significant long positions in 10-year futures, making long end rates vulnerable to the upside on any positive economic data.

The combination of a pushing out of RBNZ tightening expectations and lower global rates see NZ's 5-year swap rate trading near the bottom of the range for this year. We suspect that any further reduction will be hard to come by and the bigger risk by year-end is some modest reversal of recent rate declines.

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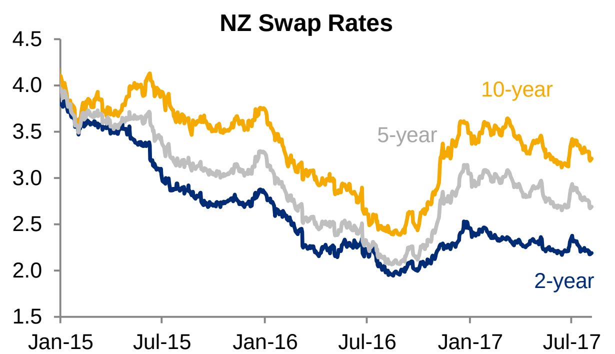
Rates Close to the Bottom of the Range This Year



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.95	1.92 - 1.97
NZ 2yr swap (%)	2.22	2.20 - 2.33
NZ 5yr swap (%)	2.77	2.75 - 2.91
NZ 10yr swap (%)	3.29	3.26 - 3.42
2s10s swap curve (bps)	107	105 - 111
NZ 10yr swap-govt (bps)	30	30 - 40
NZ 10yr govt (%)	2.99	2.90 - 3.03
US 10yr govt (%)	2.29	2.22 - 2.39
NZ-US 10yr (bps)	70	62 - 70
NZ-AU 2yr swap (bps)	31	23 - 38
NZ-AU 10yr govt (bps)	30	21 - 30

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD fell last week on all the key crosses, down 1½% against the USD, JPY, EUR and CNY and down ½% against the AUD and GBP. NZ HLFS employment growth was much weaker than expected, but the rest of the labour market data suggested a tightening labour market and hints of wage inflation bottoming out.

The market reaction wasn't deserved based on the data alone, but it was a good excuse to sell the NZD, after its blistering run heading towards the end of July. Net speculation positioning remains extremely long NZD (close to a record high), making the currency vulnerable to the downside on any negative news. The move up through USD 0.75 proved to be a step too far. The NZD has settled around 0.74, helped by a strong US employment report that keeps alive the prospect of another rate hike later this year, although the market remains fairly sceptical.

We see the bias for the week ahead remaining to the downside for the NZD. Thursday's Monetary Policy Statement shouldn't offer much support for the NZD. The underlying message will be that the RBNZ is in no hurry to join some other major central banks in looking to remove policy accommodation. In fact, we expect inflation forecasts to be reduced a little, reflecting the strength of the NZD more than offsetting any possible inflationary impulse from stronger terms of trade.

Q2 CPI undershot RBNZ expectations, leading to a lower starting point for the inflation projections and, importantly, the RBNZ's preferred measure of core inflation – based on it's sectoral factor model – showed annual inflation slipping further away from the 2% mid-point target, at just 1.4%.

We doubt the RBNZ will up the rhetoric on the NZD. At the June OCR Review, when the NZ TWI was trading close to the current level, the Bank stuck to the facts, noting the prior increase in the TWI, partly explained by higher export prices. The Bank merely suggested that "a lower NZD would help rebalance the growth outlook towards the tradeables sector". We expect similar language.

Overall, the Bank's Statement should read slightly more dovish than the May Statement, but this shouldn't surprise the market. From a relative monetary policy perspective the Bank's stance likely won't be lending any support to the NZD through the rest of the year.

The global data calendar is fairly sparse this week. We could well see tight trading ranges for the NZD for most of the week, at least leading up to the MPS. The key US release is the CPI due Friday night. After four months of surprising to the downside, the risk is growing of a positive surprise and should that occur it would be USD-supportive.

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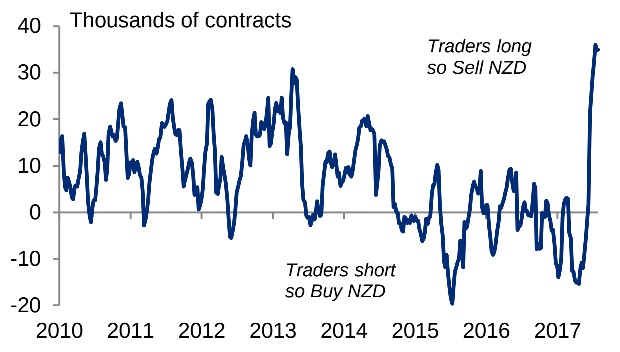
Net Speculative Positioning Extremely Long NZD



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7403	0.7330 - 0.7560
NZD/AUD	0.9346	0.9220 - 0.9460
NZD/GBP	0.5678	0.5560 - 0.5750
NZD/EUR	0.6288	0.6240 - 0.6440
NZD/JPY	81.99	81.70 - 83.90

*Indicative range over last 3 weeks, rounded figures

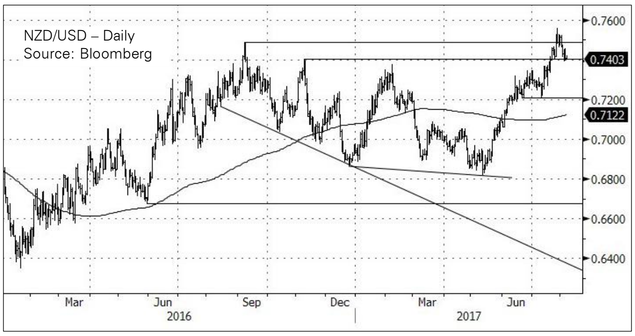
BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7660	-3%
NZD/AUD	0.9240	1%

Technicals

NZD/USD

Outlook: Top of the range
ST Resistance: 0.7490 (ahead of 0.7550)
ST Support: 0.7200 (ahead of 0.7100)



The NZD broke through the September 2017 peak of 0.7490, but it wasn't a convincing move and it has come off sharply. So 0.7490 remains the first line of resistance ahead of the 0.7550 peak towards the end of July. Support levels remain much lower, some 2 cents away at 0.7200.

NZD/AUD

Outlook: Trading range
ST Resistance: 0.9425 (ahead of 0.9500)
ST Support: 0.9250 (ahead of 0.9200)

Remains a messy technical picture, with few key levels to get excited about. We'll call 0.9250-0.9425 the key technical range for lack of any better idea.

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NZ 5-year Swap Rate

Outlook: Neutral
ST Resistance: 2.88
ST Support: 2.63

Broke through trend line support last week. Next level is 2.63 & resistance has been lowered to 2.88. A break of 2.63 would signal a significant move.

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

Outlook: Steeper
ST Resistance: +72
ST Support: +45

Still expect move steeper stop on break of +45.

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Key Upcoming Events

	Forecast	Median	Last
Monday 7 August			
Aus, ANZ Job Ads, July			+2.7%
Aus, Construction PMI (AiG), July			56.0
Germ, Industrial Production, June		+0.2%	+1.2%
Tuesday 8 August			
Aus, NAB Business Survey, July			+9
China, Trade Balance, July		+¥292b	¥294b
Jpn, Eco Watchers Survey (outlook), July		50.9	50.5
Germ, Trade Balance, June		+€23.0b	+€22.0b
US, NFIB Small Business Optimism, July		103.5	103.6
US, JOLTS Job Openings, June		5,700	5,666
Wednesday 9 August			
Aus, Housing Finance, June		+1.5%	+1.0%
Aus, Consumer Sentiment - Wpac, August			96.6
China, CPI, July y/y		+1.5%	+1.5%
China, PPI, July y/y		+5.6%	+5.5%
US, Productivity (non-farm), Q2 saar 1st est		+0.7%	flat
US, Wholesale Inventories, June 2nd est		+0.6%	+0.6%P

	Forecast	Median	Last
Thursday 10 August			
NZ, (circa) REINZ Housing Data, July			
NZ, Electronic Card Transactions, July	+0.3%	+0.3%	+0.1%
NZ, RBNZ Monetary Policy Statement	1.75%	1.75%	1.75%
China, (circa) Aggregate Financing (RMB), July		¥1,000b	¥1,780b
Jpn, Tertiary Industry Index, July		+0.2%	-0.1%
Jpn, Machinery Orders, June		+3.7%	-3.6%
UK, Industrial Production, June		+0.1%	-0.1%
UK, RICS Housing Survey, July		+9%	+7%
UK, Trade Balance, June		-£2.5b	-£3.1b
US, Jobless Claims, week ended 05/08		240k	240k
US, PPI ex-food/energy, July y/y		+2.1%	+1.9%
Friday 11 August			
NZ, Food Price Index, July			+0.2%
NZ, BNZ PMI (Manufacturing), July			56.2
Aus, Lowe Testifies, Semi-annual			
Germ, CPI, July y/y 2nd est		+1.7%	+1.7%
US, CPI ex food/energy, July y/y		+1.7%	+1.7%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.86	1.83	1.86	2.19
2mth	1.91	1.89	1.93	2.23
3mth	1.95	1.95	1.99	2.25
6mth	2.00	2.00	2.02	2.23
GOVERNMENT STOCK				
12/17	1.78	1.77	1.81	1.79
03/19	1.89	1.93	2.10	1.78
04/20	2.03	2.11	2.30	1.82
05/21	2.18	2.26	2.42	1.84
04/23	2.49	2.58	2.71	1.91
04/25	2.74	2.83	2.92	2.03
04/27	2.90	2.99	3.03	2.15
04/33	3.28	3.34	3.37	2.48
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	75.75	77	84	109
N. AMERICA 5Y	57.78	58	60	72
EUROPE 5Y	51.73	52	56	68
SWAP RATES				
2 years	2.19	2.22	2.37	2.03
3 years	2.36	2.42	2.59	2.04
5 years	2.69	2.77	2.92	2.13
10 years	3.21	3.29	3.42	2.44

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7408	0.7516	0.7343	0.7198
NZD/AUD	0.9342	0.9413	0.9550	0.9476
NZD/JPY	82.07	83.09	82.49	73.70
NZD/EUR	0.6287	0.6396	0.6429	0.6444
NZD/GBP	0.5678	0.5719	0.5643	0.5449
NZD/CAD	0.9367	0.9360	0.9527	0.9395
TWI	78.28	79.31	78.76	76.60

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