9 October 2017

Laboured NZ First Negotiations of National Importance

- **NZ Government announced Thursday?**
- **Migration outcomes of great interest**
- **Retail spending and housing moderating**
- **Manufacturing battles on**
- **More food for thought on inflation**

The final votes are in and, as expected, both the Green and Labour Parties picked up an extra seat at the expense of National losing two. At the margin, this increases the likelihood that New Zealand First can form a Government with the Left, as the combined total of seats in the House, under a Greens-Labour-NZ First coalition would be 63 – a much more workable majority (in a 120 seat parliament) than the 61 delivered on election night. But this is only a small shift. The final outcome still depends on whether New Zealand First decides to lean left or right.

There is a multitude of factors that will drive the final determination but, at the most basic level, New Zealand First has to decide whether to go with: the party whose policies are closest to its own (Labour) or the team which they find easiest to negotiate with on a day to day basis (National rather than the two party mix of Labour and Green). And overarching this decision is where can New Zealand First make the most visible difference such that it can remain a political force at the time of the 2020 election – a task made that much more difficult by the fact that current leader, Winston Peters appears increasingly unlikely to lead the party into the next plebiscite.

Policy issues aside, Labour is pushing the barrow that there has been a big swing to the Left amongst voters while National contends that the voter outcome shows sustained support for a right-leaning government. They both have a point. The bar chart below shows the movement between parties, while the pie chart above shows the current state of play. There is no doubt that Labour is the big winner in this election but, equally, only 4 of the 14 seats that it gained came from National while 6 came from the Greens.

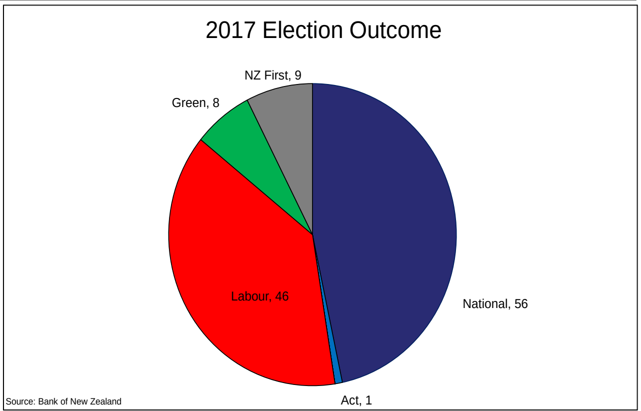
We have written previously about what a change to a Labour-led Government might mean so we won't repeat ourselves at this stage, particularly as we don't yet know whether the Government will have a blue or red centrepiece. What we can say, though, is that New Zealand First will (whether in Government or on the cross benches) influence policy.

In our opinion, the impacts on policy that will be most likely are:

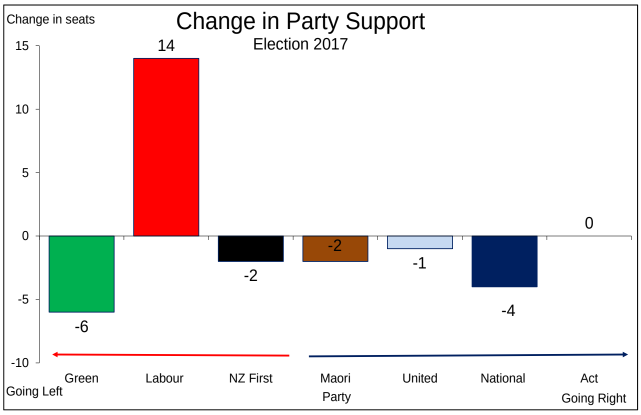
- the age of entitlement to superannuation payments capped at 65;
- more entitlements for the elderly;
- tighter rules on foreign ownership of New Zealand assets;
- tighter rules on migration;
- some alteration to the RBNZ's policy framework.

The thing that most economy watchers seem most interested in is the potential for net migration to decline under NZ First influence. We believe this is an inevitable outcome but stress that we also think net migration will moderate anyway. The net migration inflow for the year ended August 2017 was just over 72,000. Our current forecasts are predicated on a similar inflow over calendar 2018 before dropping steadily to 35,000 over the following four years. One assumes that there is room for give and take on both sides of any negotiation so it would be

National still the major party



A shift to the left



reasonable to hope that some middle ground can be reached between what is perceived as an extremist NZ First position and the status quo.

It looks like the RBNZ will move to some form of committee decision-making process no matter the hue of government. The exact form of the committee will depend on whether National or Labour rule the roost. With New Zealand First's influence some wording changes to the Policy Targets Agreement can be expected though we doubt that the parties focus on the exchange rate will be implemented in any meaningful way.

More generally, it needs to be remembered that minor parties don't set the political and policy agenda they, instead, block policies they don't like and negotiate for policy compromises where and when they can.

Whatever the outcome, we expect to see an announcement on Thursday of this week. This is Winston Peters' self-imposed deadline for a decision. It would appear to be in National and Labour's best interests to sign up to this deadline as well, though we do stress that either of the major parties could yet force a delay in proceedings. The outcome really could go either way but if we had to make a call we'd lean ever so slightly to a National-led Government.

Other domestic developments this week will pale in significance but the host of partials that are being released is worthy of some respect as concerns that economic momentum may be peaking increase.

On Tuesday we get an update on September month retail spending. We are expecting a 0.4% increase in both headline and retail electronic card transactions spending. The value of retail spending has now fallen for four consecutive months and we are looking for a bounce-back to ameliorate concerns that household expenditure is under pressure. Were we to get another negative reading it would question our generally optimistic view for the sector.

One of the reasons retail spending may be coming under pressure is the deteriorating state of the housing market. Residential construction growth is stalling, which reduces the demand for big ticket items. At the same time, reduced turnover in house sales and moderating house price inflation will also have an adverse impact.

We should get a further look at the state of play in the existing housing stock with the release of REINZ's latest data due sometime this week. There will be particular interest in the under-pressure markets of Auckland and Christchurch and whether there are spillover impacts into the rest of the economy. We are looking to some stabilization in house prices with an annual drop in turnover of around 20%. The results will, of course, be impacted by pre-election uncertainty though we don't buy into the argument that this is having a major impact on the market.

On Wednesday, we get an update on the state of tourism with August data for accommodation. We expect these data to show ongoing signs of capacity constraint as tourism numbers remain lofty while significant under-way hotel construction is yet to be completed.

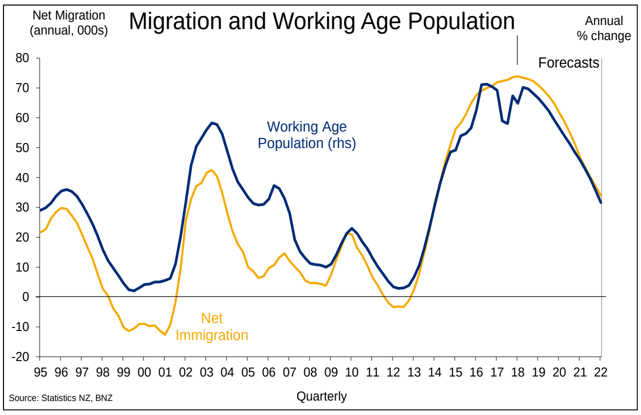
The latest food price data are released on Thursday. We have assumed that food prices drop 0.4% in the month largely due to an unwind of previously storm-impacted fruit and vege prices. But food prices have been surprising to the upside of late. Any further surprise in this direction would add to our belief that both Q3 and Q4 CPI inflation will prove higher than that forecast by the RBNZ in its August Monetary Policy Statement.

Also on Thursday is the ANZ's consumer confidence reading. We would not be surprised if the October outcome was down on September as this indicator has been running super-high compared to other consumer confidence measures and relative to actual retail sales.

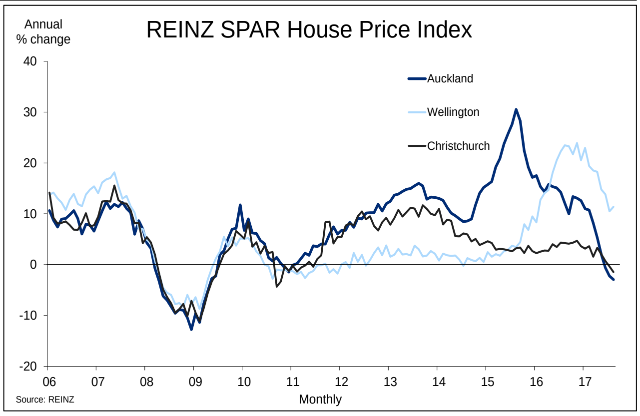
Last, and definitely not least, is Friday's PMI. We have been surprised by the resilience of this indicator in the face of political uncertainty, construction sector growth moderation and capacity constraints. We expect some moderation from August's 57.9 outturn but, equally, anticipate that both the headline reading and its sub-components will confirm that the sector, and the economy as a whole, remains on a fairly firm footing.

stephen_toplis@bnz.co.nz

Net migration peaking



House prices under pressure



Global Watch

- **Tuesday's NAB business survey in focus**
- **US data include CPI and retail sales**
- **Plus a fair few Fed speakers to note.**

Australia: Tuesday sees the release of September's NAB Business Survey, followed Wednesday with the monthly WMI Consumer Sentiment Survey. With financial stability very much part of monetary policy considerations, there'll be understandable interest in Friday's RBA Financial Stability Review and its characterisation of the housing market and household debt. The RBA's Debelle also speaks on Tuesday, but is expected to have little monetary policy relevance with the topic being the FX Global code of conduct.

As for the NAB Business Survey, we only state what happened in the previous release. In August, Business Conditions continued their solid run, while business confidence took a hit. Business conditions rose 1 point to hit +15 index points, the highest level since early 2008 and significantly higher than the long run average level.

Most industries performed well, but retail remained a concern, also evident in last week's Retail Trade report. August's NAB Survey revealed a notable jump in employment, followed up by another strong employment report. There was also a lift in a number of inflation measures from the Survey.

As for Consumer sentiment, it lifted 2.5% last month to an index level of 97.9, just 2% below its long term average and not in fact materially different from the most recent reading on Business Confidence (that pulled back in August). Last week's disappointing Retail Trade very much played to the tune of a still wary consumer, though it's not clear whether the pull-back in Sales reflected a more cautious tone of spending (say in the wake of higher gas and electricity prices), heightened discounting of supermarkets, or "normal" month-to-month or even quarter-to-quarter variations in volumes.

China: China comes back after its Golden Week holidays with the Caixin Services/ Composite PMIs on Monday, then quiet until International Trade on Friday. Money supply/lending for Sep is due any day from Tuesday. Foreign reserves are due today.

Chart 1: Is consumer sentiment that weak?

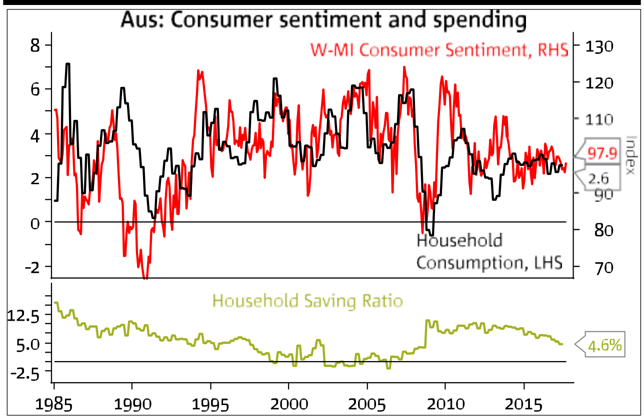
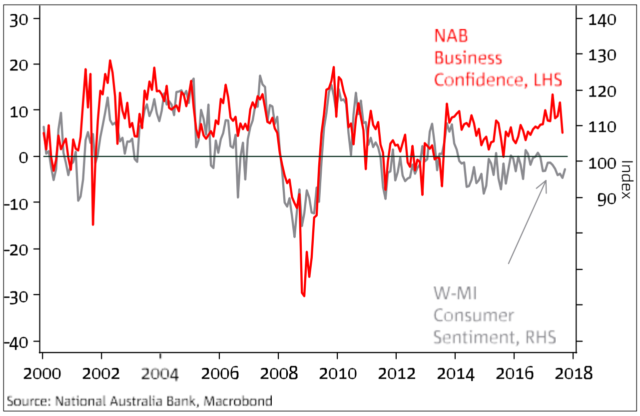


Chart 2: Tentative signs of convergence



US: It's quiet for data ahead of PPI on Thursday, then CPI and Retail Sales on Friday – this should see core CPI up another 0.2% and Retail sales rebound. There are numerous Fed speeches scheduled between now and the end of this week (but not Yellen), along with the minutes from the 20 September FOMC meeting.

Japan: A light local data week for yen watchers; Tuesday's Current Account the pick.

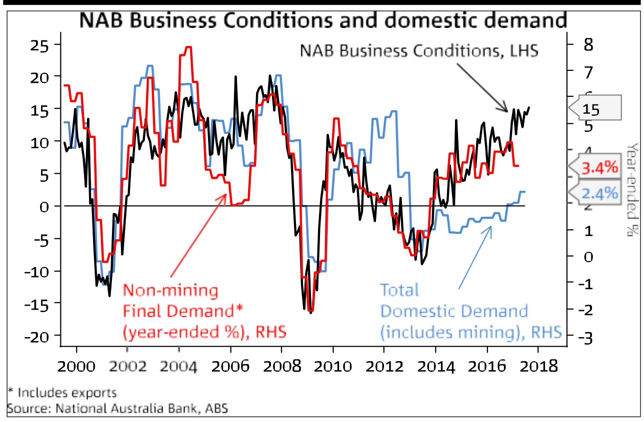
Eurozone: Very quiet for data; there will be some interest in ECB Chief Economist's Praet's speech on Wednesday in New York.

UK: There will be some economy focus with Industrial Production and Trade on Tuesday, with some interest too in Thursday's RICS House Price balance.

Canada: For the coming week, it is mostly second tier data. The BOC's Wilkins speaks twice in Washington, on an IMF panel on Tuesday and on an IIF panel on Thursday.

david.degaris@nab.com.au

Chart 3: Positive business and economic momentum



Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The NZD has proven to be jumpy on NZ political headlines but the rates market is taking a potential change in government in its stride. In the lead-up to the election, when polls swung towards Labour, the NZD fell and when polls swung towards National the NZD rose. There was another knee-jerk downward reaction to the NZD after special votes showed National lost 2 seats to the Labour-Greens bloc, even though this outcome was widely expected.

Back in the real world, fixed income investors remain unperturbed by the prospects of either a National-led or Labour-led government, with NZ First holding the balance of power. Short-term rates remain well anchored by expectations of unchanged monetary policy for some time. Long-rates remain at the mercy of global forces. And NZ-Australia and NZ-US bond spreads show no sign of a political risk premium being built into the market.

The NZ-Australia 10-year government bond spread currently sits at a tight 15bps, while the NZ-US spread sits around 60bps. Rather than NZ political forces being a factor on the market, spread contraction at the long end has largely followed the same spread contraction at the short end. Against a backdrop of steady (flat) expectations for NZ monetary policy, the market has become more confident in US Fed hikes ahead, and has been pricing in an increasing chance of the RBA tightening policy next year.

We think that these moves have been justified. A couple of months ago, our colleagues at NAB moved to factor in two rate hikes by the RBA next year and our projections for Fed rate hikes have consistently been above market pricing.

The RBNZ's resolve to keep policy unchanged for an extended period will be tested once new (easier) fiscal policy is added into the mix. But we aren't at that point yet, with a new government yet to be formed and a new Budget yet to be formulated. There's also the uncertainty around who the next RBNZ Governor will be and what the Policy Targets Agreement will be.

So as long as global forces are lifting global rates, there will be some stickiness to NZ rates, which keeps downward pressure on NZ-global rate spreads. We don't see much implication for the rates market from a possible change of government. It's all "at the margin" stuff, with no likely material impact. Fiscal policy will be easier whatever the new government configuration and NZ's Fiscal Responsibility Act ensures that any new government must be fiscally responsible.

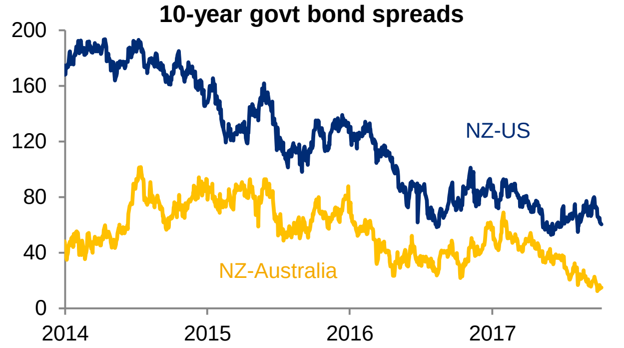
In the week ahead, the market will have one eye on Thursday's likely announcement by NZ First leader Winston Peters. Globally, the focus will be on US CPI data on Friday night and the large number of Fed speakers in force this week. We see the US CPI friendly to the idea that the Fed will be hiking in December and through next year.

The US 10-year rate met some resistance at 2.40% at the end of last week and that level remains in focus. A sustained break would open up a test of the 2.60% area. But as the new week begins, Trump's provocative comments at the end of last week and tweets over the weekend regarding North Korea act as a moderating influence on the uptrend in US bond yields.

On balance, global forces mean that we continue to see the risks skewed to the upside for NZ 5 and 10-year swap rates, with a test of 2.90% and 3.40% not ruled out for later in the year.

jason.k.wong@bnz.co.nz

NZ-Global 10 year Spreads Narrow



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.95	1.93 - 1.96
NZ 2yr swap (%)	2.22	2.19 - 2.28
NZ 5yr swap (%)	2.76	2.69 - 2.82
NZ 10yr swap (%)	3.27	3.18 - 3.32
2s10s swap curve (bps)	105	99 - 108
NZ 10yr swap-govt (bps)	31	23 - 31
NZ 10yr govt (%)	2.96	2.94 - 3.08
US 10yr govt (%)	2.36	2.21 - 2.40
NZ-US 10yr (bps)	60	60 - 80
NZ-AU 2yr swap (bps)	20	14 - 20
NZ-AU 10yr govt (bps)	15	12 - 23

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

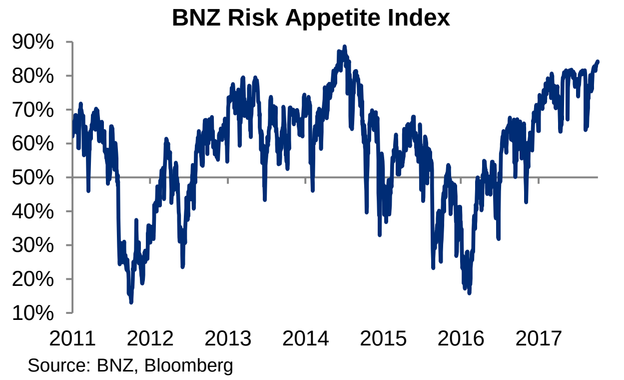
The NZD underperformed last week, falling by 1-1½% on the major crosses except for a 1% gain against the weak GBP. We saw the fall as inexplicable against the backdrop of high risk appetite, with our index reaching a fresh high for the year. A softer than expected GDT dairy auction can only partially explain the weaker NZD. The NZD opened the new week softer in reaction to the counting of special votes which saw National lose two seats to the Labour-Greens bloc. That result was widely expected and our usual missive of fading any politically-motivated currency reaction applies.

Given the inexplicable underperformance of the NZD last week one might see a skewed knee-jerk reaction when Winston Peters decides which form of government to back, likely to come on Thursday. The NZD could see a bigger positive reaction on the announcement of a National-NZ First government than a negative reaction to a Labour-Greens-NZ First combo.

Of course, there are still a number of permutations to consider, including NZ First remaining on the cross-benches. Our view continues to be to fade any knee-jerk reaction, whatever the final make-up of government. There are many offsetting implications for the NZD on the form of the government and it is just not clear which way it should travel. At the end of the day, global forces will determine the medium-term path of the NZD, not NZ political forces, given the fairly modest gap in macroeconomic policies between the two competing political blocs.

The key global release this week is the US CPI, but it won't be coming out until Friday night. The odds favour a further pick-up in inflation, boosted by higher oil prices and a reversal of the temporary factors that kept core inflation lower than otherwise. The data should support the view that the Fed will hike again in December and add to support for the USD.

Surely Risk Appetite Must Fall From Here



Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7067	0.7050 - 0.7430
NZD/AUD	0.9087	0.9100 - 0.9250
NZD/GBP	0.5390	0.5340 - 0.5460
NZD/EUR	0.6022	0.6040 - 0.6190
NZD/JPY	79.52	79.80 - 82.80

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7640	-8%
NZD/AUD	0.9170	-1%

The market will be on high alert for an announcement of the new Fed Chair, which could come any time this week or next. It looks like a race between current Governor Powell, which would provide some continuity from current Chair Yellen, and Warsh who would be seen, rightly or wrongly, as taking the Fed down a more hawkish path and seeing a knee-jerk positive USD reaction.

The other variable to consider as the new week begins is the ongoing tensions between US and North Korea. Trump continues to tease North Korea, implying that military action is now the only path forward. It's a dangerous game, with any misstep or misunderstanding resulting in a catastrophic outcome. It's enough to keep a lid on risk appetite this week.

While political risk overhangs the NZD, the same can be said for EUR and GBP. Catalan's desire for independence from Spain remains in the background, while in the UK PM May's position continues to look tenuous. At the end of last week the FT reported that Germany and France have dashed British hopes of fast-tracking talks on a two-year post-Brexit transition deal, insisting that the UK's EU divorce bill be resolved first. An unstable UK government and tough Brexit talks ahead are doing no favours to GBP.

Overall, we see competing forces on the NZD. It looks oversold at present, and probably ought to be trading around USD 0.73-0.74, given where risk appetite sits at present (our FV level of 0.76, adjusted for its upside bias this year). But then, risk appetite should surely fall from its highly elevated level? And USD forces are currently positive. Our year-end projection of 0.70 has been based on lower levels of risk appetite prevailing and a stronger USD. It looks like that milestone could be reached ahead of time, based on current trends.

jason.k.wong@bnz.co.nz

Technicals

NZD/USD

Outlook: Downside risk

ST Resistance: 0.7200 (ahead of 0.7350)

ST Support: 0.6950 (ahead of 0.6820)

Support levels continue to be broken as the NZD heads south. The next area of trendline support is around 0.6950, ahead of this year's low around 0.6820.

NZD/AUD

Outlook: Trading range

ST Resistance: 0.9230 (ahead of 0.9400)

ST Support: 0.9075 (ahead of 0.8975)

Weak support is around 0.9075, with stronger support not really kicking in until the year's low around 0.8975.

jason.k.wong@bnz.co.nz

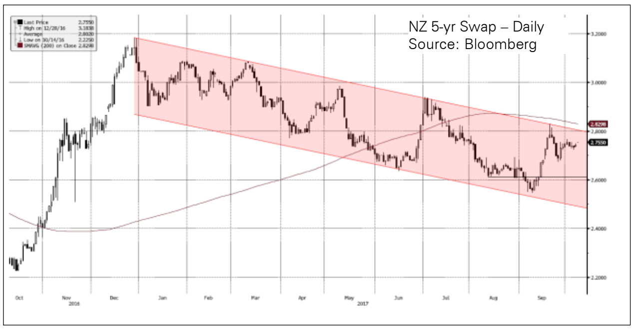
NZ 5-year Swap Rate

Outlook: Neutral

ST Resistance: 2.83

ST Support: 2.61

Market reached our target of 2.83 and we now expect some consolidation. We continue to await a break to initiate a new position.



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

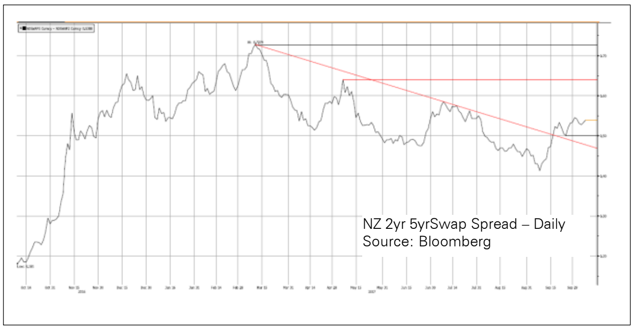
Outlook: Steeper

ST Resistance: +62

ST Support: +50

Trendline breached, so expect a move to +62

pete_mason@bnz.co.nz



Key Upcoming Events

	Forecast	Median	Last
Monday 9 October			
China, Services PMI (Caixin), September			52.7
Germ, Industrial Production, August		+0.9%	flat
Tuesday 10 October			
NZ, Electronic Card Transactions, Sept	+0.4%	+0.7%	+0.6%
Aus, RBA's Debelle Speaks			
Aus, NAB Business Survey, September			+5
Jpn, Eco Watchers Survey (outlook), September		50.5	51.1
Germ, Trade Balance, August		+€19.5b	+€19.5b
UK, Industrial Production, August		+0.2%	+0.2%
UK, Trade Balance, August		-£2.8b	-£2.9b
US, NFIB Small Business Optimism, September		105.0	105.3
Wednesday 11 October			
Aus, Consumer Sentiment - Wpac, October			97.9
Jpn, Machinery Orders, August		+1.0%	+8.0%
UK, RICS Housing Survey, September		+4%	+6%
US, FOMC Minutes, 20 Sept meeting			
US, JOLTS Job Openings, August		6,160	6,170
US, Fed's Evans/Williams Speak			

	Forecast	Median	Last
Thursday 12 October			
NZ, Food Price Index, September	-0.4%		+0.6%
NZ, ANZ-RM Consumer Confidence, October			129.9
Aus, Housing Finance, August	flat	+0.5%	+2.9%
Euro, Industrial Production, August		+0.6%	+0.1%
US, Fed's Powell/Brainard Speak			
US, Jobless Claims, week ended 07/10		252k	260k
US, PPI ex-food/energy, September y/y		+2.0%	+2.0%
Friday 13 October			
NZ, BNZ PMI (Manufacturing), September			57.9
Aus, Financial Stability Review			
China, Trade Balance, September		+CNY266b	+CNY286b
Germ, CPI, Sep y/y 2nd est		+1.8%	+1.8%P
US, Mich Cons Confidence, October 1st est		95.0	95.1
US, CPI ex food/energy, September y/y		+1.8%	+1.7%
US, Retail Sales, September		+1.6%	-0.2%
US, Business Inventories, August		+0.6%	+0.2%
Sunday 15 October			
US, Yellen Speaks, Monetary Policy			

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.83	1.84	1.84	2.17
2mth	1.88	1.89	1.88	2.20
3mth	1.93	1.96	1.95	2.20
6mth	2.00	1.98	2.00	2.23
GOVERNMENT STOCK				
03/19	1.90	1.92	1.87	1.93
04/20	2.07	2.10	1.99	2.00
05/21	2.24	2.25	2.11	2.06
04/23	2.54	2.56	2.40	2.21
04/25	2.81	2.83	2.65	2.37
04/27	2.96	2.99	2.79	2.48
04/33	3.30	3.33	3.14	2.79
04/37	3.51	3.54	3.38	3.05
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	70	73	68	103
Nth America 5Y	54	55	57	74
Europe 5Y	57	56	52	73

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.22	2.22	2.16	2.09
3 years	2.42	2.42	2.30	2.11
4 years	2.60	2.60	2.45	2.18
5 years	2.76	2.76	2.58	2.26
10 years	3.27	3.29	3.07	2.63
FOREIGN EXCHANGE				
NZD/USD	0.7069	0.7196	0.7254	0.7136
NZD/AUD	0.9090	0.9194	0.9034	0.9382
NZD/JPY	79.45	81.14	79.35	73.93
NZD/EUR	0.6023	0.6132	0.6068	0.6406
NZD/GBP	0.5404	0.5419	0.5510	0.5772
NZD/CAD	0.8860	0.9001	0.8784	0.9402
TWI	75.0	76.3	75.8	76.5

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
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +(64 3) 353 2219
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 Interest Rate Strategy
+(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