12 June 2017

NZ GDP Having Technical Issues

- We expect Q1 GDP expanded 0.5% (2.4% y/y)
- But expectations within a credibly wide range
- Capacity constraints coming to the fore
- External accounts a non-issue for Q1 and after
- May's (ECT) transactions clang with a 0.2% dip
- Also due this week: May's FPI, PMI (and REINZ?)

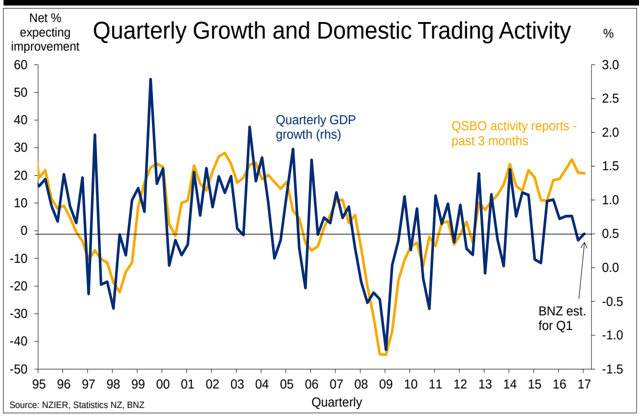
For Thursday's March quarter GDP report we have toned down our growth expectation to a quarterly 0.5% (2.4% y/y). But we are at pains to point out the unusually wide range it could conceivably fall within. And this is not so much about the market range of 0.1 to 1.1%, with a median expectation of 0.7%. It's more about the range of outcomes that we perceive as quite conceivable.

Big-picture, finger in the air, we sense Q1 GDP growth should be near 1.0%. This notion is supported by very strong expansion in population and jobs. The business surveys have also been at or above trend, including the PMI and PSI averages through Q1. The Quarterly Survey of Business Opinion (QSBO) suggests a March quarter expansion in activity in excess of 1.0%.

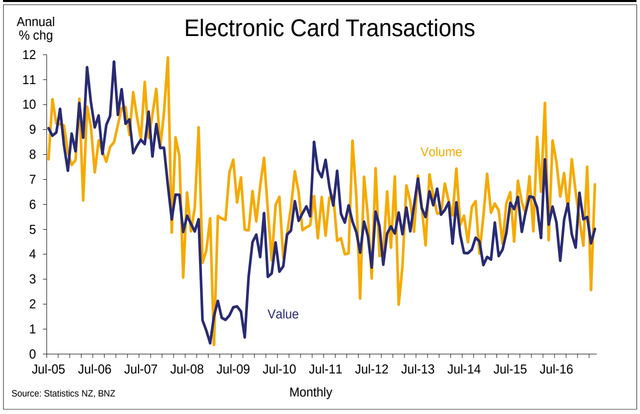
Granted, the QSBO has been doing that for a good while now, only for GDP outturns to not live up. At least, that is, from a production-GDP point of view. GDP when measured from the expenditure side has cracked quarterly growth of 1.0% or more, thrice over the last 18 months.

And speaking of measurement issues, we also remind readers of the way GDP outcomes can be revised noticeably in due course. Q2 2013 GDP was initially reported as a 0.2% increase, for instance, but is now estimated to have lifted 1.1%. When forecasting is difficult enough, forecasting revisions add another dimension.

Diverging Views



Not Really Disappointing



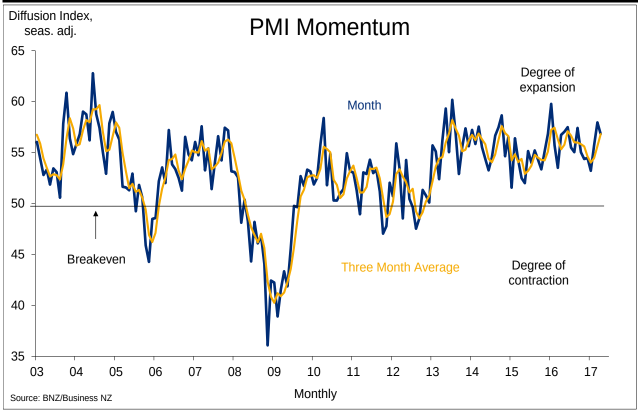
And then there are the technicalities of Q1 2017 GDP itself. These are struggling to net much growth at all, specifically after the recent run of "partials". While there were positives from retailing and wholesaling, manufacturing looks to have posted an underwhelming bounce from its dip in Q4. Building and export activity fell decidedly in Q1. Illustrative of "technical issues", our expenditure GDP estimate is for an increase of just 0.2%, as it also has to reckon past the inventory spike of Q4.

But even accepting the wide fan-chart we see around Q1 GDP growth possibilities, it infers there is a good chance that Q1 GDP does not increase by as much as the 0.9% the RBNZ expected in its May Monetary Policy Statement. This will only nourish the Bank's recently reserved tone.

This is even though a slow GDP result wouldn't change our estimation of capacity constraint in the economy, which is becoming a real sticking point. We make this judgement not based particularly on running a Hodrick-Prescott trend filter through real GDP, in the hope of estimating an output gap. Rather, it's trusting in what we're hearing from the business sector directly, and via the wealth of capacity constraint indicators out there. Whether CPI inflation is picking up (enough) or not, resources are certainly getting stretched.

But it's not all about GDP this week. Indeed, we've already witnessed May's electronic card transactions, which were published by Statistics NZ this morning. In suffering a negative surprise, could these be dubbed Theresa? They slipped a seasonally adjusted 0.2%, weighed down, once again, by a 1.8% fall in spending on fuel. The retail component dipped 0.4%, following an increase in April that has been downgraded to 0.9%, from 1.1%. This

Very Good



confounded market expectations, which were for a rise of 0.2% in May's retail-ECT.

We anticipated an increase of 0.5% in total ECT. So the outcome dents our expectation for Q2 retail trade volume growth. We are now looking for a modest, rather than strong, gain. However, it's worth recalling how Q1 retail volumes surged 1.5%, way above expectations. So Q2 might involve an aspect of payback (particularly around vehicles, we suspect).

However, as some indication that volume growth is holding up OK, the number of electronic transactions in May was up 5.0% on a year ago. This was close to the average over the last 6-12 months, and was actually better than the annual growth in April, of 4.4%.

Looking at the rest of the week's NZ data, Wednesday's Balance of Payments (BOP) is noted. That being said, it should be a non-issue in its outcome. We expect a year to March current account deficit equivalent to 2.7% of GDP, so unperturbed from the calendar 2016 result. However, there might be some news in the exports and imports data, which could affect our feeling (of risk) around GDP for the March quarter.

At the same time as the BOP, we'll get May's Food Price Index. We anticipate this to rebound 1.1%. This is after surprising on the low side for April, with a drop of 0.8%. Our expectation is implicit to the 0.1% increase we've toned down to on the Q1 CPI, which would trim its annual inflation to 1.8%, from 2.2% in Q4.

May's BNZ Performance of Manufacturing Index is scheduled for Friday (10:30am). At 56.8 in April, it did well to stay in touch with March's stellar result of 58.0, especially with April's holidays and awful weather. Anything close to these levels in May would be a great result.

Also watch for Real Estate Institute to publish its residential housing numbers for the month of May, sometime during the week. This will no doubt provide further evidence that Auckland's market is coming off the boil. But the REINZ report will be most useful for what it says about housing markets around the rest of the country, which variously still have momentum.

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Global Watch

- US FOMC announcement Wednesday
- Australia business survey and jobs
- China retail sales and IP

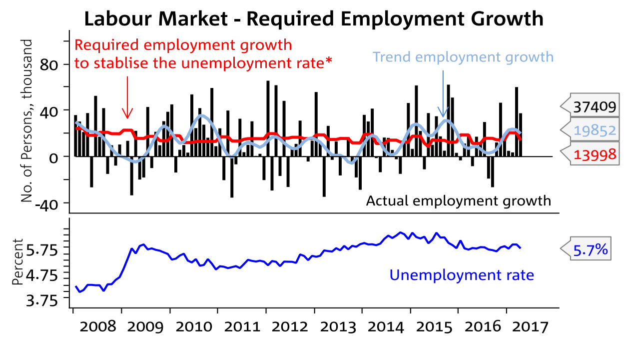
Australia

A holiday shortened week ahead with a public holiday Monday in all states bar QLD and WA. The clear highlights are the NAB Business Survey Tuesday and the Employment report Thursday. Second tier data worth watching includes Monthly Consumer Confidence Wednesday and Consumer Inflation Expectations Thursday.

The major pieces of data this week are the NAB Business Survey (Tuesday) and Employment (Thursday). Other data worth noting include Monthly Consumer Sentiment Wednesday and Consumer Inflation Expectations Thursday.

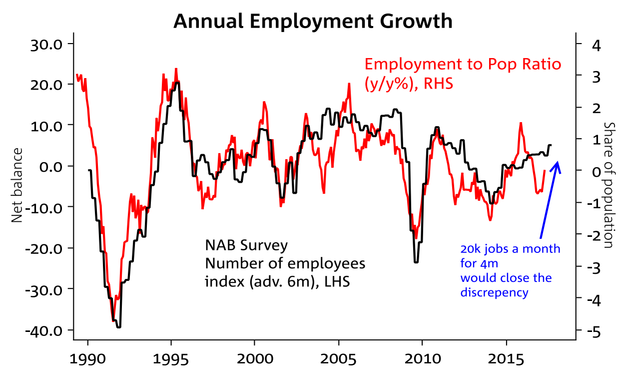
We make no comment on the NAB Business Survey as usual apart from stating what it did last month. In April the survey remained well above its long-run average levels with conditions at +14, while the employment sub-index rose to +8, the later consistent with official employment growth of around 20k a month.

Chart 1: Employment the Major Focus Domestically



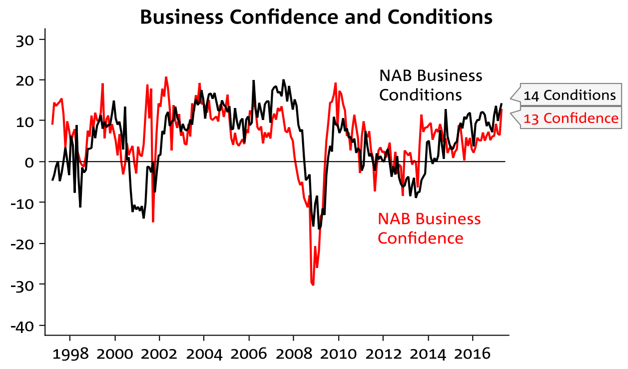
* Calculated so that the unemployment rate is unchanged each month with a constant participation rate
Source: National Australia Bank, ABS

Chart 2: Employment Catching Up To Other Indicators



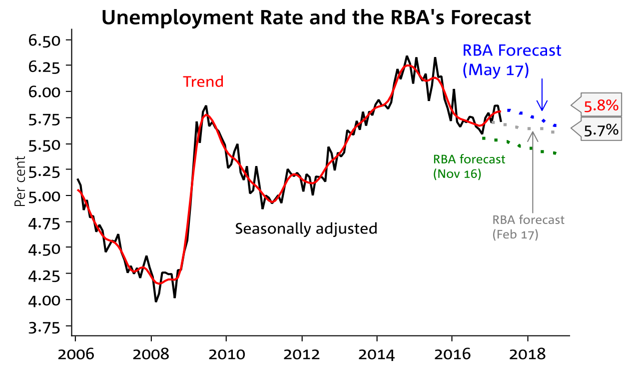
Source: National Australia Bank

Chart 3: NAB Business Survey – Strong in Recent Months



Source: National Australia Bank, Macrobond

Chart 4: Unemployment Rate Tracking With Forecasts



Source: National Australia Bank, ABS, RBA

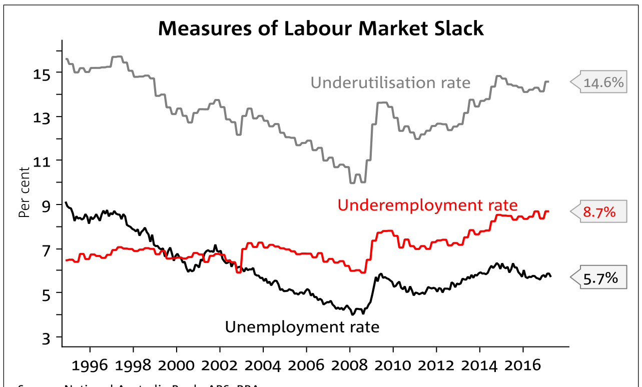
Employment Thursday is the likely focal point for markets domestically. The market consensus looks for employment growth +10k m/m after two consecutive months of strong reads (Chart 1). NAB's read of the leading indicators suggests upside risk to the market consensus with our models pointing to a +21.3k m/m outcome.

Our +21.3k expectation is informed by our own business survey from April as well as the pace of job advertisements which has picked up in recent months. We also note that sample rotation in the labour market survey is more favourable to a stronger print this month with the outgoing sample having a lower employment to population ratio (59.5%) compared to the sample as a whole (61.3%). We have had mixed experiences in using sample rotation in assessing the risks to employment, but it does add to weight suggestive of a better than expected outcome to the market consensus.

For the unemployment rate, both NAB and the market are expecting an unchanged 5.7% outcome. Such an outcome would be slightly better than the RBA's unemployment track from the May Statement on Monetary Policy.

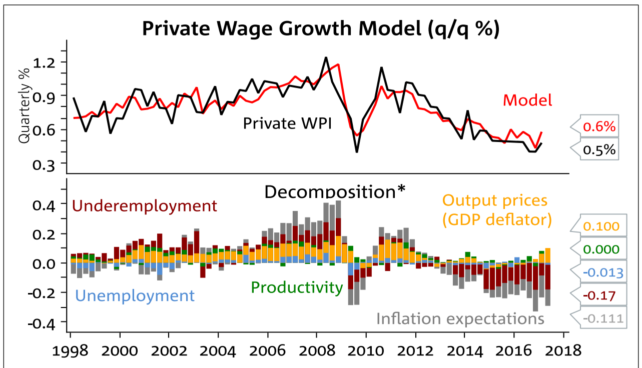
The other focus from the Employment report this month will be on wider measures of labour market slack. The underutilisation rate, which comprises both the

Chart 5: Labour Market Slack At 1998 Levels



Source: National Australia Bank, ABS, RBA

Chart 6: Underemployment Dragging On Wages



* Decomposition excludes the constant term
Source: National Australia Bank, ABS, IMF

underemployment rate and unemployment rate, remains elevated driven by greater underemployment (those wanting to work more hours but are not able to). Elevated underemployment has been a key drag on wages growth over the past few years and inroads in this will be needed in order to lift wages growth (Chart 6).

US

The FOMC meeting will take front and center on Wednesday (Thursday 4am AEST) and the market currently prices around a 90% chance of a June rate hike. The meeting is shaping up as a significant one with the market currently only pricing two rate hikes by the end of 2018 compared to the Fed's median dot point of five. Attention will also be on Fed Chair Yellen's press conference that follows. Datawise the major releases are CPI Wednesday, Retail Sales also Wednesday, and Industrial Production Thursday. The TIC data on Friday may also garner some attention given recent reports that China was prepared to increase holdings of US Treasuries.

UK

The election aftermath will dominate with a hung parliament certain. As we go to print, the BBC predicts the Tories will get 318 seats and will thus need to form a coalition or a minority government with support from another party to form government (326 votes to form government or 322 to form a workable majority given Sinn Fein's seven members do not participate in parliament). Datawise it's a busy week, but it is likely to be overshadowed by politics. The Bank of England meets Friday (unanimously on hold); key data points include CPI Tuesday, Unemployment Wednesday and Retail Sales Thursday.

China

It's quiet until Wednesday when the key monthly data of Retail Sales, Fixed Asset Investment and Industrial Production are released. The market consensus looks for a similar pace of growth to last month (Retail Sales 10.7% y/y and Fixed Asset Investment 10.3% y/y). There is also credit data due anytime from Saturday to Thursday.

Japan

A quiet week with Machine Orders Monday and a final measure of Industrial Production Wednesday. Bank of Japan meets Friday.

Eurozone

An important week with the ZEW Tuesday, Industrial Production Wednesday, Trade Balance Thursday and CPI Friday.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

With the NZD on a firmer path and oil prices falling, market pricing of the first potential rate hike this cycle continues to nudge out further. On our pricing model, the first full rate hike now looks like August 2018, where an OCR of 2.05% is priced, compared to 1.98% by June 2018. In terms of financial markets, that seems like an eternity.

With expectations of the RBNZ sitting on its hands for an extended period, volatility at the short end of the curve remains low. If anything, rates still have a small downside bias, given the external force of contracting US LIBOR-OIS spreads, which is spilling over into the local market. This sees 2-year swap at 2.20%, with the risk of slipping a little further, with traders happy to clip the carry on received positions, downward pressure on the 90-day bank bill rate, and the NZD remaining strong.

Locally, there are a number of economic releases this week, with the focus on Q1 GDP on Thursday. Growth is expected to be fairly underwhelming, following the underwhelming result in Q4. The odds are stacked in favour of a weaker result compared to RBNZ expectations, supporting the short end of the curve. However, given NZ's strong terms of trade, we think it is more apt to focus on nominal GDP, which will remain very strong.

For the long end of the curve, the key event risk this week is the FOMC policy announcement on Thursday morning. A 25bps rate hike is near certain and is close to fully priced so the focus will be on the FOMC's economic and rate projections and the tone of the policy statement.

While recent US data on both growth and inflation have been on the soft side of expectations, the unemployment rate has fallen by more than expected. Thus, medium-term inflation risks haven't evaporated and we think that the FOMC's "dot-plot" of projected rate increases will remain unchanged. Market pricing has been moving away from the Fed's rate projections, which might suggest that on the day we see upward pressure on US rates if the Fed can convince the market that the outlook really hasn't changed.

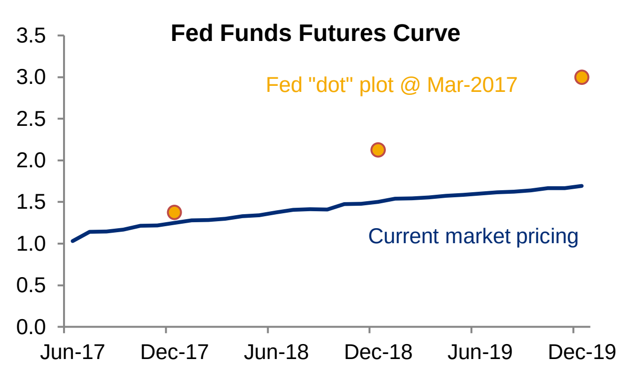
In the hours ahead of the FOMC statement, data on US retail sales and CPI will be closely watched and those could ultimately be important market drivers. Another soft reading for both and the market would show less reaction to a more hawkish- than-expected FOMC announcement.

The US 10-year rate bottomed around 2.13% last week and has since nudged higher to around 2.20%. Former FBI Director Comey's testimony to a Senate committee passed without any fresh revelations that would increase of the possibility of a Presidential impeachment. Traders remain long US 10-year futures and US bond funds have seen strong inflows of late. The US economic dataflow has recently been through a soft patch, but we see a better run of data ahead. Overlay that with the possibility of the Fed making little change to its policy assessment, we think the odds are stacking up for the US 10-year rate to head back up towards the 2.40% mark over coming weeks.

If we're right, then NZ rates should lift from recent lows for the year. That could see 5-year swap back up through 2.80% and 10-year swap back to 3.30% or so. In the big scheme of things, these wouldn't be large moves, and our overall message is that from current levels the balance of risk favours slightly higher rates rather than a push down to fresh lows.

Swap-bond yield spreads have looked stretched of late as government bonds have outperformed, and we would be positioned for a narrowing of the gap over coming weeks. In other words, NZ long-term government bond rates have more potential upside risk than NZ swap rates.

Market Pricing of US Policy Well Below Fed Projections



Source: BNZ, Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.94	1.94 - 1.97
NZ 2yr swap (%)	2.20	2.18 - 2.26
NZ 5yr swap (%)	2.69	2.66 - 2.80
NZ 10yr swap (%)	3.16	3.13 - 3.30
2s10s swap curve (bps)	96	95 - 104
NZ 10yr swap-govt (bps)	40	40 - 45
NZ 10yr govt (%)	2.76	2.68 - 2.87
US 10yr govt (%)	2.20	2.13 - 2.30
NZ-US 10yr (bps)	56	53 - 61
NZ-AU 2yr swap (bps)	43	40 - 50
NZ-AU 10yr govt (bps)	36	32 - 43

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD put in another solid performance last week, rising on all the major crosses, including a 1% gain against the USD and a 2½% gain against GBP, following the shock UK election result. There was no particular trigger for the strength of the NZD. It just happens to be recovering from the oversold position seen over recent months. Strong terms of trade and high global risk appetite support the move, although this isn't a new theme.

Our short term fair value model estimate still has a 0.75 handle but we suspect that the NZD will run into headwinds from here. On the technical picture, near-term term resistance sits around 0.7250. We suspect that the USD might find some support, with former FBI Director Comey's testimony to a Senate committee now out of the way and not throwing up any fresh curveballs and possibly the US dataflow improving after the recent soft patch.

There is plenty of event risk this week with the highlight likely to be the FOMC Statement on Thursday morning (NZ time). A 25bps rate hike is near certain and is close to fully priced so the focus will be on the FOMC's economic and rate projections and the tone of the policy statement.

While recent US data on both growth and inflation have been on the soft side of expectations, the unemployment rate has fallen by more than expected. Thus, medium-term inflation risks haven't evaporated and we think that the FOMC's "dot-plot" of projected rate increases will remain unchanged. Market pricing has been moving away from the Fed's rate projections, which might suggest that on the day we see upward pressure on US rates and the USD if the Fed can convince the market that the outlook really hasn't changed.

In the hours ahead of the FOMC statement, data on US retail sales and CPI will be closely watched and those could ultimately be important market drivers. Another soft reading for both and the market would show less reaction to a more hawkish-than-expected FOMC announcement.

Bank of England and Bank of Japan policy updates late in the week are expected to be uneventful by comparison. A dark cloud will continue to overhang GBP for some time, as UK political risk lingers and Brexit talks get underway.

In NZ, current account and GDP data are the headline acts, with more interest in the latter. Q1 growth is expected to be fairly underwhelming, following the underwhelming result in Q4. The odds are stacked in favour of a weaker result compared to RBNZ expectations, risking a negative NZD reaction on the day. However, given NZ's strong terms of trade, we think it is more apt to focus on nominal GDP, which will remain very strong.

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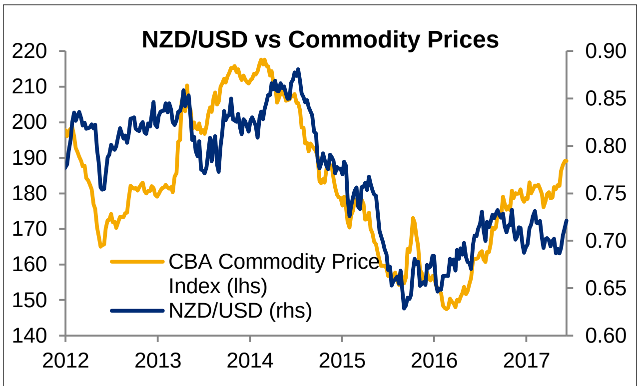
The combo of the FOMC announcement and potentially soft NZ real GDP data might see the NZD struggle to make further gains this week.

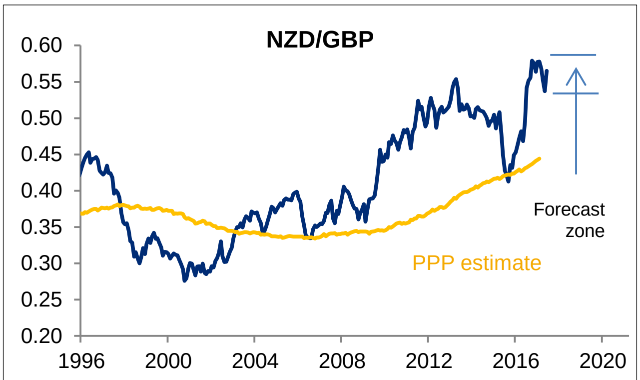
Australian employment data on Thursday will provide scope for some intra-day volatility in AUD, which is typical. NZD/AUD has had a strong run since falling below 0.91 around mid-March. Both of our short term models put fair value in a 0.94-0.95 range. Technical resistance sits around 0.96-0.9650. Thus, we think that the cross will struggle to climb much further over coming weeks.

Higher NZ Commodity Prices Are NZD-Supportive



Source: BNZ, Bloomberg

NZD/GBP Likely to Remain Richly Priced for Some Time



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7209	0.6990 - 0.7220
NZD/AUD	0.9570	0.9350 - 0.9620
NZD/GBP	0.5667	0.5380 - 0.5700
NZD/EUR	0.6431	0.6220 - 0.6460
NZD/JPY	79.54	77.60 - 79.80

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7530	-4%
NZD/AUD	0.9410	2%

Technicals

NZD/USD

Outlook: Downward channel
ST Resistance: 0.7250 (ahead of 0.7350)
ST Support: 0.7100 (ahead of 0.6970)

The NZD has edged up further and is approaching technical resistance at 0.7250. The bigger picture remains of a downward channel from September and so resistance levels become stronger the higher the NZD nudges up. The first area of support cuts in around the 200-day moving average of 0.7100, while stronger support cuts in closer to the 0.6970 mark.

NZD/AUD

Outlook: Trading range
ST Resistance: 0.9650 (ahead of 0.9750)
ST Support: 0.9400 (ahead of 0.9270)

The 0.9650 represents an area of strong technical resistance , a level it has rarely breached over the past couple of years. Given the recent strong run, support levels are well south of current spot.

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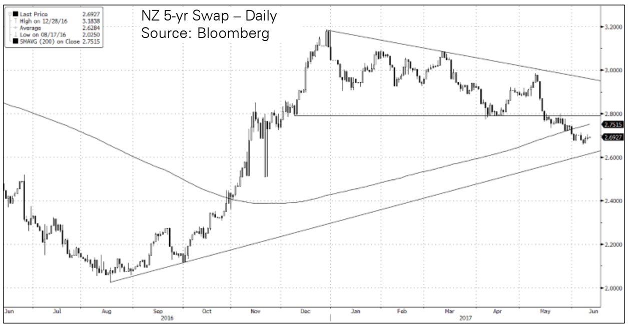
NZ 5-year Swap Rate

Outlook: Lower
ST Resistance: 2.795
ST Support: 2.62

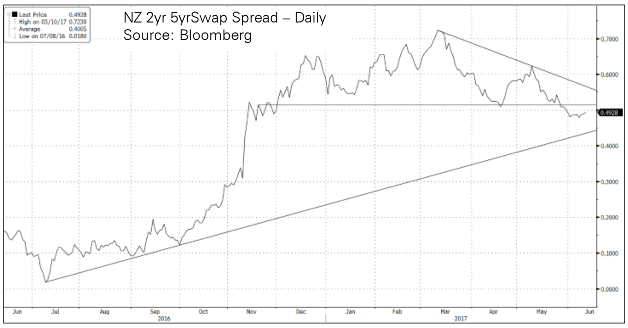
Break through 200 day moving average signals a move to trendline support coming in at 2.62 now.



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

Outlook: Flatter
ST Resistance: +56.5
ST Support: +44

Still expect to move to trendline support that comes in now at +44.



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Key Upcoming Events

	Forecast	Median	Last
Monday 12 June			
NZ, Electronic Card Transactions, May	+0.5%	+0.2%	+0.5%
Aus, RBA's Debelle Speaks, Hong Kong			
Aus, Holiday, Queen's Birthday			
Jpn, Machinery Orders, April		+0.5%	+1.4%
Tuesday 13 June			
Aus, NAB Business Survey, May			+13
Jpn, BSI Business Survey, Q2			+1.3
Germ, ZEW Sentiment, June		+21.7	+20.6
UK, CPI, May y/y		+2.7%	+2.7%
US, NFIB Small Business Optimism, May		104.5	104.5
US, PPI ex-food/energy, May y/y		+1.9%	+1.9%
Wednesday 14 June			
NZ, Balance of Payments, Q1	-2.7%	-2.7%	-2.7%
NZ, Food Price Index, May	+1.1%		-0.8%
Aus, Consumer Sentiment - Wpac, June			98.0
China, Retail Sales, May y/y		+10.7%	+10.7%
China, Industrial Production, May y/y		+6.4%	+6.5%
Euro, Eurozone Employment, Q1 y/y			+1.1%
Euro, Industrial Production, March		+0.5%	-0.1%
Germ, CPI, May y/y 2nd est		+1.5%	+1.5%P
UK, Unemployment Rate (ILO), April		4.6%	4.6%
US, CPI ex food/energy, April y/y		+1.9%	+1.9%

	Forecast	Median	Last
Wednesday 14 June cont'd…			
US, Retail Sales, April		+0.1%	+0.4%
US, FOMC Policy Announcement, Upper	1.25%	1.25%	1.00%
US, Business Inventories, April		-0.1%	+0.2%
Thursday 15 June			
NZ, GDP, Q1	+0.5%	+0.7%	+0.4%
Aus, RBA's Debelle Speaks, Thomson Reuters			
Aus, Employment, May	+21k	+10k	+37k
Euro, Trade Balance, April s.a.		+€22.0b	+€23.1b
UK, Carney Speaks, Mansion House			
UK, Retail Sales vol., May		-1.0%	+2.3%
US, NAHB Housing Index, June		70	70
US, Empire Manufacturing, June		+5.0	-1.0
US, Industrial Production, May		+0.2%	+1.0%
US, Philly Fed Index, June		+25.0	+38.8
Friday 16 June			
NZ, BNZ PMI (Manufacturing), May			56.8
Jpn, BOJ Policy Announcement, Policy Rate		-0.1%	-0.1%
Euro, Labour Costs, Q1 y/y			+1.6%
Euro, CPI, May y/y 2nd est		+1.4%	+1.4%P
US, Housing Starts, May		1,218k	1,172k
US, Mich Cons Confidence, June 1st est		97.1	97.1

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.85	1.84	1.85	2.26
2mth	1.89	1.89	1.91	2.31
3mth	1.94	1.94	1.98	2.37
6mth	1.99	1.99	2.03	2.38
GOVERNMENT STOCK				
12/17	1.80	1.80	1.81	2.02
03/19	1.94	1.93	2.09	2.03
04/20	2.09	2.08	2.30	2.07
05/21	2.18	2.18	2.45	2.10
04/23	2.45	2.45	2.71	2.18
04/25	2.65	2.66	2.95	2.40
04/27	2.76	2.76	3.05	2.56
04/33	3.06	3.06	3.31	2.85
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	85	86	82	128
N. AMERICA 5Y	60	60	62	74
EUROPE 5Y	59	62	63	73

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.20	2.21	2.34	2.24
3 years	2.39	2.40	2.58	2.27
5 years	2.69	2.71	2.94	2.41
10 years	3.17	3.20	3.43	2.81
FOREIGN EXCHANGE				
NZD/USD	0.7207	0.7134	0.6905	0.6908
NZD/AUD	0.9569	0.9530	0.9309	0.9375
NZD/JPY	79.53	78.81	77.87	74.27
NZD/EUR	0.6433	0.6337	0.6282	0.6083
NZD/GBP	0.5656	0.5528	0.5324	0.4780
NZD/CAD	0.9695	0.9615	0.9437	0.8858
TWI	77.80	77.00	75.36	73.85

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