13 November 2017

Nominally Important

- **Q3 GDP growth might struggle for 0.7%**
- **But CPI still set to exceed RBNZ expectations**
- **So can HYEFU sustain its nominal GDP forecasts?**
- **Q3 PPIs to slow on terms of trade peak**
- **Concrete and REINZ data of RBNZ interest**
- **Will politics spook Friday's Oct. PMI?**

Last week's RBNZ Monetary Policy Statement (MPS) has given us a well-defined reference point, but also a lot to chew on. Even with the Bank's firmer outlook on CPI inflation we still believe there is potential for upside surprise on this, for instance. For today, however, we want to tease out a couple of points – in accordance with the bits of NZ data due this week – that relate to September quarter GDP and the housing market, including construction.

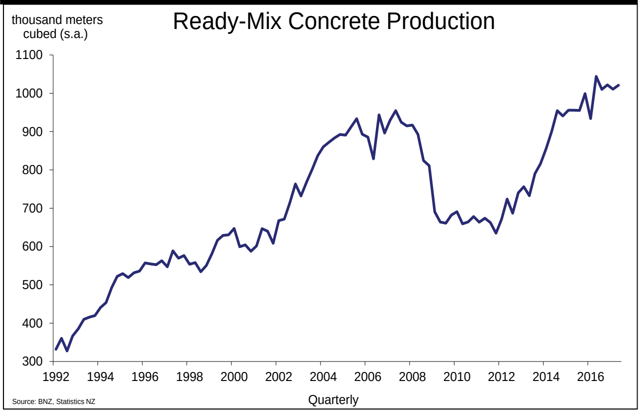
With respect to Q3 GDP, November's MPS anticipated a 0.7% increase. We expect this as well. However, we feel the risk is for lower growth than this, rather than higher. The impact of the weather on agriculture output is on our mind, as is the potential for a big correction in retail trade and tourist expenditure in Q3 after their bumper (inter-related) results in Q2.

Also, our 0.7% expectation for Q3 GDP growth assumes a 2.0% bounce in construction activity, when this might be a tad too soon to expect it. Nonetheless, we do believe building industry activity is set for a solid rebound before too much longer. Building consents have certainly swooped right back up this year, after wobbling quite a bit last year. And one look at architects' expectations in the latest NZIER Quarterly Survey of Business Opinion reveals a positive pipeline as well.

But as for whether this is converting into more building activity just yet, we'll have to wait for the data. As a precursor to the Q3 GDP report, September quarter Building Work Put in Place is not due until 5 December. But this Thursday morning Statistics NZ is scheduled to publish its Q3 ready-mixed concrete production figures. As a "hard" indicator, they don't get much better than this. And concrete mixing should surely be a good lead to what gets built.

The Reserve Bank certainly made a lot of construction activity at its MPS release of last week, in particular the recent slippage in residential building investment. So any hard evidence of a rebound will likely go a long way to settling the Bank's nerves on this front. This speaks to the fact that the Bank needs ongoing strong inflation in the

Poised for More



home-building industry to help it achieve and maintain annual CPI inflation in the order of 2%.

Consistent with this, for the most part, is the Bank's latest assumptions on house price inflation. These essentially expect house prices to edge up only very slowly from here, so largely retaining their recent altitude. Any reboot would no doubt worry the Bank from a financial stability point of view. But any correction in house prices – for whatever reason, at whatever stage – would presumably threaten the Bank's CPI inflation objective via many channels, including consumer confidence and spending and any ensuing moderation in (private sector) residential construction.

So for many reasons the housing market remains important to keep tabs on. The Real Estate Institute is due to publish its October residential results any day now and presumably before the end of this week. While these will still be caught in the political headlight they will nonetheless be interesting to see – and hear, with respect to the commentary that the REINZ provides.

Also with the recent change in government in mind, Thursday afternoon ANZ is scheduled to publish its consumer confidence report for November. This will be the first clean read on sentiment fully after the new government was declared. But also realise that this confidence measure usually gains a few index points compared to October, simply because of the time of year.

Turning to Friday's local data it begins with the BNZ/Business NZ Performance of Manufacturing Index. Pertaining to the month of October this could be muddied by politics, although we note that in September, the month of the election, it was still solid, at a seasonally adjusted 57.5.

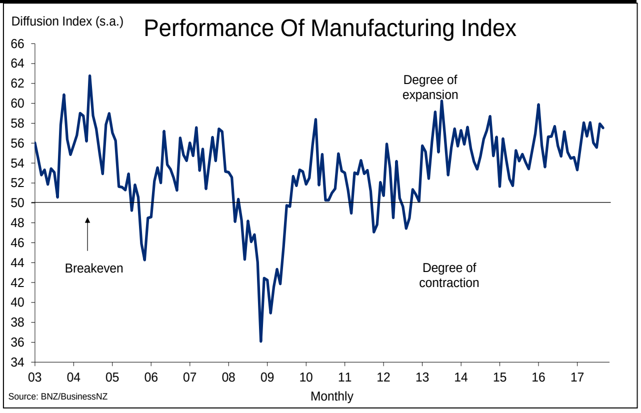
Friday's producer output prices for Q3 will probably lose momentum, given the peaks we're seeing in export prices. However, there might been some ongoing impetus to watch for on the inputs side, considering the recent upshift in oil prices.

The latest RBNZ household inflation expectations survey is also due for publication on Friday, in the afternoon. However, with its inherent biases, and volatility, we don't expect it will influence market opinion in any way shape or form.

Meanwhile, we continue to wonder how the Half-Year Economic and Fiscal Update (HYEFU), due to be published in December, is going to look. It should bring to a head many issues – including greater detail on the new government's policies as well as the accusations that Labour's election-campaign budget was just too tight to be credible.

There might also be the perception that Treasury's economic forecasts for the HYEFU won't be able to be as strong as those embodied in the pre-election EFU. While this could well be true of its real-GDP forecasts there does

What Election?



seem potential for Treasury to revise up its view on inflation concurrently. This could net out to little change in the Treasury's forecasts of nominal GDP growth, thus largely maintaining the tax revenue projections for new government. But we are just as keen to see all the other component parts of December's HYEFU.

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Global Watch

- **Focus on CPI data from US, EU, Canada**
- **Yellen, Draghi, Kuroda and Carney to speak**
- **Chinese data concentrated on Tuesday**
- **AU employment, wages, bus. confidence data due**

Australia
It's a busy week this week with the two most significant pieces of data being Q3 Wages on Wednesday and Employment on Thursday. These two pieces will be important for the outlook for monetary policy with the RBA clearly wanting to see evidence of a reduction in spare capacity and a lift in wages growth before they can be confident that inflation will lift towards the 2-3% target band. Also out in the week is the NAB Business Survey on Tuesday, along with two potentially interesting RBA speeches —Deputy Governor Debelle on Monday and Assistant Governor Ellis on Wednesday.

The WPI on Wednesday will be closely watched to see whether subdued wages growth has bottomed in Australia. This quarter the market expects wages to increase 0.7% q/q and 2.2% y/y, boosted by the increase in the minimum wage which was hiked 3.3% on July 1. Although NAB's forecast is similar, our forecast is on the straddle of the 0.6/0.7% divide and we accordingly think the risks could be slightly to the downside of the market consensus. Our analysis of prior minimum wage increases suggests the minimum wage could add an extra 0.1% to wages growth on top of the Q2 0.5% outcome, slightly softer than the market and the RBA's estimate of a 0.2% boost.

As for Employment on Thursday, the underlying story remains of positive forward indicators that suggest the recent run of strong employment growth should continue. Trend employment growth of 24k a month will continue to put downward pressure on the unemployment rate and NAB thinks the unemployment rate is likely to reach 5¼% by mid-2018 (Chart 5).

However, for this month NAB sees some downside risks to employment growth due to unfavourable sample rotation effects in the survey that underpins the employment numbers.

Each month 1/8th of the sample gets replaced with a new sub-sample and if their characteristics differ this can impact on printed employment growth in the month.

This month the outgoing sample that will be replaced has a higher tendency to be employed compared to the sample as a whole (employment to population ratio of 62.8% compared to the sample as a whole of 61.6%).

Chart 1: Business/consumer confidence divide

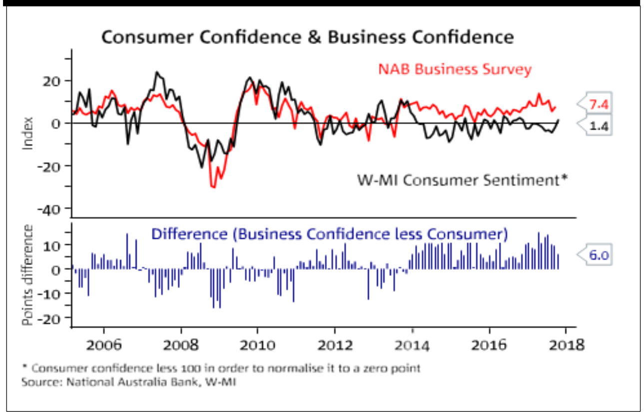


Chart 2: Wages the Aussie highlight; WA stabilising?

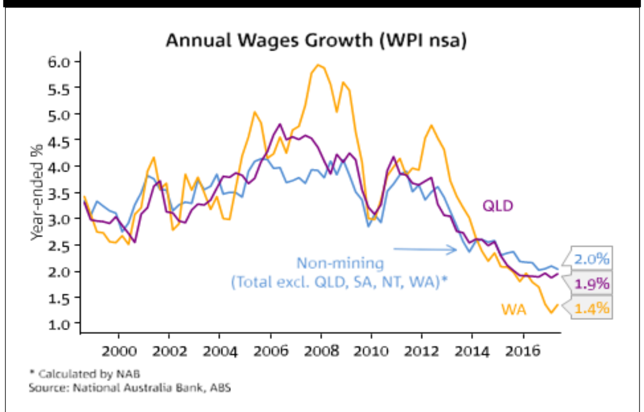


Chart 3: Wages to be boosted by minimum wage

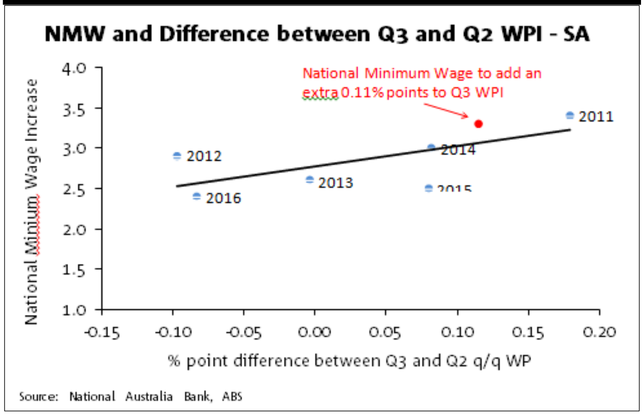
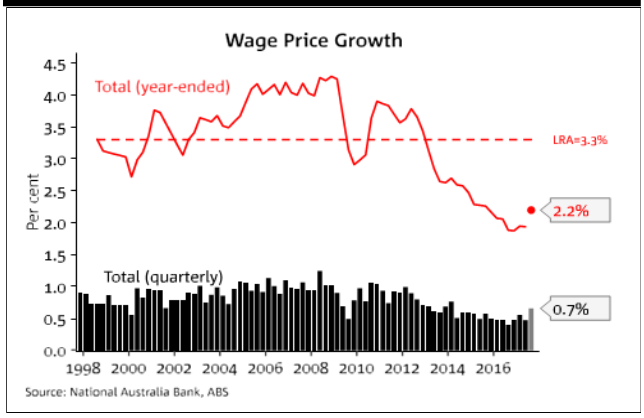


Chart 4: WPI expected to rise 0.6/0.7% q/q and 2.2%y/y



If the outgoing sub-sample is replaced with a sample that is more similar to the rest of the 7/8th of the survey, it could drag on employment growth in the month. NAB estimates that this potential drag could be worth around 12-34k. NAB consequently forecasts a below consensus print of 12k for employment this month (consensus +20k). That said we continue to assess employment growth as relatively strong. As for the unemployment rate, this is typically less affected by sample rotation and we expect the unemployment rate to be unchanged at 5.5%.

Amongst the other data in the week we would highlight the NAB Business Survey on Tuesday. As usual your scribe gives no hints here and only states what happened in September. In September, Business Confidence and Conditions both lifted, with the divide between consumer and business confidence also narrowing over the month. It will be interesting to see whether this divide continues to narrow.

China
Tuesday sees October Retail Sales, Industrial Production, and Fixed Assets Investment which are mostly expected to reveal somewhat slower growth. There's also the release of the October New Yuan Loans/Aggregate Financing report any day now.

US
Headline CPI (Wednesday) is expected to rise just 0.1% from lower gas prices but a mild step up in core inflation to 0.2% from 0.1% is tipped. That report comes with October Retail Sales, also likely to be held back by lower gas prices; ex auto and gas sales should rise 0.3% after 0.5%. Fed Chair Yellen is speaking on an ECB Conference panel in Frankfurt with Draghi, Kuroda, and Carney. There are 11 other Fed speakers.

Japan
Along with Kuroda's ECB appearance, the main interest will be Wednesday's Q3 GDP that's expected to see growth ease slightly to 0.4% from 0.6%.

Eurozone
There are speaking opportunities for Draghi to drum home the "no specific end" to the ECB's bond buying program should he wish. There are over a dozen other ECB speakers. Thursday's October inflation report (and a possible revision to the preliminary 0.6% estimate for Q3 GDP) is the main data interest. Ahead of the Eurozone GDP on Tuesday comes Germany's second GDP estimate three hours earlier.

Canada
The CPI is the focus in Canada too with the BoC's Wilkins speaking in NY.

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Chart 5: Unemployment to head lower in time

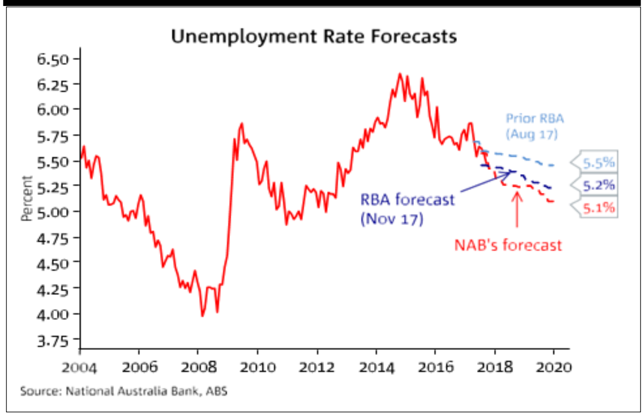
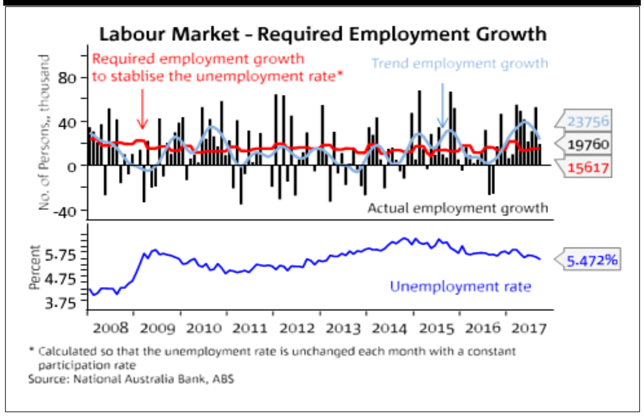


Chart 6: Employment has been very strong of late



Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The RBNZ MPS came and went last week, with the slightly more hawkish tone adding some upside pressure to rates, as expected. The Bank significantly revised upwards its CPI inflation track through to the end of next year, a reflection of the weaker NZD and higher oil prices, amongst other factors. So inflation is now projected to reach and settle at the 2% mark some nine months earlier than previously projected, around mid-2018.

The RBNZ revised its rate track only slightly, seeing an increased chance of a mid-2019 rate hike, but the symbolism of this is more important that the quantum. This sees market pricing for the first rate hike brought forward slightly, to November 2018. BNZ economists still see the first rate hike a little earlier than this in August 2018.

As important as the new forecasts, Acting Governor Spencer should have allayed those with fears that proposed changes to the RBNZ Act would significantly change the course of monetary policy. Spencer noted that moving to a dual mandate was unlikely to impact monetary policy as the Bank already considers itself a "flexible" inflation targeter, already taking into account employment dynamics. This supports our view that the Bank's reaction function will be little changed after the legislation is passed, with a target date of before the end of March 2018.

Finance Minister Robertson gave interviews to the newswires and said that he expects to discuss the central bank's current focus on the 2 percent midpoint of its inflation target band once a new governor is appointed. Some see this as a "dovish" statement, allowing the Bank to go easier on its inflation target in the context of employment being added to the Bank's mandate. But in the current context, the opposite view could well be more applicable. In the current disinflationary world where global central banks have struggled to meet their 2% inflation targets, over-stimulating economies and stoking asset price inflation doesn't make a lot of sense. Relaxing the mid-point focus could pave the way for tightening policy earlier than otherwise, "accepting" the trade-off of inflation settling in the lower half of the target range. This wouldn't be a big deal for a flexible inflation targeter, reducing the financial stability concerns that come with an overly stimulatory monetary policy environment.

With monetary policy still expected to be on hold for some time yet, the short end of the rate curve should be well under-pinned. The slightly more hawkish RBNZ reduces the chance of the 2-year swap rate falling back below 2.15%, while any global-induced selloff over the near term should restrict any gains to the 2.30% mark.

The longer end of the curve remains largely at the mercy of US rates. The US 10-year Treasury rate retested the 2.40% level on Friday on little news, more a reflection of European rates reversing course. The key data to watch this week are US CPI and retail sales due Wednesday night. We think that the Fed is pretty committed to hiking rates next month for the third time this year. A weak or strong result for inflation will have more impact on expectations of policy through next year, with some reaction likely for US Treasuries on a surprise result. The tendency has been for the CPI to surprise to the downside over the past six months, so any market reaction might be skewed if we saw a positive surprise. A number of Fed speakers are due this week as well, and all the key central bank heads will be talking at the ECB's conference.

The combination of a slightly more hawkish RBNZ and the global rates sell-off last week sees the NZ 5-year swap rate up 10bps to 2.72% compared to this time last week, and the 10-year swap rate up 14bps to 3.24%. The path of least resistance seems to be higher rates as the year draws to a close.

In the bond market, the DMO's announcement to defer the new 2029 bond issue to 1H18 caused significant volatility in longer term yields but the market has now settled. Near-term supply conditions remain tight, but the government's fiscal update mid-December will probably show much increased supply over coming years, in the order of an extra $2-3bn pa compared to previous forecasts.

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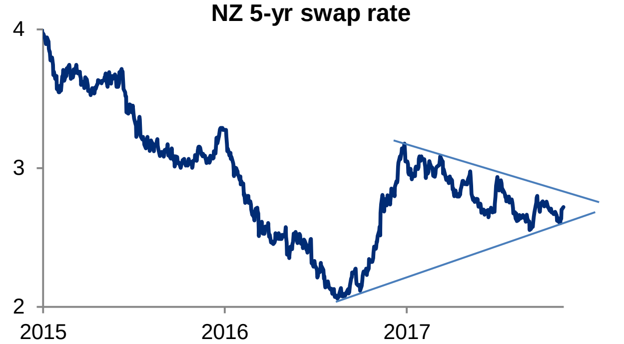
Becoming Interesting…



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.93	1.93 - 1.95
NZ 2yr swap (%)	2.21	2.15 - 2.22
NZ 5yr swap (%)	2.72	2.60 - 2.72
NZ 10yr swap (%)	3.24	3.09 - 3.26
2s10s swap curve (bps)	103	93 - 108
NZ 10yr swap-govt (bps)	31	20 - 34
NZ 10yr govt (%)	2.93	2.75 - 3.04
US 10yr govt (%)	2.40	2.30 - 2.48
NZ-US 10yr (bps)	53	43 - 61
NZ-AU 2yr swap (bps)	29	16 - 29
NZ-AU 10yr govt (bps)	32	19 - 32

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

Looking at currency movements, last week was fairly uneventful, given the dearth of global economic data and lack of newsflow. The NZD ended the week a smidgeon higher against the USD and AUD but all the key NZD crosses we follow didn't change by more than 0.5% for the week. But beneath the surface there are some interesting dynamics in play which we are keeping our eye on.

Risk appetite remains high, but has shown signs of slipping, particularly over the past couple of weeks, as high-yield and emerging market credit spreads blow out, while the VIX index has nudged up from recent lows. Our risk appetite index sits at a 2-month low of 76%, down from as high as 85% just a few weeks ago. A reduction in risk appetite back to a more normal level represents a key downside risk factor for the NZD.

And while strong global economic momentum has driven global commodity prices higher, dairy prices are falling for idiosyncratic reasons, largely owing to increasing supply conditions. The last three GDT dairy auctions have shown falling prices, taking the cumulative reduction in average prices to 7%. Further downside is possible and an upturn seems unlikely until well into next year.

On a more positive note the domestic political risk premium built into the NZD since the formation of the new government appears to be fading. Acting Governor Spencer should have allayed those with fears that proposed changes to the RBNZ Act would significantly change the course of monetary policy. Spencer noted that moving to a dual mandate was unlikely to impact monetary policy as the Bank already considers itself a "flexible" inflation targeter, already taking into account employment dynamics. This supports our view that the Bank's reaction function will be little changed after the legislation is passed, with a target date of before the end of March 2018.

Last week's RBNZ MPS was in line with our expectations, providing some mild support for the NZD. Spencer noted that the NZD was closer to a sustainable level, in the vicinity of fair value, and this was backed up by the Bank projecting a flat TWI at 73.5. It was a refreshingly honest assessment and something we agree with when seen in a medium-term context. That the NZD didn't rally hard after this comment suggests that traders aren't really in a mood to push the NZD a lot higher, perhaps a reflection of the global backdrop, with commodity currencies not favoured at present. It suggests a hurdle for the NZD to push on up from here.

In the week ahead there's little NZ economic data worth noting. There's an ECB conference beginning Tuesday night, where the major central bank heads will be speaking including Yellen. Draghi, Kuroda and Carney. This has some potential to throw off some currency volatility. A number of Fed speakers are on the circuit this week adding to the cacophony of central bank noise.

The key data to watch are US CPI and retail sales due Wednesday night. We think that the Fed is pretty committed to hiking rates next month for the third time this year. A weak or strong result for inflation will have more impact on expectations of policy through next year, and would impact the USD. We'll also be watching progress on the negotiations around US tax reform, where expectations are fairly low for a quick resolution.

Elsewhere, Australian employment data on Thursday offers the usual chance for some AUD volatility.

A reduction in risk appetite and lower NZ commodity prices has seen our short-term fair value estimate fall to USD 0.7150. Against a backdrop of weaker risk appetite and soft dairy prices, it'll be hard for the NZD to make any further recovery over the short term.

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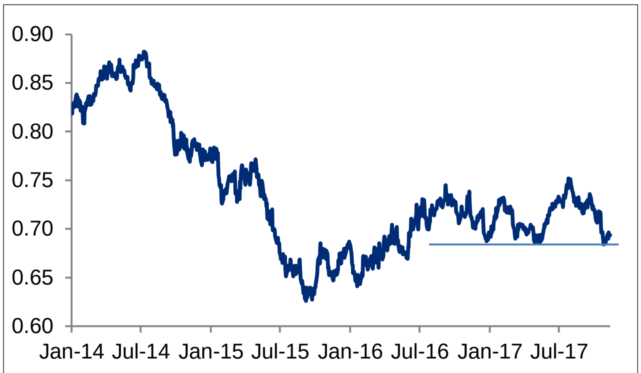
Good Support for NZD at 0.6840



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6935	0.6820 - 0.6980
NZD/AUD	0.9052	0.8860 - 0.9080
NZD/GBP	0.5257	0.5150 - 0.5320
NZD/EUR	0.5946	0.5810 - 0.6010
NZD/JPY	78.70	77.40 - 79.50

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7150	-3%
NZD/AUD	0.9070	0%

Technicals

NZD/USD

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

Strong support is evident around the 0.6820-0.6840 level, having not sustainably broken through this all year. 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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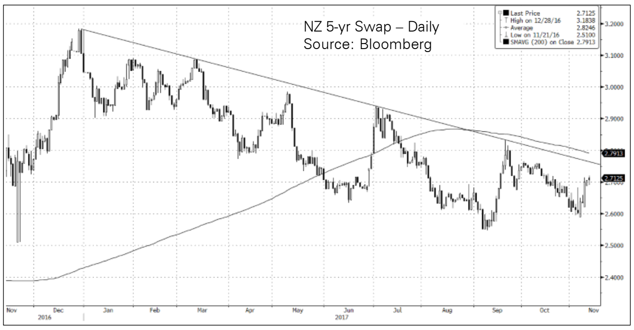
NZ 5-year Swap Rate

Outlook: Neutral
ST Resistance: 2.79
ST Support: 2.58

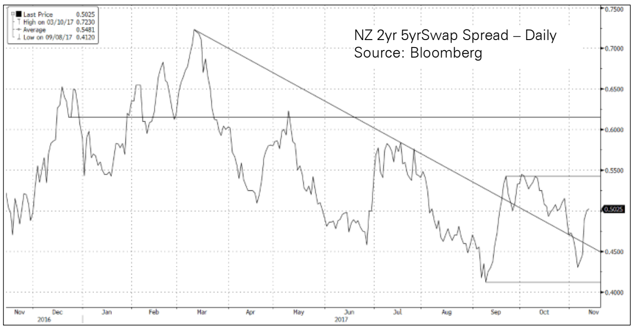
Breach of 2.61 was short lived and market has retraced higher. Key is 2.77-2.79 level now and wait to see if this is breached before initiating new position.



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

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

Break of trendline was short-lived. Should +54 be breached expect a move to +62.



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Key Upcoming Events

	Forecast	Median	Last
Monday 13 November			
Aus, RBA's Debelle Speaks, UBS Conference			
Tuesday 14 November			
Aus, NAB Business Survey, October			+7
China, Industrial Production, Oct y/y		+6.2%	+6.6%
China, Retail Sales, Oct y/y		+10.5%	+10.3%
Euro, Industrial Production, September		-0.6%	+1.4%
Euro, GDP, Q3 2nd estimate		+0.6%	+0.6%P
Germ, GDP, Q3 1st est		+0.6%	+0.6%
Germ, CPI, Oct y/y 2nd est		+1.6%	+1.6%P
Germ, ZEW Sentiment, November		+19.5	+17.6
UK, CPI, October y/y		+3.1%	+3.0%
US, PPI ex-food/energy, October y/y		+2.2%	+2.2%
US, Yellen Speaks			
US, NFIB Small Business Optimism, October		104.0	103.0
Wednesday 15 November			
NZ, REINZ Housing Data, October			
Aus, Consumer Sentiment - Wpac, Nov			101.4
Aus, Labour Price Index, Q3	+0.7%	+0.7%	+0.5%
Jpn, GDP, Q3 1st est		+0.4%	+0.6%
Jpn, Industrial Production, Sept. 2nd est			-1.1%P
Euro, Trade Balance, September s.a.		+€21.0b	+€21.6b

	Forecast	Median	Last
Wednesday 15 November cont'd			
UK, Unemployment Rate (ILO), September		4.3%	4.3%
US, Empire Manufacturing, November		+25.0	+30.2
US, Business Inventories, September		flat	+0.7%
US, CPI ex food/energy, October y/y		+1.7%	+1.7%
US, Retail Sales, October		flat	+1.6%
Thursday 16 November			
NZ, Concrete Production, Q3			
NZ, ANZ-RM Consumer Confidence, Nov			126.3
Aus, Unemployment Rate, October	5.5%	5.5%	5.5%
Aus, Employment, October	+12k	+18k	+20k
UK, Retail Sales vol., October		+0.2%	-0.8%
US, Industrial Production, October		+0.5%	+0.3%
US, Philly Fed Index, November		+24.1	+27.9
US, Jobless Claims, week ended 11/11		235k	239k
US, NAHB Housing Index, November		67	68
Friday 17 November			
NZ, Business Price Indexes, PPIO Q3 y/y			+5.2%
NZ, H/H Inflation Exp. (1yr median), Q4			+2.5%
NZ, BNZ PMI (Manufacturing), October			57.5
US, Housing Starts, October		1,190k	1,127k

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	1.75
1mth	1.78	1.78	1.81	1.96
2mth	1.86	1.86	1.87	2.02
3mth	1.94	1.94	1.93	2.07
6mth	1.96	1.97	1.97	2.12
GOVERNMENT STOCK				
03/19	1.91	1.85	1.88	2.12
04/20	2.04	1.94	2.04	2.33
05/21	2.19	2.06	2.20	2.50
04/23	2.48	2.33	2.50	2.77
04/25	2.75	2.59	2.77	2.99
04/27	2.93	2.75	2.93	3.12
04/33	3.28	3.08	3.27	3.46
04/37	3.47	3.27	3.48	3.73
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	68	66	68	115
Nth America 5Y	56	53	54	78
Europe 5Y	52	50	55	79

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.21	2.17	2.19	2.28
3 years	2.40	2.32	2.37	2.47
4 years	2.57	2.47	2.54	2.65
5 years	2.72	2.60	2.70	2.81
10 years	3.24	3.10	3.20	3.32
FOREIGN EXCHANGE				
NZD/USD	0.6932	0.6945	0.7171	0.7118
NZD/AUD	0.9056	0.9030	0.9135	0.9423
NZD/JPY	78.66	78.97	80.45	77.17
NZD/EUR	0.5946	0.5982	0.6079	0.6628
NZD/GBP	0.5261	0.5272	0.5412	0.5698
NZD/CAD	0.8794	0.8823	0.8977	0.9652
TWI	73.7	73.4	75.7	77.4

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