14 August 2017

The Lions' Final Roar

- Retail sales surge in Q2
- More to it than sports events
- But beware unwind in Q3
- PPI, CGPI inflation peaking in Q2?
- Dairy auction, consumer confidence data due

This week's economic data has already kicked off, in style. This morning's Q2 retail sales were very strong and well ahead of market (and our) expectations. The massive 2.0% quarterly lift in seasonally adjusted sales volumes was clearly boosted by sports events like the British and Irish Lions' rugby tour (mainly in June) and NZ hosting the World Masters Games (in April).

You didn't have to look too hard to see the Lions' fans when they were here. And you don't have to look too closely at the detail in today's retail figures to see the event effect. On a seasonally adjusted basis in the quarter, food and beverage service volumes rose 4.2%, accommodation lifted 6.1% and liquor sales increased 7.8%. Even the 1.3% lift in fuel sales and 1.5% increase in recreational goods would have found some support from the sports events.

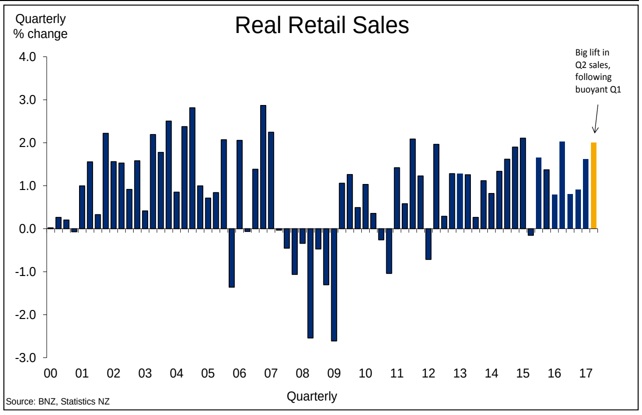
Looking through the obvious event boost to sales there was some underlying strength too. For example, crudely excluding all the increases in the event-related industries noted above, it is interesting that sales volumes for the remaining parts rose 1.4% in the quarter. Sure there may have been some tourist spending influence there too, but, regardless, it is all an impressive follow up to what was strong growth in Q1. Annual volume growth was maintained at 5.5%. Per capita sales volumes in Q2 were up 3.2% on a year ago, similar to the annual pace in Q1.

Underlying spending has been supported by the likes of a strong labour market, record net migrant inflows, lower fuel prices, and generally buoyant incomes across the primary sector (nominal sales annual growth remains stronger in areas outside the main Auckland, Wellington, and Canterbury areas).

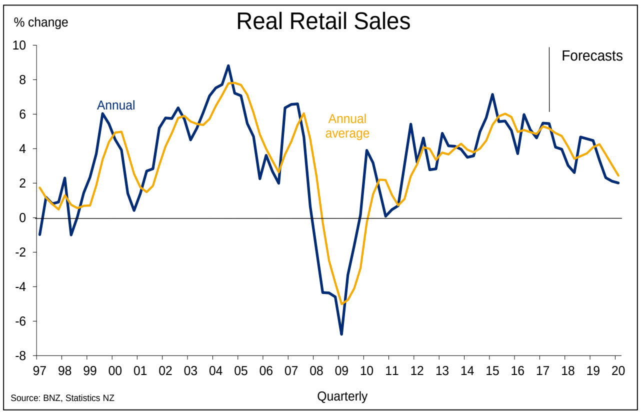
In other words, there are many facets to the current sales growth in addition to sports events and net migration.

The big spending lift only adds to our thinking that Q2 GDP will be strong. Watch for the lift in foreign spending to boost exports of services in the quarter, while maintaining downward pressure on the nation's current account deficit.

Event Boost



Slowdown expected

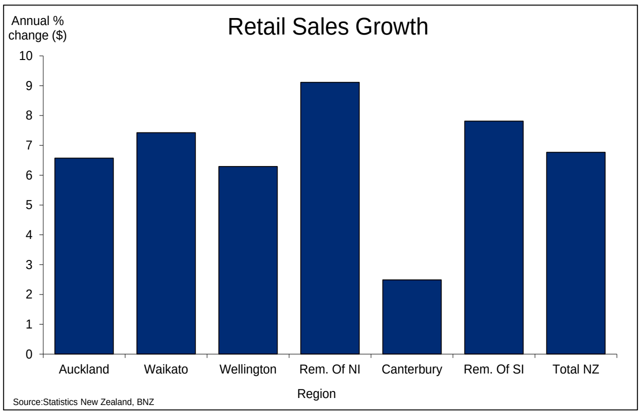


We estimate retail prices fell 0.4% in Q2, to be up 1.2% on a year ago. This was in line with what we figured from the relevant components of the CPI, so no new news. But it does mean that today's volume growth surprise was a result of more spending outright. Certainly the Q2 retail sales figures were well in excess of what the likes of the electronic card transactions data indicated. It looks like the Lions' fans used cash.

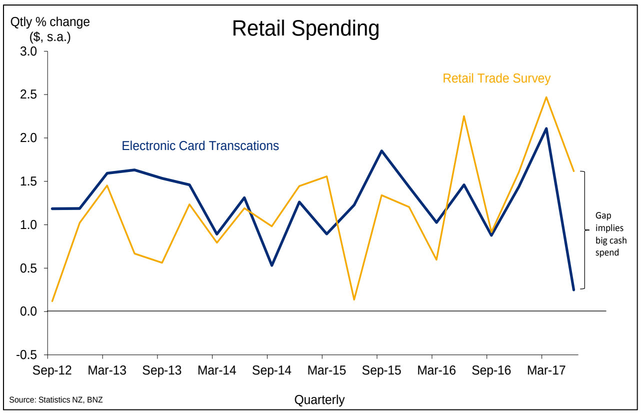
Watch for some unwind in implicit cash spending in Q3, as part of a more general slowing in sales growth that we see ahead. While Q2 sales say positive things about domestic demand, we anticipate some slowing ahead.

Initial spending indicators for Q3 have been mixed. On the negative side, total electronic card transactions fell 0.7% in July; retail dipped 0.5%. But we don't think this gives a fair guide to underlying volume growth. First because

Regions Supported By Primary Incomes



More Cash Used?



weakness was driven by lower fuel sales, as prices fell further (but have bounced in August). And second because the fall in the likes of hospitality spending is unwind from the Lions rugby tour. Moreover, spending may have also been affected by some extreme weather in July. But even with some bounce in electronic transactions in August, we wouldn't be surprised to see retail sales volumes dip in Q3 on less cash use post the big sports events in Q2. Some election uncertainty might also hinder spending in the current quarter.

Also already out this morning was the Performance of Services Index (PSI). It eased a couple of points in July to 56.0 from 58.3 in June, as sales growth eased. This suggests service sector growth cooled somewhat in the month, but again there look to be some temporary effects to blame, like the weather. Many PSI respondents noted extreme weather as having a negative impact on their business in July. Despite the disruption, the PSI remains above its long term average of 54.4 suggesting underlying growth remains solid. Strong new orders and very robust employment suggests we shouldn't get too downbeat on demand and sales ahead. The PSI remains above average despite a clear slowing in the housing market.

Last Friday's REINZ housing data for July saw house sales, on our seasonally adjusted estimate, ease another 1% in July. Sales are at genuinely low levels and down 24.5% on a year ago. House prices, according to the REINZ SPAR Index, were essentially flat in the month. Annual price inflation has now subsided to 1.2% from 2.8% last month and 15.3% a year ago. On the same basis, Auckland annual house price inflation has edged more clearly into the negative with house prices in the city of sails down 2.1% on a year ago (although did edge 0.2% higher in July itself). Non-Auckland house prices have been flat for the past three months, but still up 7.5% on a year ago. A clear slowdown in the housing market is likely to see be a drag on durable spending and is one reason why we anticipate slower retail sales growth ahead.

Turning to the remainder of the week's data, Thursday sees consumer confidence data for August. Confidence might be due a breather after a run higher, but it could ease a bit from July's firm 125.4 and still be above its long term average of 119 and imply decent retail sales growth ahead.

Also out Thursday are Producer Price and Capital Goods Price Indexes. We think there is still some commodity price (including electricity?) and construction cost inflation to come through these producer price gauges. For the quarter, we have plugged in a 1.0% lift for output prices and a 0.8% gain for inputs. This would give annual inflation of 4.9% and 4.2% respectively, both of which may be close to near term peaks.

Ongoing construction cost inflation is likely to remain a feature of the Capital Goods Price Index in Q2, while plant, machinery and equipment pricing remains muted. Overall, we expect annual inflation in the CGPI to remain around the 3.3% pace it set in Q1. Keep an eye on Q2 concrete production figures, to be released at the same time, as an early guide to how construction followed up its 2% dip in Q1 GDP figures. A lack of a bounce wouldn't help Q2 GDP calculations, but would be less worrisome now with a strong retail result in the bag.

On commodities, we will get the very latest on dairy prices via the Global Dairy Trade auction, early Wednesday morning (NZT). Indicators look reasonably constructive following a small price dip at the previous event in early-August. Any push higher would add to the case for farmgate milk prices to be in the high $6s or early $7s this season.

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Global Watch

- Australian (Q2) wage and (July) jobs data due
- Plus meeting minutes from RBA, FOMC, ECB
- China retail, IP data today, Japan Q2 GDP too

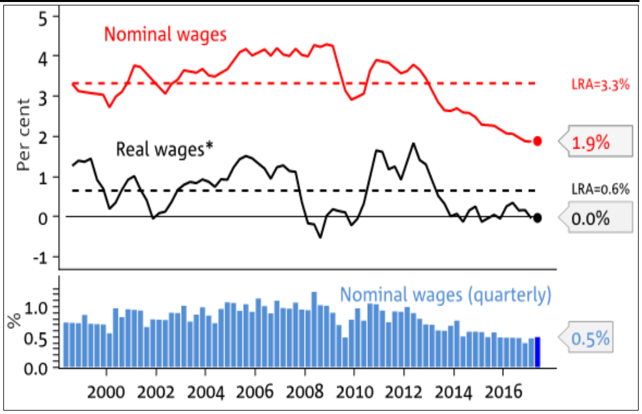
Australia

It's a big week in Australia with the RBA Minutes Tuesday, Wages on Wednesday, and Employment and Unemployment Thursday. The week also includes two RBA speeches, Kent (Monday) and Ellis (Thursday). As for the RBA Minutes, they are unlikely to add too much more given the Governor's comprehensive grilling at today's Parliamentary Testimony and the recently released August Statement on Monetary Policy. In the Testimony, the Governor noted "current market pricing implies greater probability of a rate rise than a rate reduction, it also implies that the next move in interest rates is a long way out…I think they're both reasonable assumptions".

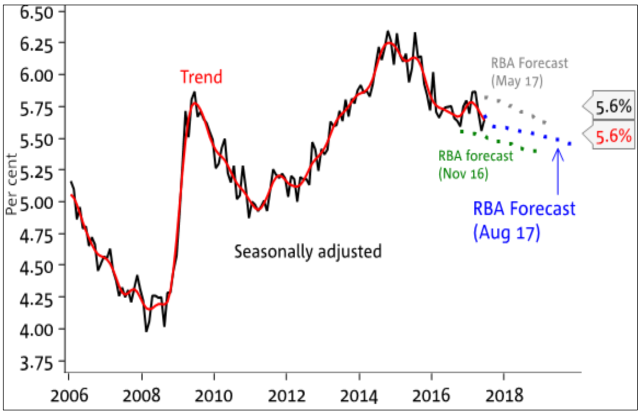
Dr Lowe also noted that employment growth has been stronger of late, though "it is likely to be some time before we reach what could be considered full employment in Australia." Going forward, it will be important to monitor the labour market's track towards full employment. The RBA will likely begin to remove policy accommodation before the economy approaches full employment. Datawise, Wednesday's Wage Price Index will be closely watched to see whether the low point in wages growth has been reached. NAB looks for a 0.5% q/q outcome, which gives a 1.9% y/y increase – the same as the market consensus (Chart 1). While wages growth is not expected to pick-up in Q2, it should start to from Q3, initially driven by the recent higher than expected increase in the minimum wage.

The minimum wage was increased by 3.3% in Australia, effective July 1. The 3.3% increase is the highest since 2011 and should add around 0.1-0.2% points to quarterly wages growth. A gradual tightening in the labour market should also eventually lead to higher wages growth. Previous modelling by NAB has shown that wider measures of labour market spare capacity such as underemployment have dragged on wages growth. As

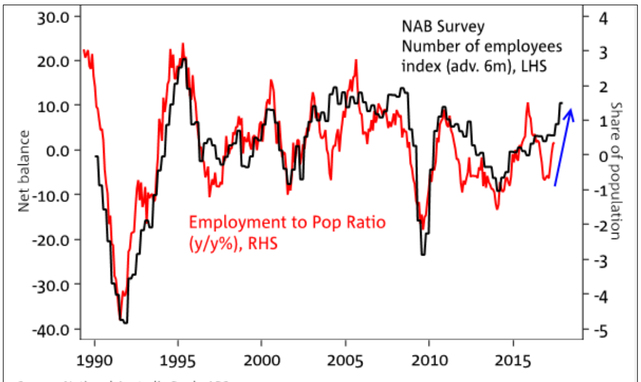
Real and Nominal Wages Price Growth



Unemployment Rate and RBA's Forecast



Annual Employment Growth



Source: National Australia Bank, ABS

these trends reverse, they will no longer drag on wages growth and should see growth pick up.

Thursday brings the key Employment/Unemployment data. It is a statistical lottery at the best of times and the market looks for employment growth of +20k and an unchanged unemployment rate at 5.6%.

Upside risks are likely to the consensus given strong forward indicators to date (rising job ads and a stronger NAB survey) and a possible upward tilt from sample rotation.

NAB accordingly forecasts employment +25k m/m with upside risks and a fall in the unemployment rate to 5.5%. Finally, the RBA's effective chief economist, Dr Luci Ellis is giving a speech titled "On Lags". A cryptic title, but is likely to be in reference to the lags in the transmission of monetary policy to the real economy. Indeed most economists' first words are "lags are long and variable"!

China

Key activity data Monday is the highlight with Retail Sales, Fixed Asset Investment and Industrial Production all released for July. The market looks for a slight easing back in the pace of growth (Retail Sales expected 10.8% y/y from 11.0% previously; Industrial Production 7.1% y/y from 7.6% previously).

US

Retail Sales Tuesday and the FOMC Minutes Wednesday are the clear highlights. Retail Sales are expected to rebound from last month's weak outcome (0.4% m/m expected from -0.2%). The FOMC Minutes for the July Meeting will be closely watched for any hints on the outlook for inflation and the likelihood of the Fed beginning its balance sheet unwind at the September meeting (which NAB thinks is very likely). Other data worth watching include Industrial Production Thursday and Uni of Michigan Consumer Confidence Friday. The Fed's Kaplan (voter, neutral to hawkish) speaks on Thursday and Friday – both with Q&A.

Japan

A big week for Japan with GDP Monday, Industrial Production Tuesday and the Trade Balance Thursday.

Eurozone

An important week with Industrial Production Monday, GDP Wednesday (German GDP Tuesday), Trade Balance and final CPI figures and ECB Minutes Thursday. The ECB Minutes are worth noting for any discussion around the language surrounding the asset purchase program – these words were unchanged in the post meeting Statement despite the previous Minutes' noting that members had discussed a change in language.

UK

CPI Tuesday and Employment/Unemployment Wednesday.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The key driver of rates markets last week was the increased geo-political risk, with US-North Korea tensions rising to an unprecedented level amidst all sorts of threats traded. While most would agree that talk is cheap and any military action would end up being catastrophic (not a particularly rational strategy), the tail risk of a truly bad outcome is enough to generate a market reaction. For example, a 5% increase in chance of a 100bp fall in 10-year rates that might follow conflict near the Korean peninsula is enough to generate a 5bps downward move in rates.

The other key dynamic for rates remains the soft backdrop of US inflation. On Friday we saw the fifth consecutive monthly miss to the downside for core CPI inflation, which saw a further pushing out of Fed rate hike expectations and supporting US 10-year Treasury yields around six week lows. The odds of another hike this year fell from 40% to 25% over the course of the week. One now has to look to the end of next year before a full 25bp rate hike is priced in, well below the four rate hikes of the median expectation of FOMC members published in June.

The RBNZ's MPS didn't surprise from a rates perspective and thus market reaction was modest, with the only surprise being the threat of currency intervention (see Currency section). We agree with the Bank's view that policy will be on hold for an extended period, probably at least a year or so, but our view differs that policy will be on hold for a full two years. Still, a year of unchanged monetary policy should help underpin the short end of the curve. We expect the 2-year swap rate to trade mainly in a 2.15-2.25% range for the rest of the year with occasional brief skirmishes outside that range, largely due to global forces

Domestic releases this week are unlikely to be market moving, with Q2 real retail sales data too dated to be that relevant for the market.

In the US, retail sales data and the minutes of the last FOMC meeting will get the most attention, while there is also a smattering of minor releases. In Australia, the RBA's minutes will be of less interest than usual, as Governor Lowe played his hand at his testimony to Parliament last week – he signalled the next move is likely to be a rate hike, but some way down the track. Thursday's July jobs report, provides its usual scope for some short-term reaction in the rates market.

But geopolitical developments could well remain in the driving seat this week. This year's intra-day low of 2.10% for the US 10-year rate could be threatened if the sabre-rattling intensifies. But our assumption is that eventually the risk around US-North Korea conflict will pass and fundamental forces will be back in the driving seat, which would see an unwind of some of the downward pressure to rates of late from this factor. Higher oil prices over the past couple of months and a weaker US dollar should ultimately lead to higher US inflation and put rate hikes back on the agenda, but that doesn't seem an immediate threat.

These global factors remain the key driver of NZ mid to long-term rates. With the RBNZ on hold for an extended period, domestic monetary policy is unlikely to be a key factor for the rates outlook over the remainder of the year.

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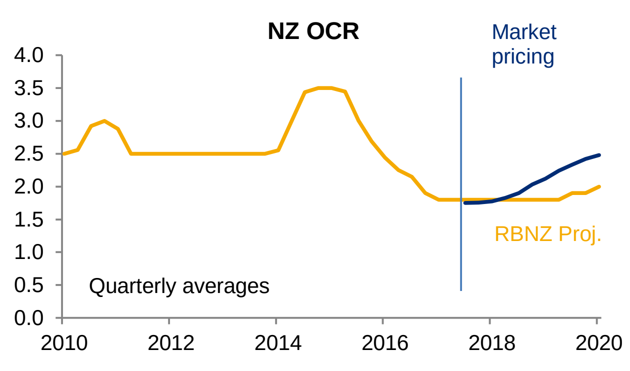
A Flat OCR Outlook For Another Year



Source: BNZ, Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.95	1.92 - 1.96
NZ 2yr swap (%)	2.16	2.15 - 2.25
NZ 5yr swap (%)	2.63	2.61 - 2.82
NZ 10yr swap (%)	3.14	3.12 - 3.35
2s10s swap curve (bps)	98	98 - 110
NZ 10yr swap-govt (bps)	34	27 - 36
NZ 10yr govt (%)	2.80	2.78 - 3.04
US 10yr govt (%)	2.19	2.18 - 2.34
NZ-US 10yr (bps)	61	55 - 75
NZ-AU 2yr swap (bps)	28	25 - 35
NZ-AU 10yr govt (bps)	21	17 - 32

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD had a rough time last week, seeing a fall on all the major crosses and taking the TWI down to its lowest level since early-June. Two key driving forces were in action – increased geo-political risk with US-North Korea tensions rising to an unprecedented level amidst all sorts of threats traded, and the RBNZ Monetary Policy Statement.

While risk appetite has fallen with the increased geo-political headlines, in our view the market was becoming far too complacent and risk appetite was well overdue for a fall, whatever the trigger. So while the tail-risk of US-North Korea military action might well come and go, we're comfortable with the idea that risk appetite can sustainably move down from the recent average into year-end. There are plenty of other risks to consider, which the market has ignored.

Last week's fall in risk appetite was enough to lop more than 2 cents off our short term NZD/USD fair value model estimate, taking it down to 0.7400 and taking the valuation gap into rounding error territory. Fair value on our NZD/AUD models has been trending lower (one at around 0.92 and the other at 0.9350), reflecting narrower NZD-AUD short rate spreads and Australian commodity prices outperforming NZ commodity prices.

The RBNZ's MPS came as no surprise and the immediate market reaction was modest, but the surprise came with Governor Wheeler and Assistant Governor McDermott upping their rhetoric on the apparent high NZD, playing the "currency intervention" card. We're surprised that the market fell for that jawboning, as we see the threat of intervention as not credible. Indeed, it makes no sense to us, with the TWI below its average for the year (even before the MPS) and NZ's terms of trade close to a record high. All that the jawboning achieved was increased volatility in the NZD over the short term with no sustained impact.

The ducks had been lining up for an NZD correction off its highs and we think that further downward pressure should prevail into year-end. That means that we think that the high point for the NZD has already passed.

In the week ahead, NZ events and data are unlikely to be NZD-sensitive. In the two key releases, we expect to see a softening in the retail sales growth trend and a positive GDT dairy auction mid-week.

In the US, retail sales data and the minutes of the last FOMC meeting will get the most attention. The fifth consecutive monthly miss to the downside on US core CPI inflation last Friday reduces hope that the USD is about to stage a recovery from over-sold levels. In Australia, the RBA's minutes will be of less interest than usual, as Governor Lowe played his hand at his testimony to Parliament last week. Thursday's July jobs report for Australia provides its usual scope for some short-term currency reaction.

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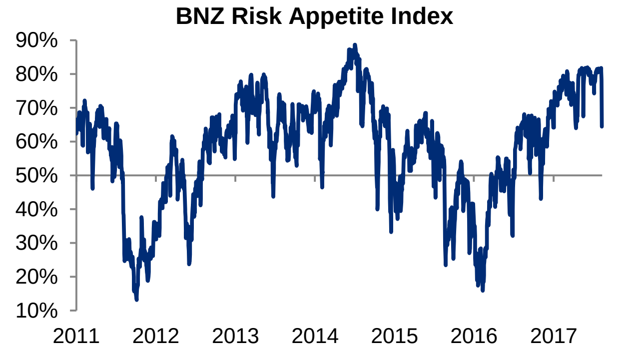
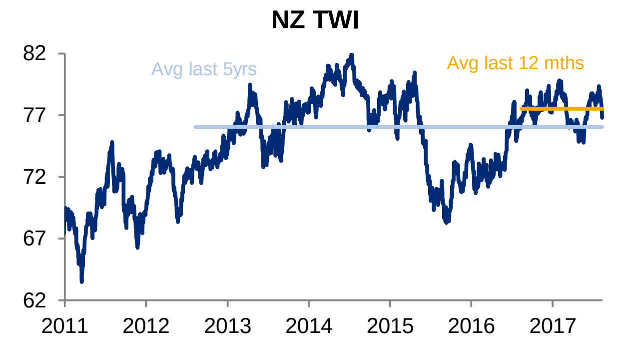
Risk Appetite Plunged Last Week



Source: BNZ, Bloomberg

A Hollow Intervention Threat Under the Circumstances



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7309	0.7250 - 0.7560
NZD/AUD	0.9260	0.9210 - 0.9460
NZD/GBP	0.5623	0.5580 - 0.5750
NZD/EUR	0.6181	0.6160 - 0.6440
NZD/JPY	79.77	79.10 - 83.90

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7400	-1%
NZD/AUD	0.9180	1%

Technicals

NZD/USD

Outlook: Down

ST Resistance: 0.7400 (ahead of 0.7490)

ST Support: 0.7200 (ahead of 0.7100)

The air proved thin above 0.74, despite reaching as high as 0.7550 in late July, so we'd put resistance at the 0.74 mark again. The bigger threat on the chart is a test of support around 0.72. A breakdown through that level opens up significant downside potential.

NZD/AUD

Outlook: Trading range

ST Resistance: 0.9400 (ahead of 0.9500)

ST Support: 0.9200 (ahead of 0.9100)

Remains a messy technical picture, with few key levels to get excited about. Initial support looks to kick in around the 0.92 mark.

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NZ 5-year Swap Rate

Outlook: Neutral

ST Resistance: 2.88

ST Support: 2.51

Move lower extended to a close of 2.6175 on Friday. Close on a sustained break, should this occur, we will head towards 2.51%

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

Outlook: Steeper

ST Resistance: +62

ST Support: +45

Still expect move steeper stop on break of +45.

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Key Upcoming Events

	Forecast	Median	Last
Monday 14 August			
NZ, Retail Trade, Q2 vol s.a.	+0.5%	+0.7%	+1.5%
NZ, BNZ PSI (Services), July			58.6
China, Retail Sales, July y/y		+10.8%	+11.0%
China, Industrial Production, July y/y		+7.1%	+7.6%
Jpn, GDP, Q2 1st est		+0.6%	+0.3%
Euro, Industrial Production, June		-0.5%	+1.3%
Tuesday 15 August			
Aus, RBA Minutes, 1 August Meeting			
Germ, GDP, Q2 1st est		+0.7%	+0.6%
UK, CPI, July y/y		+2.7%	+2.6%
US, Empire Manufacturing, August		+10.0	+9.8
US, Business Inventories, June		+0.4%	+0.3%
US, Retail Sales, July		+0.4%	-0.2%
Wednesday 16 August			
NZ, Dairy Auction, GDT Price Index			-1.6%
Aus, Labour Price Index, Q2		+0.5%	+0.5%
Aus, Westpac Leading Index, July			-0.14%
Euro, GDP, Q2 2nd estimate		+0.6%	+0.6%P
UK, Unemployment Rate (ILO), June		4.5%	4.5%
US, Housing Starts, July		1,220k	1,215k

	Forecast	Median	Last
Wednesday 16 August cont'd…			
US, FOMC Minutes, 26 July meeting			
Thursday 17 August			
NZ, Business Price Indexes, PPIO Q2 y/y			+4.1%
NZ, ANZ-RM Consumer Confidence, August			125.4
Aus, Employment, July		+20k	+14k
Aus, RBA's Ellis Speaks			
Jpn, Merchandise Trade Balance, July		+¥354b	+¥440b
Euro, ECB Minutes, 20 July Meeting			
Euro, Trade Balance, June s.a.		+€20.3b	+€19.7b
Euro, CPI, July y/y 2nd est		+1.3%	+1.3%P
UK, Retail Sales vol., July		+0.2%	+0.6%
US, Philly Fed Index, August		+18.3	+19.5
US, Leading Indicator, July		+0.3%	+0.6%
US, Industrial Production, July		+0.3%	+0.4%
US, Fed's Kaplan Speaks			
Friday 18 August			
NZ, H/H Inflation Exp. (1yr median), Q3			+2.5%
China, Property Prices, July			
US, Fed's Kaplan Speaks			
US, Mich Cons Confidence, August 1st est		94.0	93.4

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.83	1.86	1.85	2.13
2mth	1.90	1.91	1.91	2.19
3mth	1.96	1.95	1.97	2.26
6mth	1.99	2.00	2.02	2.24
GOVERNMENT STOCK				
12/17	1.78	1.78	1.81	1.80
03/19	1.89	1.89	2.05	1.79
04/20	2.02	2.03	2.27	1.81
05/21	2.15	2.18	2.40	1.83
04/23	2.44	2.49	2.69	1.92
04/25	2.67	2.74	2.90	2.08
04/27	2.82	2.90	3.02	2.20
04/33	3.20	3.28	3.35	2.53
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	78.88	76	86	104
N. AMERICA 5Y	61.55	58	62	71
EUROPE 5Y	57.63	52	57	66

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.16	2.19	2.33	2.03
3 years	2.33	2.36	2.55	2.05
5 years	2.63	2.69	2.90	2.14
10 years	3.13	3.21	3.41	2.49
FOREIGN EXCHANGE				
NZD/USD	0.7317	0.7408	0.7276	0.7117
NZD/AUD	0.9244	0.9342	0.9574	0.9356
NZD/JPY	79.99	82.07	82.95	72.69
NZD/EUR	0.6189	0.6287	0.6382	0.6353
NZD/GBP	0.5627	0.5678	0.5646	0.5443
NZD/CAD	0.9277	0.9367	0.9373	0.9384
TWI	77.17	78.28	78.46	75.88

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