15 May 2017

Unpredictable

- McDermott speech to expand on RBNZ reserve?
- A neutral stance but with OCR well below neutral
- Retail trade keeps booming in Q1
- April's slow PSI intriguing; PMI still strong
- Q1 business prices to show broader inflation
- April's tourism numbers up about 25% y/y?

Retail Trade			
Q1 (volume) %	**Actual**	Mkt Expected	Q4
quarterly	**+1.5**	+0.9%	**+0.9R**
- ex-auto	**+1.2**		**+0.7R**
annual	**+5.4**		**+4.7**
- ex-auto	**+4.8**		**+4.4**
Based on seasonally adjusted data			

We welcome the speech that RBNZ Assistant Governor and Head of Economics, John McDermott, is scheduled to give late today (5:00pm). Entitled "The Value of Forecasting in an Uncertain World" it will presumably elaborate on the reasons the Reserve Bank struck such a reserved tone in its Monetary Policy Statement last Thursday. We think it fair to say that it caught most people by surprise – certainly the markets, judging by their re-pricing on the day.

While the stance of the Reserve Bank has been commonly described as (staunchly) neutral, that's not to say its cash rate is. McDermott, in an interview late on MPS day, suggested New Zealand's neutral short-term interest rate has slipped below 4%. But, we'd argue, surely not all the way down to 1.75% (implying a near-zero real rate). Guidance from the RBNZ officials on this would be helpful, as the anchor of neutral interest rate levels is important when trying to understand central bank behaviour.

While the Bank is obviously not confident that annual CPI inflation will hold up around 2%, there is little sign that the real economy is falling by the wayside.

Indeed, this morning's retail trade figures were exceptionally strong, again. In real terms they expanded 1.5% in the March quarter. What's more, the "slowdown", to 0.6%, that was initially reported for Q4 was upgraded to a 0.9% gain. This meant annual growth in Q1 came in at 5.4% (for a total expansion over the last 5 years of 27%, or 18% in per capita terms). Note that this 5.4% is different to the 4.6% annual growth reported for actual volumes, partly because the latter does not account for trading days and, in the case of Q1 2016, the occurrence of a leap day.

This was all clearly above market expectations, which were for a 0.9% gain in Q4, and our expectation of 0.7%, for an annual 4.3%.

Note that this wasn't because inflation for the retail sector was lower than we thought for the quarter. In fact, it was at least as robust (at 1.1% for the quarter and 2.0% over the four quarters). Rather, it was the result of more nominal expenditure in Q1 than we had figured on via the monthly electronic card transactions.

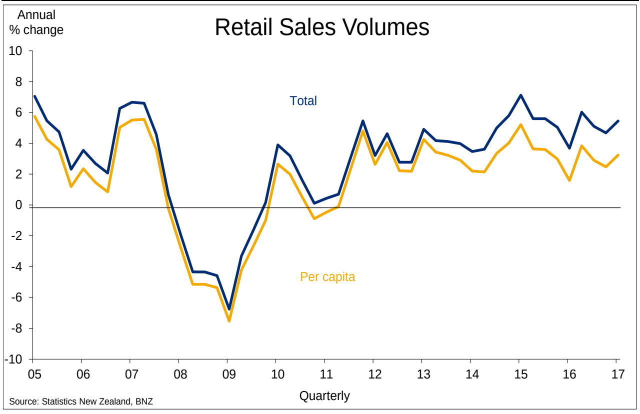
Vehicles figured strongly, again, up 5.9% in the March quarter in inflation-adjusted terms. However, it's also worth pointing out that fuel volumes continued to fall, down 3.4% in Q1 (-4.6% y/y).

Excluding these auto components retail sales expanded 1.2% in Q1, to be 4.8% higher than a year ago. That's a solid core rate. Yes, there were some ups and downs in the store-type detail, but nothing out of the ordinary. The regional stories had a more concerted positive tone for the second quarter in a succession, compared to some patchiness in the couple of quarters beforehand.

Overall, today's retail trade outcome is particularly encouraging for Q1 GDP growth, as other parts of that computation could look a bit wobbly, such as for construction, if only in a technical sense. Retail promises to hold Q1 GDP growth to the 0.7% rate we expect.

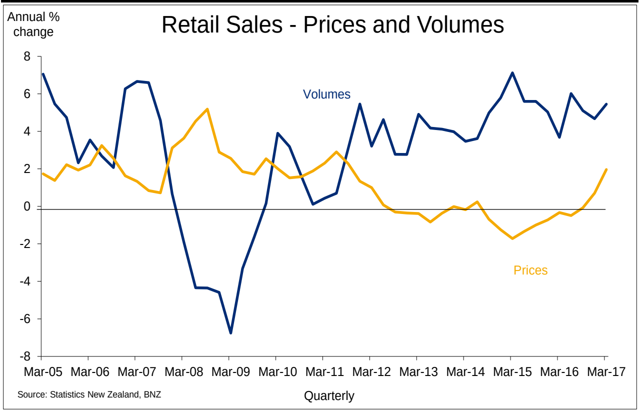
Of course, retail spending is not the same thing as total spending by NZ residents (consumption). But it's good prima facie evidence that the latter is in good heart. The RBNZ forecasts consumption growth to gradually dissipate over the next few years, down to an annual rate of about 2%. And by the look of it, the Bank expects a decent, rather than hefty, increase in consumption in Q1 2017; as did we, before we witnessed today's retail trade figures.

More Than Population



National Australia Bank

In Prices Too

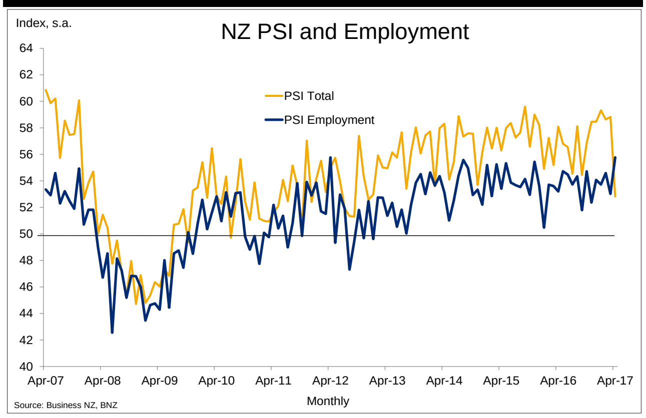


This morning's Performance of Services Index (PSI) wasn't so strong. In fact, it slowed quite a bit, to 52.8, from 58.8 in March. While this big fall cannot be taken lightly, we wonder the extent to which it reflected April being riven with (Easter and school) holidays as well as stormy weather. We also note that the inventories component was by far the biggest drag in the month, while the PSI employment index actually improved to an equal record high, of 55.8. So we prefer to see the May and June PSI readings before we come to any strong conclusions on the sharp slowdown in April's issue.

Meanwhile, the Performance of Manufacturing Index remained clearly upbeat in April. Sure, it couldn't quite match March's result of 58.0. But at 56.8 it was still well above trend. This is happening as the global PMI has reclaimed a decent pulse, from having been extremely faint a year or so ago.

Tomorrow afternoon sees the release of the RBNZ survey of household inflation expectations. But with RBNZ officials suggesting that only "unreliable" measures of inflation expectations have risen – presumably including the Bank's own quarterly survey of businesses and analysts – then tomorrow's results might only be important if they fall.

What's Up?



For the latest Global Dairy Trade auction, due early Wednesday morning (NZT), we are looking for a relatively steady result in the overall price index, notwithstanding a probable dip in its whole-milk powder price component. If so, this would bolster our belief there is room for Fonterra to nudge up its final milk price for 2016/17, from its current intention of $6.00. We still expect $6.10.

As for next season's (2017/18) milk price, Fonterra is required to issue its first forecast of this by the end of May. While this makes for something to watch for this week, we think it more likely to occur next week, after Fonterra absorbs the latest GDT auction results. Our forecast of the final milk price for 2017/18 – far ahead as it is – is $6.00.

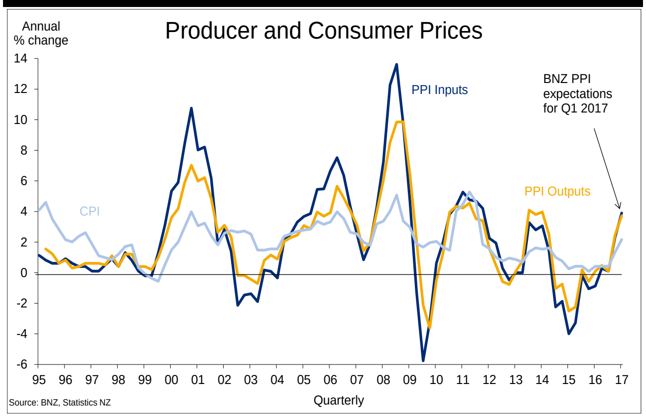
Later on Wednesday (10:45am) the Q1 business price indexes are published by Statistics NZ. In these, we see producer price annual inflation pushing up through 3%, even closer to 4%. This is on the basis of further rebound in commodity prices and ongoing building cost pressures. The PPI results should be a reminder that inflation (and nominal income) pressures are not confined to recent CPI results.

Similar to the PPI story, there is a good chance the Capital Goods Price Index at least maintains its relatively firm annual inflation in Q1, at around 3.4%.

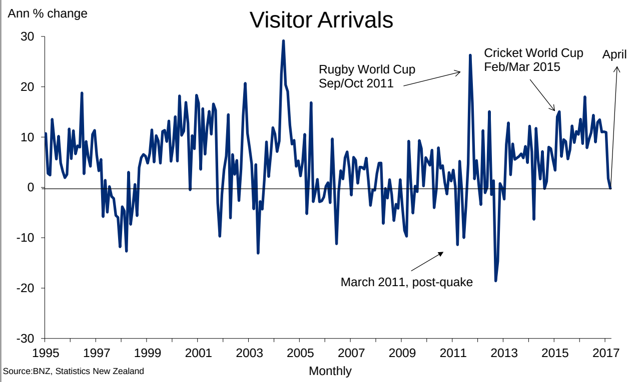
At the same time – Wednesday 10:45am – Statistics NZ is scheduled to publish March quarter ready-mixed concrete output. This will help us gauge whether there has been a technical drop in building activity in the quarter, or not (one of our reservations around Q1 GDP).

The ANZ Roy Morgan measure of consumer confidence in April might have been affected by abnormal weather when it edged down to a still reasonable 121.7. May's read (due Thursday 1:00pm) will help us judge if there was a bit more to the dip than just the weather. Going by the recent undercurrents in retail spending, household sentiment remains OK.

Broadly Speaking



A Masterly Help



Source:BNZ, Statistics New Zealand

Turning to Friday's migration figures, we haven't seen anything to indicate a softening in the net inflow, from March's near record seasonally adjusted gain of +6,100. And now there's increasing public attention on the results, as we count down to September's election.

As for short term visitor arrivals in April, watch for a massive lift (circa 25%? y/y) on account of the hosting of the World Masters Games and the timing of Easter. April's credit card billings are scheduled for Friday afternoon (3:00pm).

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Global Watch

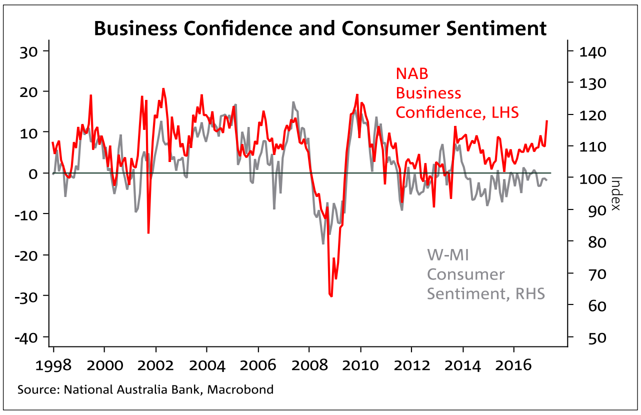
- China's activity data out today
- CPIs for EU, UK and Canada due during week
- Draghi speaks Thursday
- AU focus on wages and employment

Australia

It's a focus on the consumer this week. It starts in earnest with the monthly Westpac-Melbourne Institute Consumer Sentiment survey on Wednesday – polled last week (and also following the weekly ANZ-Morgan Consumer Sentiment release Tuesday) – and coming that day with the key ABS Wage Price Index (WPI) for Q1. The RBA Minutes are being released on Tuesday, though they are unlikely to be market moving. (See more on these below.)

Consumer sentiment has, to date, been lagging the pick-up in business confidence. As for Wednesday's WPI, NAB continues to expect still soft wages growth at 0.5% for the quarter, a repeat of December quarter growth which keeps annual growth unchanged at a still-low 1.9%. Such an outcome might be sufficient to give the RBA a little more confidence that wages growth is bottoming, especially if it's followed Thursday by another positive reflection of the labour market report, this one for April. The RBA will also be paying some attention to Thursday's Melbourne Institute's consumer inflationary expectations survey for May, the survey throwing more light on the low inflation and wages trap, a vulnerability for consumer spending.

Chart 1: Business Confidence Leading the Way



Even though the market and analysts now fully understand the unpredictability of the ABS Labour Force Survey, there is still close attention paid to the outcome. Last month, the Survey for once disclosed a surprise on the high side, employment up 60,900, after two months of below expectations outcomes, despite signs from labour demand leading indicators pointing to renewed employment growth.

Chart 2: Playing Catch-Up – More Jobs Ahead

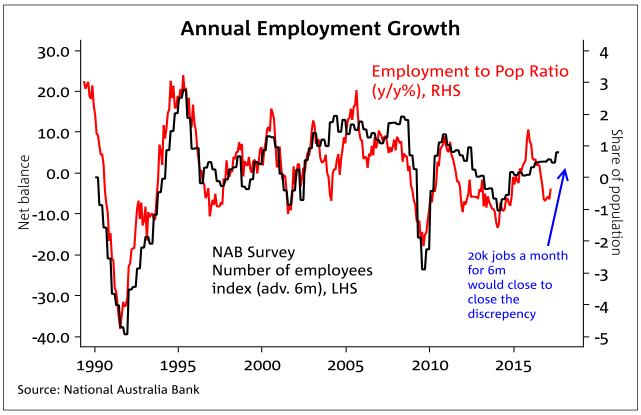


Chart 3: Slower Wages In Most Sectors

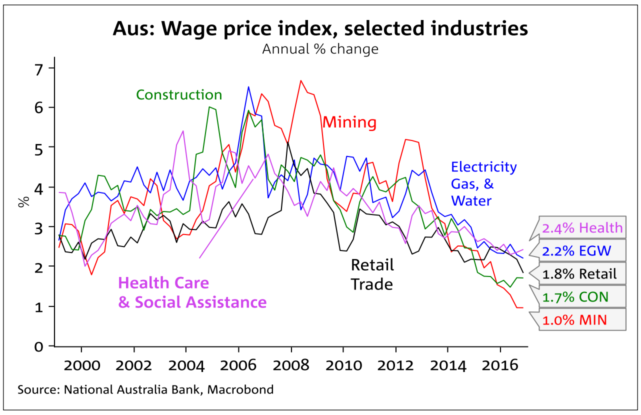
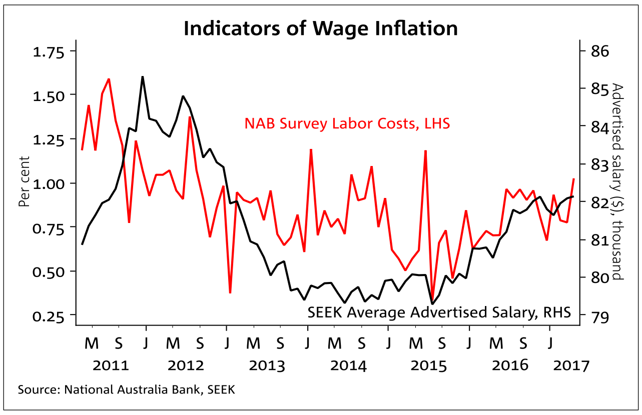
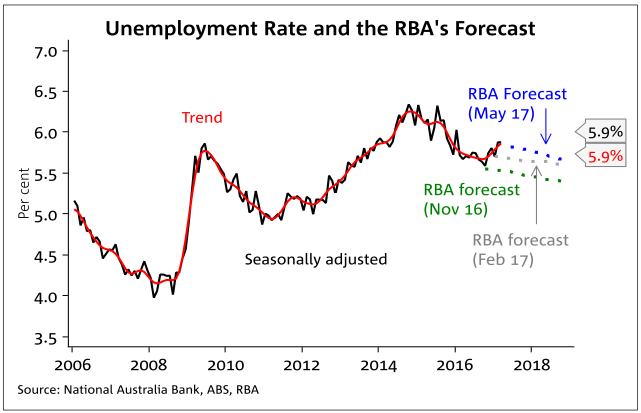


Chart 4: Indicators Suggest Low Wages Point Has Passed



Among a wide array of possible survey outcomes, NAB expects further growth, tipping growth of 10,000, somewhat above the 5,000 consensus. Depending on the also volatile participation rate, NAB expects a slight dip in the unemployment rate, from 5.9% to 5.8% in April. We expect that Cyclone Debbie likely had a less material impact on the outcome, the ABS definition of employment including those who worked at least one hour in the week, so even if hours were much shortened, such workers would be included in the estimate of employment. Any

Chart 5: Forecasting Unemployment



downside surprise in employment would be viewed for any influence from Queensland especially, while another upside surprise would provide the RBA with more confidence that the underlying trend in the labour market is improving.

Also being released this week is Housing Finance approvals for March, being released on Monday. The most interest we expect will be in Investment Lending approvals that fell 5.9% in March, after having risen in four of the previous six months. This release pre-dates the further measures announced by the monetary authorities to restrict growth in lending for housing investment.

The RBA Minutes this month are unlikely to throw too much more light on RBA thinking, given the already released Statement on Monetary Policy and a follow-up speech from RBA Governor Lowe. The May RBA Board meeting and subsequent statements were very much "no surprises" statements, indicating that the RBA is unlikely to change interest rates in either direction any time soon. The focus remain on the trends in both the housing and labour markets, principal areas of concern for the RBA, the latter also a principal data focus this coming week.

China

China releases its key Industrial Production, Retail Sales, and Fixed Assets Investment reports for April. Chinese Property Prices for April are out on Thursday.

US

It's a quiet week with the NAHB Housing Index, Housing Starts/Building Permits and Industrial Production. There are Fed speakers – but non-voters – with Bullard speaking twice, along with Mester.

Japan

Wednesday's Industrial Production and Thursday's Q1 GDP the focus points.

Eurozone

The second cuts of Q1 GDP is out Tuesday and April's CPI on Wednesday. There'll be continued interest in any comment ECB President Draghi might have to make on the zone's economy and monetary policy when he speaks in Tel Aviv on Thursday, including any inkling/hints on winding back QE.

UK

While there'll be some interest in Tuesday's CPI, Wednesday's labour market report, Thursday's retail sales, and Friday's CBI Trends survey will be dissected for any signs of softness, especially retail sales that were especially weak in March.

Canada

Quiet data-wise ahead of key Retail Sales and CPI on Friday.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The RBNZ's Monetary Policy Statement last week shocked the market. The Bank reiterated its view that "monetary policy will remain accommodative for a considerable period". While that was no surprise, the market was perplexed with the Bank's assessment that developments since the February MPS had no impact on its policy outlook. The Bank saw the recent increase in headline inflation as transitory and it gave more weight to its own-calculated measure of core inflation that put it steady over the past eighteen months at 1.5%. This compares to most official measures which have seen a rising trend and sit just over 2%.

The Bank maintained a neutral stance, which in practice means an equal chance of a rate cut or hike at this juncture and believes that an unchanged OCR of 1.75% through to late 2019 will be required to generate headline inflation of 2% over the medium term. With even the most dovish analysts in the market expecting a nod towards an earlier projected tightening than late-2019, a significant rally in short-mid rates ensued.

While we differ with the RBNZ's inflation and rate projections, its view must be respected. Even if the Bank's forecasts prove to be wrong, it would take some time for the RBNZ to change its policy course.

A softer credit environment is seeing little paying pressure on short term swap rates and, with the RBNZ's view on the policy outlook crystal clear, the threat of a surprisingly hawkish turnaround by the RBNZ seems remote at this juncture. So traders are likely to be happier to receive 2-year swap, even at the current year-low levels. The pre-MPS trading range for 2-year swap was around 2.25-2.35% and the new range over coming months is now more likely to be at least 10bps lower at 2.15%-2.25%.

We still think that the RBNZ will raise rates in 1H18, but with the Bank far from convinced that the recent pick-up in inflation is sustainable, it is unlikely to give an early signal of possible rate hikes ahead for next year. The Bank's likely stance is to delay any signal for as long as possible, and this is likely to dampen upward pressure on the mid-curve as well. Pre-RBNZ MPS, the range for 5-year swap was about 2.80-3.00% and we think that the new range over coming months is more likely 2.65-2.85%.

US CPI data late last week also raises a question mark over the Fed's policy outlook. For the second month in a row, the CPI was weaker than expected. The Fed's preferred core PCE deflator due at the end of the month could come in as low as 1.4% y/y, which would be the lowest rate in nearly 18 months. A June rate hike is well priced by the market and looks like a reasonable bet, but more soft inflation data would raise the risk of a pause in the US tightening cycle.

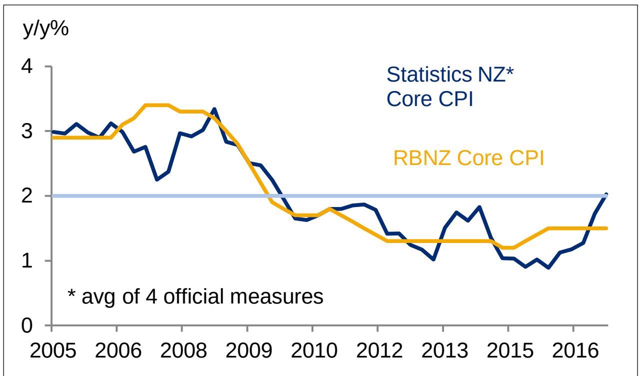
Ultimately, we think the tight US labour market will lead to higher inflationary pressure, but any softening in policy tone by the FOMC could delay the push up in US 10-year rates we had pencilled in for the second half of the year.

The combo of a dovish RBNZ MPS and soft US inflation data has helped support the long end of the NZ curve. The NZ 10-year swap rate could soon test the year-to-date low around 3.25%, but ultimately we see upward pressure to yields reverting in the second half of the year. The path of US inflation remains crucial.

In the week ahead we expect tight ranges to prevail, given the lack of heavy-hitting data on the economic calendar. Assistant Governor McDermott's speech tonight is the most relevant event of interest to the short end of the curve.

There aren't any top-tier US economic releases this week, which limits the likely range for US rates, in the absence of any political developments.

Core Inflation…Take Your Pick



Source: BNZ, Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.99	1.97 - 2.00
NZ 2yr swap (%)	2.21	2.21 - 2.37
NZ 5yr swap (%)	2.77	2.77 - 2.99
NZ 10yr swap (%)	3.29	3.29 - 3.48
2s10s swap curve (bps)	108	105 - 112
NZ 10yr swap-govt (bps)	36	32 - 39
NZ 10yr govt (%)	2.93	2.93 - 3.10
US 10yr govt (%)	2.33	2.27 - 2.42
NZ-US 10yr (bps)	60	58 - 77
NZ-AU 2yr swap (bps)	40	40 - 49
NZ-AU 10yr govt (bps)	35	33 - 47

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

Last week's price action was all about the RBNZ's Monetary Policy Statement (MPS). The consensus view leading up to the Statement was that data since the February MPS unambiguously pointed in the direction of much higher inflationary pressure than the Bank previously thought and that would lead the Bank to show a gentle lift in its OCR track towards the back end of its forecasts. In a shock move, the Bank "discovered" some disinflationary pressure that would offset the most obvious inflationary impulses. The rate track showed no possible hike until late-2019, an unchanged assessment from February.

In the space of a couple of hours, the NZ TWI gave back all its prior gains for May. NZD/USD reached a fresh low for the year around 0.6820 and has settled close to a key technical support level of 0.6850 since. So where to from here?

With the hurdle seemingly higher for the RBNZ to give a nod to tighter policy, one supportive force we saw for the NZD has been stripped away. We still think that the Bank will raise rates in 1H18, but rather than give an early signal of possible rate hikes ahead next year, the Bank's likely stance is to delay any signal for as long as possible. The Bank is far from convinced that the recent pick-up in inflation is sustainable.

This dynamic is a negative force for the NZD against a backdrop of the US Federal Reserve tightening monetary policy. However, the second CPI miss to the downside in the US, raises a question over the Fed's tightening path as well. A June rate hike is well priced by the market and that looks like a reasonable bet, but more soft inflation data would raise the risk of a pause in the US tightening cycle.

In addition to considering NZ-US rate spreads, the other dynamic currently in play is the general underperformance of commodity currencies. This is acting as a drag on the NZD even though NZ's export commodity prices are holding up quite nicely. The market is likely giving some weight to tightening liquidity conditions in China and signs that the country's growth momentum is fading.

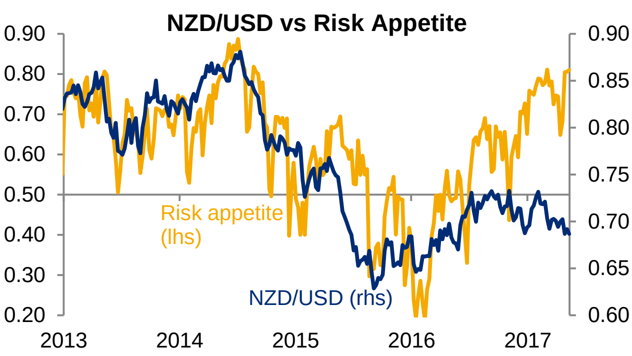
The positive correlation between the NZD and risk appetite has also been broken. With the NZD falling against the positive backdrop of high risk appetite and supportive NZ commodity prices, the gap between spot and our short term fair value estimate is a historically high 8%.

The bottom line is that with risk appetite seemingly not a key influence on the NZD, global commodity prices having more influence on the currency than NZ commodity prices, and an RBNZ determined to sit on its hands all year, the prospect of the NZD recovering towards our short term model estimate well into the 0.70s is diminishing. It seems that the weakness in the NZD we saw for later in the year, has been brought forward. We maintain our year-end target of USD 0.67, but flag the possibility of that level being reached earlier than previously expected.

The week ahead looks fairly uneventful from an economic perspective. After retail sales data today, a speech by Assistant RBNZ Governor McDermott tonight and a GDT dairy auction early Wednesday morning are the local highlights.

In Australia, employment data on Thursday provides the opportunity for some AUD volatility. The soft RBNZ Statement has knocked the wind out of the sails for the NZD/AUD cross rate, but we still like the cross higher on a medium term perspective. There aren't any top-tier US economic releases this week. Overall, it seems like an apt environment for range-bound currency markets this week.

NZD Not Tracking Higher Risk Appetite Anymore



Source: BNZ Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6856	0.6820 - 0.6970
NZD/AUD	0.9276	0.9150 - 0.9430
NZD/GBP	0.5318	0.5270 - 0.5490
NZD/EUR	0.6270	0.6240 - 0.6460
NZD/JPY	77.62	76.10 - 79.40

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7440	-8%
NZD/AUD	0.9210	1%

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Technicals

NZD/USD

Outlook: Downward channel

ST Resistance: 0.6970 (ahead of 0.7090)

ST Support: 0.6820 (ahead of 0.6675)

The 0.6840-6890 zone remains a key area of technical support, with last week's intra-day low of 0.6820 also of some technical interest. A break of this opens up about 1½-2 cents of downside potential. Mild short-term resistance comes into play just under the 0.70 mark.

NZD/AUD

Outlook: Trading range

ST Resistance: 0.9350 (ahead of 0.9400)

ST Support: 0.9170 (ahead of 0.9100)

A pretty messy technical picture, really, for a cross that has largely tracked sideways for several years. 0.91 is a key area of technical support,with resistance around 0.9350-0.94.

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NZ 5-year Swap Rate

Outlook: Neutral

NT Resistance: 2.98

NT Support: 2.6875

Paid position was stopped immediately. Await a trigger to initiate new position. 200 day mvg avg at 2.6873 key now.

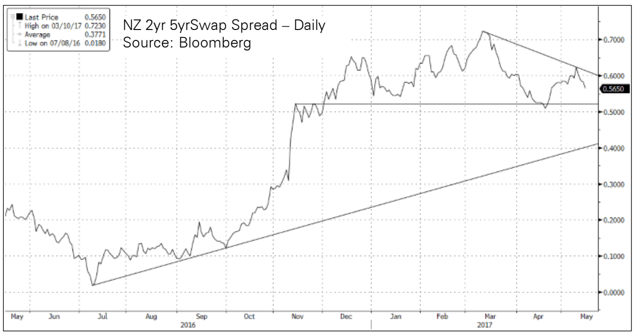
NZ 2-year - 5-year Swap Spread (yield curve)

Outlook: Bearish

ST Resistance: +72

ST Support: +52.5

Break support at 52.5 wasn't held and now forms support. Stop through +52.5.



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Key Upcoming Events

	Forecast	Median	Last
Monday 15 May			
NZ, RBNZ's McDermott Speaks, Uncertainty			
NZ, Retail Trade, Q1 vol s.a.	+0.7%	+0.9%	+0.6%
NZ, BNZ PSI (Services), March			59.0
Aus, Housing Finance, March	+0.9%	flat	-0.5%
China, Industrial Production, Apr y/y		+7.0%	+7.6%
China, Retail Sales, Apr y/y		+10.8%	+10.9%
China, Fixed Assets (ex rural), Mapr ytd		+9.1%	+9.2%
US, Empire Manufacturing, May		+7.3	+5.2
US, NAHB Housing Index, May		68	68
Tuesday 16 May			
NZ, H/H Inflation Exp. (1yr median), Q2			+2.0%
Aus, RBA Minutes, 2 May Meeting			
Jpn, Tertiary Industry Index, March		+0.1%	+0.2%
Euro, Trade Balance, March s.a.		+€18.7b	+€19.2b
Germ, ZEW Sentiment, May		+22.0	+19.5
UK, CPI, April y/y		+2.6%	+2.3%
US, Industrial Production, April		+0.4%	+0.5%
US, Housing Starts, April		1,260k	1,215k
Wednesday 17 May			
NZ, Business Price Indexes, PPIO Q1 y/y			+2.5%
NZ, Dairy Auction, GDT Price Index			+3.6%
NZ, Concrete Production, Q1			

	Forecast	Median	Last
Wednesday 17 May cont'd…			
Aus, Westpac Leading Index, April			+0.08%
Aus, Labour Price Index, Q1	+0.5%	+0.5%	+0.5%
Aus, Consumer Sentiment - Wpac, May			99.0
Jpn, Industrial Production, March 2nd est			-2.1%P
Jpn, Machinery Orders, March		+2.5%	+1.5%
Euro, CPI, Apr y/y 2nd est		+1.9%	+1.9%P
UK, Unemployment Rate (ILO), March		4.7%	4.7%
Thursday 18 May			
NZ, ANZ-RM Consumer Confidence, May			121.7
Aus, Unemployment Rate, April	5.8%	5.9%	5.9%
Aus, Employment, April	+10k	+5k	+61k
China, Property Prices, April			
Jpn, GDP, Q1 1st est		+0.4%	+0.3%
UK, Retail Sales vol., April		+1.1%	-1.8%
US, Leading Indicator, April		+0.4%	+0.4%
US, Philly Fed Index, May		+18.5	+22.0
Friday 19 May			
NZ, Credit Card Billings, April			+0.8%
NZ, External Migration, April s.a.			+6,100
Euro, Consumer Confidence, May 1st est		-3.0	-3.6
Germ, PPI, April y/y		+3.2%	+3.1%
UK, CBI Industrial Trends, May		+4	+4

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.87	1.85	1.75	2.27
2mth	1.93	1.91	1.75	2.31
3mth	1.99	1.98	1.75	2.36
6mth	2.01	2.03	1.75	2.34
GOVERNMENT STOCK				
12/17	1.81	1.81	1.85	2.00
03/19	1.94	2.09	2.10	2.02
04/20	2.15	2.30	2.29	2.08
05/21	2.32	2.45	2.43	2.12
04/23	2.61	2.71	2.75	2.26
04/25	2.83	2.95	3.03	2.48
04/27	2.93	3.05	3.13	2.62
04/33	3.23	3.31	3.48	2.93
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	81.56	82	84	136
N. AMERICA 5Y	62.68	62	65	85
EUROPE 5Y	63.08	63	74	80

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.21	2.34	2.29	2.19
3 years	2.42	2.58	2.50	2.23
5 years	2.77	2.94	2.85	2.42
10 years	3.29	3.43	3.37	2.87
FOREIGN EXCHANGE				
NZD/USD	0.6868	0.6905	0.6934	0.6843
NZD/AUD	0.9296	0.9309	0.9244	0.9276
NZD/JPY	77.82	77.87	77.26	73.41
NZD/EUR	0.6285	0.6282	0.6556	0.6004
NZD/GBP	0.5328	0.5324	0.5605	0.4742
NZD/CAD	0.9417	0.9437	0.9301	0.8845
TWI	75.09	75.36	75.77	72.98

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