16 October 2017

The Arbitrariness of Self-Imposed Targets

- **CPI likely stronger than the RBNZ thought**
- **In Q3, Q4, Q1 (and beyond?)**
- **PSI (56.0) like PMI (57.5) robust to election doubt**
- **With declaration of govt. expected (early?) this week**
- **Dairy price slippage likely not just Golden Week Migration still falling in September?**

Sometimes the targets we set for ourselves are just too precise to be reasonable. With this in mind, we can appreciate why negotiations regarding New Zealand's next government are continuing past the point in time (12 October) initially indicated by NZ First party leader, Winston Peters, as some sort of "deadline". It's actually pretty complicated. There is much for many to nut out, and a lot to understand under the surface. We would carry this thought over to New Zealand's CPI inflation target, where people's obsession to hit 2%, and relatively soon, risks creating issues to the detriment of New Zealand over the longer haul.

As for the government formation process, the NZ First caucus and board are meeting today in Wellington. But what is being discussed, exactly, and what can be determined today, is not at all clear to us. And as the leader of the National party, Bill English, alluded to this morning, there might yet need to be further clarification/agreement from parties other than NZ First before the nation's next government can be agreed upon. For the meantime, all we can do is sit and wait.

Once we do hear the stripes of the next government we'll then need to know the key policy details that flow from it, before being able to make any changes to our economic and financial views. How long this takes is also (reasonably) uncertain.

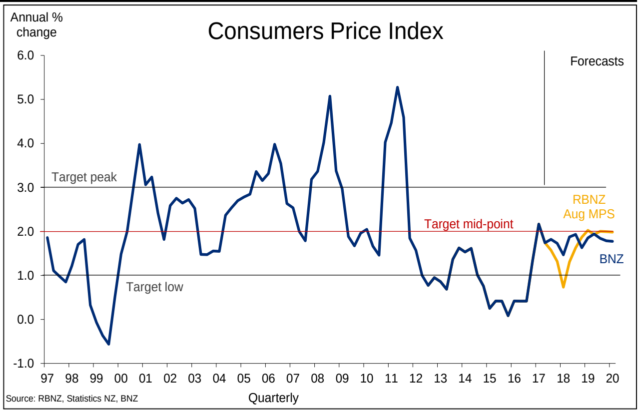
But the economic data wait for no man. In this respect, tomorrow's Q3 CPI report will re-focus attention back on the economy rather than politics. The market is looking for a pick-up in this, with a quarterly gain of 0.4%, lifting the annual rate of increase to 1.8%, from 1.7% in Q2. We are in line with this.

The Reserve Bank, in its August Monetary Policy Statement (MPS), anticipated the Q3 CPI to increase 0.2%, for the annual rate of inflation to ease to 1.6%, from 1.7%. That looks too low-ball to us. In fact, we think it will mark the start of the CPI proving higher than the RBNZ expected for not just Q3, but right the way into early 2018. Recall that the August MPS forecast annual CPI inflation to drop away to 0.7% during the March quarter of 2018. We forecast it to hold up around 1.5% (aided by the fact the trade-weighted exchange rate is some 3% below where the RBNZ assumed it would average over the December quarter).

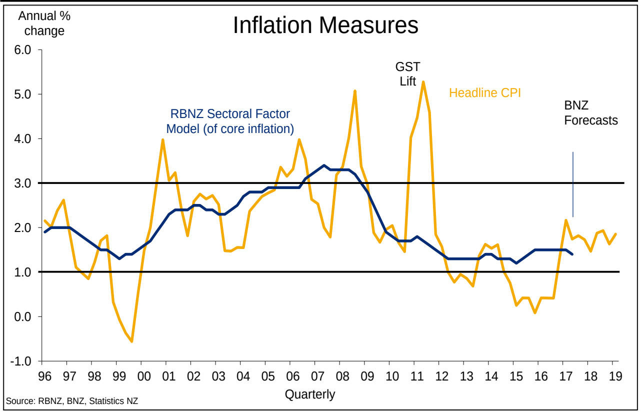
This deviation seems important. While the Bank has (at times) shown a decent tolerance for headline inflation deviating from its 2% ideal, it has also been quick to worry when this looks to have affected inflation expectations.

While this remains relevant, we also note the Reserve Bank has been putting less store in traditional inflation expectations survey measures when it comes to forecasting inflation, while putting more weight on recent historical inflation outcomes as influencing the process. Specifically, that headline CPI inflation outcomes tend to affect non-tradables CPI inflation with a lag. This is outlined in an analytical paper published by the Reserve Bank last week – entitled "Does past inflation predict the future", by Chris McDonald. It's part of the RBNZ trying to

An Uncomfortable Dip Avoided



Technically Speaking



understand how non-tradables inflation, in particular, has undershot its forecasts over recent years.

The "good" news, if one accepts the RBNZ's econometric approach, is that the rebound in headline CPI inflation over the last year or so should presumably reinforce upside around non-tradables inflation ahead, all else equal.

The bad news is that if one believes annual CPI inflation (including globally) is going to naturally struggle to make 2% on a sustainable basis, then the RBNZ will probably feel as though it has to fight a bigger battle in getting inflation to 2%, with all that that entails for the policy rate.

So to the extent the Bank is still thinking headline CPI inflation will wither into the start of 2018 then it will probably be worried about its flow-on impact to non-tradable inflation. If, instead, annual CPI inflation holds up around 1.5% over this time frame, as we expect, the Bank's worry will presumably be much less so.

Stemming from the RBNZ analytical note there is also the question of what an upside shock/wave to headline CPI inflation (perhaps driven by commodities, again?) might mean for RBNZ policy? Assuming symmetry in the Bank's thought process, this might start to imbed itself in higher-than-ideal inflation in the non-tradables CPI. This, in turn, would suggest the Bank might have to run tighter OCR policy than it would have if it was still putting emphasis on the inflation expectations survey measures in its Phillips curve inflation equations.

For the meantime, however, there is also the issue of how core inflation measures perform, and not just in terms of non-tradables inflation. Indeed, with reference to tomorrow's CPI report, we'll be attuned to the sectoral factor model version that the RBNZ constructs (and publishes in the afternoon). It's worth recalling that this measure actually decelerated a smidge in Q2, to 1.4% y/y, having been steady at 1.5% for the many quarters preceding.

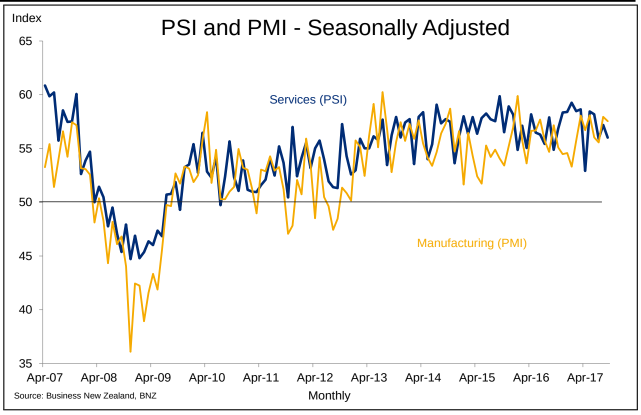
As for the "real" economy this morning's Performance of Services Index (PSI), like the PMI did last week, told of an expansion robust to uncertainties around the election process. The PSI held up pretty well, at a seasonally adjusted 56.0, while the PMI largely sustained its pace at 57.5. So, whatever the next government might mean for the New Zealand economy, there is evidence that it had solid momentum at the tail end of the last one.

For the Global Dairy Trade auction – scheduled for the small hours of Wednesday morning – we expect its weighted-price index to be broadly stable, perhaps up a fraction. However, to the extent it doesn't make up for its surprise 2.4% drop at the last auction (on China's Golden Week?), it will leave downside risk around our milk price forecast of $6.75 for this season.

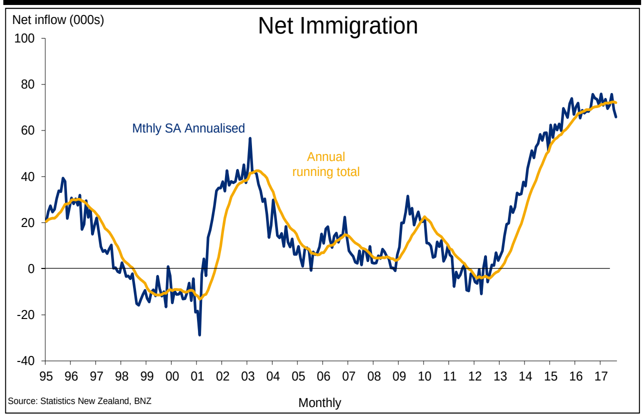
Any further fall in Friday morning's net inward migration result for September, meanwhile, would represent three on the trot, which would be interesting. As for short-term visitor arrivals for the month, these look to be roughly flat on year-ago comparison. Credit card billings for September are also due Friday (3:00pm).

craig_ebert@bnz.co.nz

Robust to Election Uncertainty



Rolling Over Regardless?



Global Watch

- Limited global data this week
- AU employment due Thursday
- China's 19th Party Congress starts Wednesday
- Central bankers speaking: Yellen, Draghi, Kuroda, Carney

Australia: Thursday's Labour Force report for September will draw most of the market interest along with Tuesday's RBA's Board Minutes and its likely positive reflections of the global and domestic economies, if with still low wage and price inflation. RBA Assistant Governors Ellis and Bullock speak on Tuesday and Thursday, Ellis on a panel at an investment conference and Bullock speaking to the Australian Shareholders Association on Wednesday.

NAB releases two reports on Wednesday, the relatively new NAB Cashless Retail Sales index for September on Wednesday and the NAB Commercial Property Survey, followed Thursday by the quarterly version of the NAB Business Survey with its additional detail on Capital Expenditure expectations and constraints on growth.

The NAB Cashless Retail Sales is likely to garner some interest given its accurate prediction of last week's weak Retail Sales print. As for the NAB Quarterly survey, we will be paying attention to the number of firms finding it difficult to find suitable labour. This series leads the direction in underutilisation by 2 quarters.

As for Thursday's Employment report, leading indicators, including the Employment Index from the NAB Business Survey, point to yet another strong employment print.

NAB's model points to what's turned out to be an above-consensus pick of +25K (market +15K). Such growth would arithmetically be sufficient to push the unemployment rate lower, except that it may well come from a lift in workforce participation. The risk on the unemployment rate is to the lower side.

China: The 19th Party Congress starts Wednesday with the President's address, followed Thursday with Q3 GDP and September month activity reports. CPI & PPI are released Monday.

US: It's a very light week with only Industrial Production and home sales the picks, they may also well be distorted by hurricane effects. Yellen speaks on monetary policy since the GFC on Friday.

Japan: Quiet for data, Thursday's trade balance the pick. The BoJ's Kuroda speaks in Tokyo on Friday.

Eurozone: Catalonia-Spain is the major interest. First comes Monday's deadline from Madrid for Catalonia to make their position on independence. They have till Thursday to rescind a "yes". Draghi speaks on Wednesday. Very light for data.

UK: Tuesday's CPI, Wednesday's labour market and Thursday Retail Sales are all key for markets. BoE Governor Carney and senior colleagues testify on Tuesday.

Canada: Friday's CPI and Retail Sales are both important for the C$ and BoC pricing.

david.degaris@nab.com.au

Chart 1: What will the NAB Quarterly say about Labour?

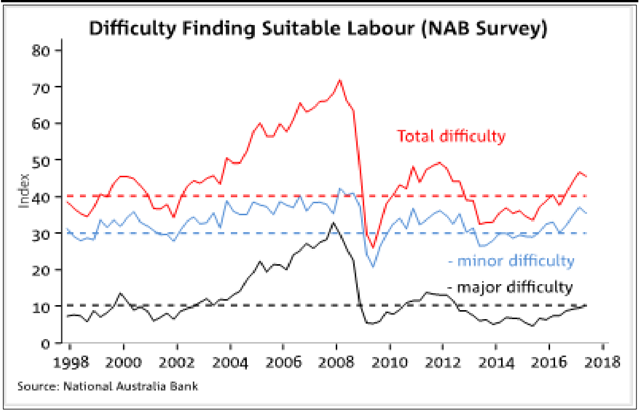
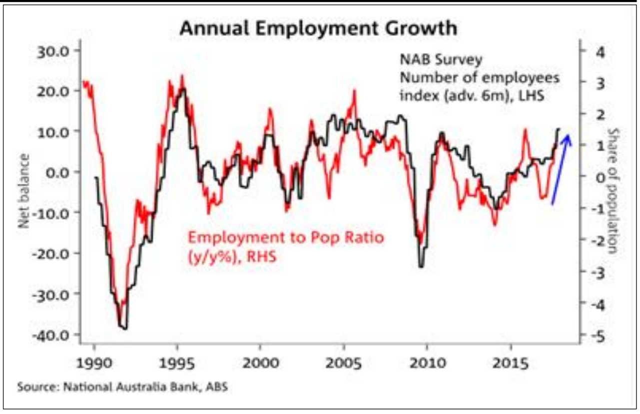


Chart 2: Labour demand still on the rise



Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

This time last week we thought we'd know the form of the new NZ government, but negotiations are taking longer than expected. We might found out later today, but there's certainly no guarantee around that. In the meantime, the NZ rates market is behaving like business-as-usual, with no discernable impact of political uncertainties on market pricing since the election.

While we'd expect the currency market to show a knee-jerk reaction to any announcement, the rates market will likely be less jumpy to any such announcement. Apart from the sticker-shock of the form of the next government, the rates market will be more interested in implications for monetary and fiscal policy.

The RBNZ takes the last set of official government projections as its baseline, adjusted for any differences from Treasury's economic outlook. The Bank won't be able to build any likely fiscal variations into its projections until there is more clarity on policy. That will have to wait for several months, perhaps longer, but the market won't be waiting around and it will make its own real-time assessment. So alongside any formation of government announcement, we'll be closely looking at any major concessions on fiscal policy made to secure the agreement.

The Fiscal Responsibility Act should ensure that any slippage in fiscal policy will be moderate rather than significant and this should limit any market reaction.

Tomorrow sees NZ Q3 CPI data released, the key local economic release for the market this week. We (and the market) think inflation is tracking ahead of the RBNZ's projections, driven by higher food and oil prices, so a result around 0.4% q/q (0.2 percentage points above the RBNZ's estimate) shouldn't be market moving. We need to see core inflation measures move a lot higher to get the RBNZ's attention, which will likely take more time.

So the 2-year swap rate remains well anchored around the current level of 2.20%, an anchor we expect to be sustained right through until the end of the year and into early next year. The first rate hike for the cycle is fully priced by November 2018, a few months later compared to our projection, but given the uncertainty around government policy, the new (unknown) Governor from March 2018 and the monetary policy framework, we won't split hairs.

The US CPI release for September released last Friday showed the core CPI rising by just 0.1% m/m, a rate it has achieved for 5 of the past 6 months. The soft run lends support to the view that structural, rather than temporary forces might be holding back inflation. Since that release, Fed Chair Yellen reiterated the party line that Fed officials "will be paying close attention to the inflation data in the months ahead" and her best guess is that "these soft readings will not persist". A December rate hike remains well priced but if the weak run of inflation continues, then that would raise some serious questions about how much more tightening the Fed will achieve this cycle.

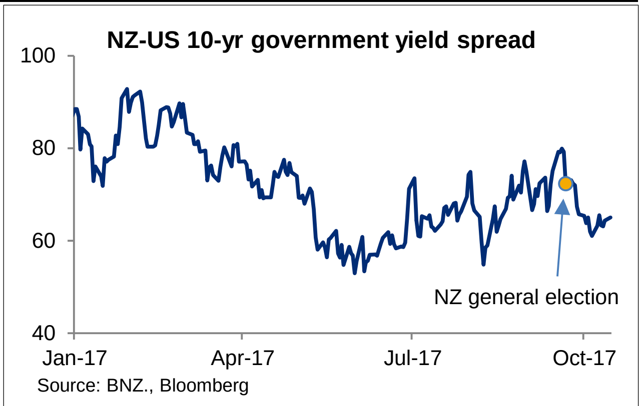
The threat of the US 10-year rate breaching the key resistance level of 2.40% has passed for now and it currently sits at 2.27%, its lowest level in over two weeks. Leading indicators still point to higher US wages and CPI inflation, but until actual inflation outcomes are visible, then the 2.40% mark might well be hard to crack. We might have to await the next CPI reading, a month away.

Without the backdrop of stronger evidence of US inflation, NZ longer term rates look capped now for another month or so, with 5-year swap resistance at 2.75%, 10-year swap resistance at 3.30% and 10-year government bond yield resistance at around 3.0%.

Since the election, the NZ-US 10-year bond spread has tracked between 61-73bps and, if anything has narrowed. So it's hard to detect any NZ political risk premium in the curve at present. We don't expect much change, even as the market contemplates a larger bond programme under easier fiscal policy settings. US Fed policy and inflation dynamics remain a greater force on the market.

jason.k.wong@bnz.co.nz

NZ – Global 10-year Spreads Narrow



Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.93	1.92 - 1.96
NZ 2yr swap (%)	2.18	2.17 - 2.25
NZ 5yr swap (%)	2.70	2.69 - 2.77
NZ 10yr swap (%)	3.21	3.18 - 3.30
2s10s swap curve (bps)	103	99 - 108
NZ 10yr swap-govt (bps)	28	23 - 30
NZ 10yr govt (%)	2.93	2.92 - 3.02
US 10yr govt (%)	2.27	2.21 - 2.40
NZ-US 10yr (bps)	66	61 - 72
NZ-AU 2yr swap (bps)	19	16 - 22
NZ-AU 10yr govt (bps)	15	12 - 18

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

NZD/USD and the TWI recovered from fresh year-to-date lows early last week to end the week on a more positive footing. The uncertainty around the form of the next NZ government had formed a cloud over the NZD, but after its recent underperformance selling pressure evaporated.

NZ's political uncertainty remains, of course, and we expect a knee-jerk reaction to the NZD on the announcement of the new government no matter which way it goes. A decision could come as early as late-Monday or as late as Friday. There are apparently still nine permutations on the table, with the majority of them not positive for the NZD. For example, even if NZ First supports a National government, a decision to remain on the cross benches might well be perceived to be negative, with the government at the mercy of NZ First to pass any legislation. And then one must consider any policy concessions that have had to be made in the process.

We continue to believe that NZ political forces on the NZD will only be transitory, with global economic forces being the more powerful driver.

Softer US inflation data was one reason the NZD performed well at the end of last week. The lack of an inflationary pulse is doing no favours to the USD, while the ability of the US government to pass tax reform policy remains doubtful – Trump's constant barbs to fellow Republicans on Twitter only makes the task of passing legislation more difficult.

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Globally, China will be in focus, as the 19th Party Congress starts Wednesday with the President's address, followed by the key activity indicators the next day. In Australia, employment data on Thursday will be the focus, while in the UK, CPI data and Carney's testimony to Parliament are the focus. We don't expect second-tier hurricane-affected data in the US to rattle the market.

As we await the announcement of a new government, the NZD sits in slightly "oversold" territory, with the currency not keeping pace with the tailwind of higher risk appetite. Our short-term fair value model estimate sits around USD 0.76 but taking into account its upside bias this year fair value drops down to around 0.73. On technicals, last week's low around 0.7050 provides some support, while resistance would be met around 0.7350.

NZD/AUD is close to fairly priced, with our model estimate sitting around the AUD 0.92 mark, well within normal error bands. We don't have a strong view on this cross at present and it seems to remain at the whim of relative NZ/Australia commodity price variations.

jason.k.wong@bnz.co.nz

Cross Rates and Model Estimates

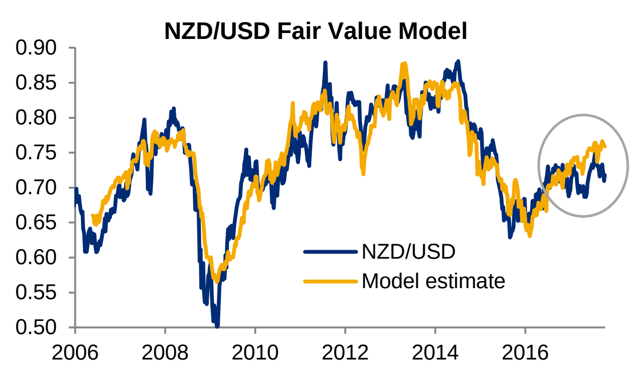
	Current	Last 3-weeks range*
NZD/USD	0.7174	0.7050 - 0.7240
NZD/AUD	0.9097	0.8990 - 0.9250
NZD/GBP	0.5393	0.5340 - 0.5440
NZD/EUR	0.6072	0.5970 - 0.6160
NZD/JPY	80.17	79.30 - 81.70

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

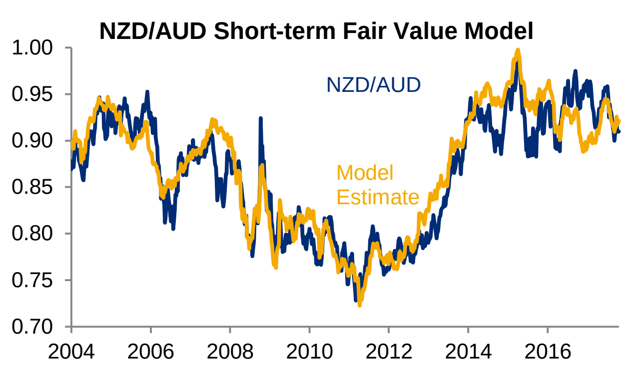
	Model Est.	Actual/FV
NZD/USD	0.7590	-5%
NZD/AUD	0.9220	-1%

NZD Slightly Oversold on Our Model



Source: BNZ, Bloomberg

NZD/AUD Fairly Priced



Source: BNZ, Bloomberg

Technicals

NZD/USD

Outlook: Downside risk
ST Resistance: 0.7200 (ahead of 0.7350)
ST Support: 0.7050 (ahead of 0.6960)

Last week the NZD hit a fresh low for the year of 0.7050 and recovered nicely, so that becomes a new level of support. We still see 0.7350 as the strongest level of resistance ahead.

NZD/AUD

Outlook: Trading range
ST Resistance: 0.9230 (ahead of 0.9400)
ST Support: 0.9075 (ahead of 0.8975)

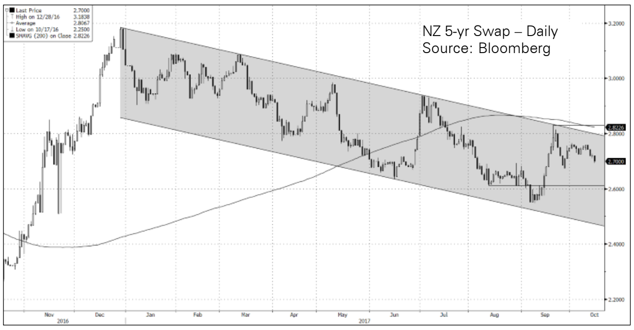
Weak support is around 0.9075, with stronger support not really kicking in until the year's low around 0.8975. Initial resistance at 0.9230.

jason.k.wong@bnz.co.nz

NZ 5-year Swap Rate

Outlook: Neutral
ST Resistance: 2.83
ST Support: 2.61

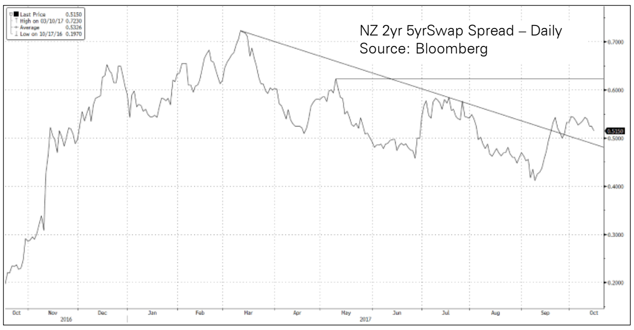
Range remains intact. We continue to await a break to initiate a new position.



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

Outlook: Steeper
ST Resistance: +62
ST Support: +48.5

Trendline breached, so expect a move to +62.



pete_mason@bnz.co.nz

Key Upcoming Events

	Forecast	Median	Last
Monday 16 October			
NZ, BNZ PSI (Services), Sept			57.3
China, CPI, July y/y		+1.6%	+1.8%
China, PPI, Sept y/y		+6.4%	+6.3%
Euro, Trade Balance, August s.a.		+€20.2b	+€18.6b
US, Empire Manufacturing, October		+20.5	+24.4
Tuesday 17 October			
NZ, CPI, Q3 y/y	+1.8%	+1.8%	+1.7%
Aus, RBA Minutes, 3 October Meeting			
Euro, CPI, Sept y/y 2nd est		+1.5%	+1.5%P
Germ, ZEW Sentiment, October		+20.0	+17.0
UK, CPI, September y/y		+3.0%	+2.9%
US, NAHB Housing Index, October		64	64
US, Industrial Production, Sept		+0.2%	-0.9%
Wednesday 18 October			
NZ, Dairy Auction, GDT Price Index			-2.4%
Aus, Westpac Leading Index, Sept			-0.08%
UK, Unemployment Rate (ILO), August		4.3%	4.3%
US, Beige Book			
US, Housing Starts, Sept		1,175k	1,180k
US, Fed's Dudley/Kaplan Speak			

	Forecast	Median	Last
Thursday 19 October			
Aus, NAB Business Survey, Q3			+7
Aus, Employment, Sept	+25k	+15k	+54k
Aus, Unemployment Rate, Sept	5.6%	5.6%	5.6%
China, Industrial Production, Sept y/y		+6.4%	+6.0%
China, GDP, Q3 y/y		+6.8%	+6.9%
China, Retail Sales, Sept y/y		+10.2%	+10.1%
Jpn, Merchandise Trade Balance, Sept		+¥560b	+¥114b
UK, Retail Sales vol., September		-0.1%	+1.0%
US, Leading Indicator, Sept		+0.1%	+0.4%
US, Philly Fed Index, October		+22.0	+23.8
Friday 20 October			
NZ, External Migration, Sept s.a.			+5,490
NZ, Credit Card Billings, Sept			-0.7%
US, Existing Home Sales, Sept		5.30m	5.35m
US, Yellen Speaks, MP post GFC			
Monday 23 October			
NZ, Holiday, Labour Day			
China, Property Prices, Sept			
Euro, Consumer Confidence, Oct 1st est			-1.2
UK, CBI Industrial Trends, October			+7

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.81	1.83	1.84	2.15
2mth	1.87	1.88	1.88	2.16
3mth	1.93	1.94	1.94	2.15
6mth	1.97	2.00	1.99	2.15
GOVERNMENT STOCK				
03/19	1.89	1.92	1.94	1.89
04/20	2.06	2.10	2.10	1.96
05/21	2.22	2.27	2.24	2.04
04/23	2.52	2.57	2.57	2.22
04/25	2.80	2.84	2.85	2.40
04/27	2.96	2.99	3.00	2.53
04/33	3.30	3.34	3.35	2.85
04/37	3.51	3.55	3.58	3.11
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	68	70	65	105
Nth America 5Y	55	54	56	76
Europe 5Y	55	57	50	73

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.19	2.21	2.23	2.08
3 years	2.38	2.41	2.41	2.12
4 years	2.56	2.59	2.58	2.19
5 years	2.71	2.75	2.73	2.28
10 years	3.22	3.26	3.24	2.67
FOREIGN EXCHANGE				
NZD/USD	0.7171	0.7064	0.7263	0.7134
NZD/AUD	0.9099	0.9111	0.9123	0.9352
NZD/JPY	80.26	79.61	81.01	74.11
NZD/EUR	0.6071	0.6017	0.6076	0.6485
NZD/GBP	0.5397	0.5376	0.5384	0.5856
NZD/CAD	0.8948	0.8866	0.8929	0.9366
TWI	75.5	75.1	76.1	76.8

Contact Details

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Jason Wong
Senior Markets Strategist
+(64 4) 924 7652

Main Offices

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

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

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891