22 May 2017

A Choice Looking Budget

- Thursday's Budget to part-return surplus dividend
- A net stimulus (that the May MPS couldn't include)
- Wheeler talking Wednesday (off record)
- Fonterra's 1st forecast of 2017/18 milk price this week
- We are above market for April's merchandise exports
- April's home lending figures dented by trading days?

It's all looking choice for Thursday's Budget. New Zealand's fiscal trajectory is looking more and more positive. This is thanks to a long efficiency drive on the part of government spending, along with solid tax-flow from a robustly expanding economy. However, as this is an election year – and a tight looking one at that – there's added pressure to funnel some of the surfeit back into the economy.

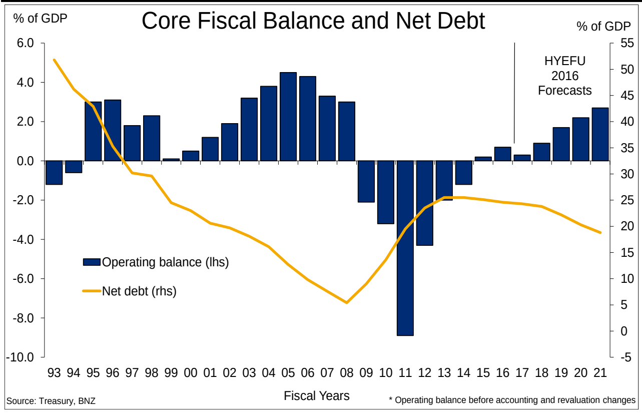
For sure, there will be adjustments to personal tax rate thresholds, with associated tweaks to Working for Families rebates. Just bear in mind that even twenty dollars extra per week for the average employee would cost the government in the order of $2 to 3 billion on an annual basis. Yes, there is already some provision for new initiatives. However, last year's Budget reduced the step-up for 2017/18 to only $1.5b (from $2.5b), as it front-loaded some expenditure into 2016/17.

Of course, those provisions have room to move higher. This is based on the much better than expected starting point for the fiscal accounts, and the cumulated overshoot in the core operating surplus they can sustain, all else equal. However, also bear in mind the potential for Treasury to have to tone down its GDP forecasts. In its December 2016 Half-year Update (HYEFU) it anticipated real GDP growth of 3.7% for the year to June 2017, 3.5% for 2017/18 and 3.0% for 2018/19. We forecast 2.8%, 2.6% and 2.3% respectively.

On the other hand, while the HYEFU forecast annual CPI inflation of "only" 1.5% for the year to June 2017 it envisaged 2.0% for 2017/18 and the June year after that. We can't see why Treasury would have to lower this view (even though the RBNZ forecasts annual CPI inflation to fall to 1.1% in the coming year to March 2018). In any case, with New Zealand's terms of trade close to reclaiming their highest level since the early 1970s (partly on rebounding dairy prices) we can imagine Treasury can revise up its nominal GDP forecasts by way of the GDP deflator.

Along with personal tax relief, Thursday's Budget will also feature (greater) increases in direct government expenditure, in part a response to the strong population

Better and Better

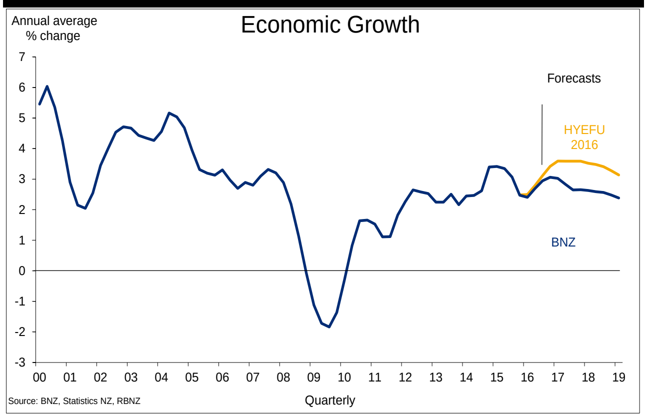


growth the country is experiencing. So as well more running expenditure, some of the most significant boosts are likely to be those confirmed for infrastructure.

The Budget policies will represent a clear net fiscal stimulus (which the RBNZ would not have been able to include in its May Monetary Policy Statement, it's worth noting). Even so, there will still likely be increasing core operating surpluses in the projections, to a moderate degree. And enough cash discipline over the medium term to keep net Crown debt, as a per cent of GDP, moderating in line with new extended target of 10 to 15% of GDP by 2025. This will keep the debt programme limited to what the Debt Management Office prefers as a gross amount, to maintain liquidity and the like.

New Zealand's fiscal story will thus continue to stand out on the global stage (including against the difficult spot that Australia still finds itself in, as its Budget last week highlighted). We would thus expect the rating agencies to make positive noises about New Zealand's Budget.

Pushing It



Non-fiscal issues will likely still be hampering Standard and Poor's and Fitch from upgrading, from AA-stable, any time soon while, relatively speaking, Moody's has effectively kept New Zealand two notches higher, on triple-A all along.

Of course, there will be the usual day-after Budget talks by the Finance Minister. But also be aware that Reserve Bank Governor, Graeme Wheeler, is scheduled to give a luncheon address, Wednesday, to the Waikato Institute of Directors. The indicated topic is "Developments in the New Zealand and Global Economies". However, note that this speech is not public.

But Fonterra will likely go public later this week, with its initial forecast for the 2017/18 milk price. We don't want to second guess this first guess. While current spot prices suggest scope for something around $7.00, if Fonterra forecasts a moderation in international dairy prices then it might pitch its first milk price forecast for 2017/18 closer to $6.00. As for our forecast for the 2017/18 milk price – the final one, not Fonterra's initial forecast – it's still conservatively cast at $6.00 (partly on the view we do see some moderation in global dairy prices over the coming season).

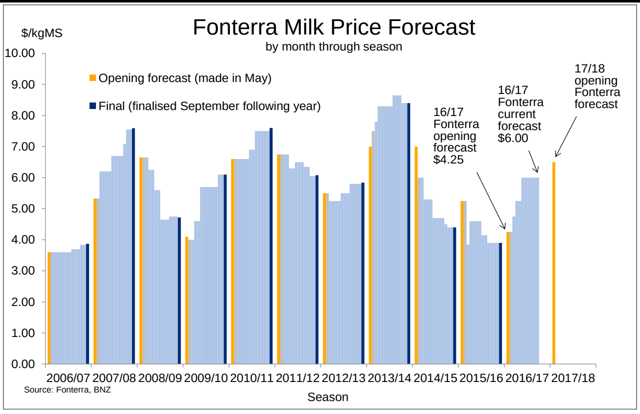
Of course, the occasion also affords the chance for Fonterra to update its view on the milk price for this current (2016/17) season. There is scope for this to be revised up, from Fonterra's current view of $6.00. But this will depend on how a lot of parameters are tying up, not just spot dairy prices. For the record, and our macro-economic view, we expect the final milk price for 2016/17 to be $6.10.

Turning to the local data for the coming week, we are going for a 6% increase in April's merchandise exports y/y, in Wednesday's account. Commodity export prices suggest a (much) bigger gain than this. But we are conscious of April's holidays and bad storms, which could well have compromised port activity. Similarly, we anticipate a 3% annual gain in goods imports, in spite of the rebound in oil prices. This would deliver a monthly merchandise trade surplus of $490m, compared to $350m in April of last year.

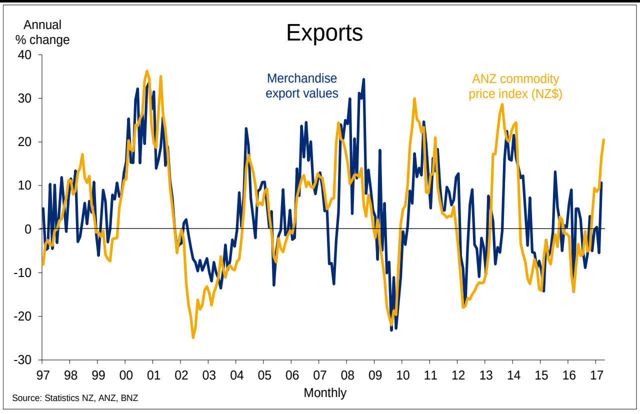
We are pitched higher than the market's pick of a +$233m surplus, on account of a relatively stronger story on exports (not weaker imports).

New residential lending in March turned out to be not as soft as we anticipated. It was down 8.9% on a year ago, whereas the annual decline in February was 15.2% and 14.2% in January. This is all post the tighter LVR restrictions that came into effect over the second half of 2016. However, bear in mind that April's numbers, due Wednesday (3:00pm), will have the added impost of holiday outages and extremely bad weather (affecting housing activity). Indeed, these disruptions are something to bear in mind for all the monthly NZ data, including the way it might affect March-quarter/June-quarter splits.

How Good?



Upside



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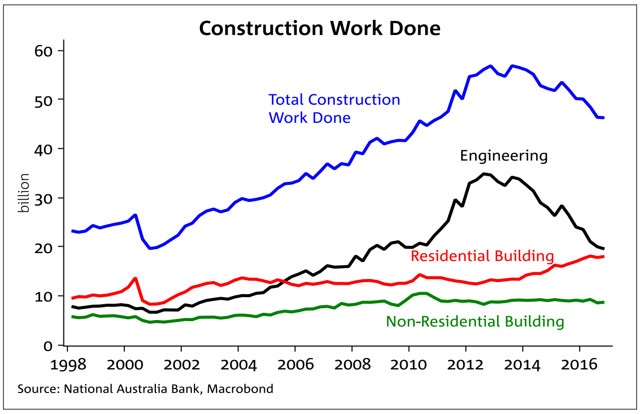
Global Watch

- Very Quiet data week ahead
- FOMC minutes and Fed speak to note
- AU, UK GDP updates
- OPEC meets on Thursday

Australia

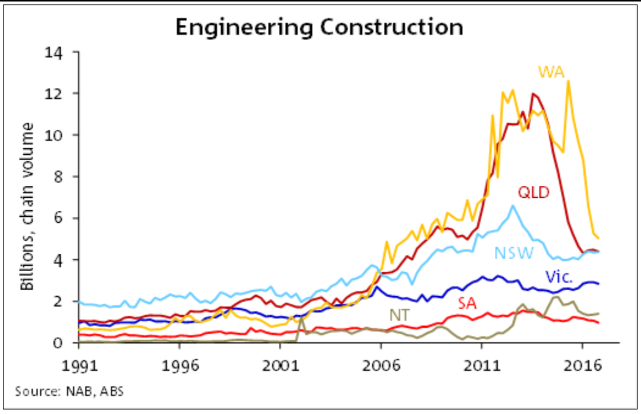
It's a quiet week, Wednesday's Q1 Construction Work Done the main focus. There are also two RBA senior officers, Deputy Governor Guy Debelle and Head of Payments Policy Tony Richards speaking. Given their seniority and experience, the market would be interested in any comments on the economy and markets.

Chart 1: Multi-faceted construction drivers



As for Construction Work Done, NAB's forecast calls for a modest decline of 0.5% in real terms for the quarter. The further modest wind-down in spending on major resource projects is set to dissipate. Meanwhile, road and rail public infrastructure spending has been rising, moderating the decline in big ticket spending. For this quarter, exceptionally wet weather in Sydney in March, the wettest in 27 years, is almost certainly to have affected construction activity in that State. Cyclone Debbie is also likely to have hit spending this quarter.

Chart 2: NSW activity weather-affected?



Along with the weekly ANZ Roy Morgan Consumer Confidence, Westpac Leading index and Skilled Vacancies, there is the NAB Consumer Behaviours Survey for Q1, tracking Consumer Anxiety and its drivers, out Wednesday.

China

Very quiet. Industrial Profits are due on Saturday, ahead of PMIs next week.

US

The Trump Administration is expected to release its Budget request on Tuesday, having released an outline in March. FOMC Minutes are on Thursday morning, and a host of Fed speeches during the week. More housing focus with New and Existing Home Sales and House Prices. Q1 GDP is out Friday, a modest upward revision from 0.7% to 0.9% saar expected. Durable goods orders and the UoM Consumer Sentiment are both due on Friday.

Japan

Friday's CPI reading likely to be the most watched. Wednesday's Nikkei Manufacturing PMI also worth a look. BoJ Governor Kuroda is speaking twice, on Wednesday and Saturday.

Eurozone

The list of ECB speakers includes Draghi on Wednesday. It's not a heavy data week, but the releases that are scheduled can be market moving. Germany releases its second estimate of Q1 GDP and the Ifo Survey, both Tuesday. There's also the first cut of May EZ PMIs (including Germany and France's) out Wednesday.

UK

Thursday's second estimate of Q1 GDP will get some scrutiny in a quiet week for key releases.

Canada

Bank of Canada meets on Wednesday with the Bank expected to leave rates on hold. That's the unanimous pick among analysts. BoC Deputy Governor Sylvain Leduc is speaking on Thursday. OPEC's meeting on Thursday is a watch point for the Canadian dollar.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The short end of the NZ curve is flat-lining, after the initial shock post the RBNZ's Monetary Policy Statement earlier this month. The 2-Year swap rate has closed at 2.22-2.23% every day for the past six trading days. The OIS curve shows little chance of the RBNZ tightening policy this year, with just 3bps of hikes priced in for the November meeting. The first full hike is not priced until June 2018 which, in practice, means a toss-up between the Bank first tightening in either May or August 2018.

With the RBNZ's clear policy message and tightening policy prospects in the distant future, the short end of the curve should be tightly bound over coming months. With positive carry on received positions in 2-year swap, it is difficult to see a sustained move higher over the next couple of months. On nice round figures, 2.15-2.25% seems a likely range.

While the RBNZ sees an equal chance of a rate hike or cut at this juncture, the market strongly begs to differ with that prognosis. This would make it difficult for 2-year swap to trade sub-2.15%. It would likely take some sort of global shock to drive such an outcome.

The mid part of the swap curve probed a fresh low for the year, with the 5-year rate falling to 2.75%. The move lower has been supported by the combination of a dovish outlook by the RBNZ and UST yields trading near the bottom of the recent range. The current 5-year rate is consistent with a delayed start to the tightening cycle (at least a year away) and not much more than a 100bps increase in rates through the next tightening cycle. That's not a particularly aggressive tightening outlook for the next few years. This should limit downside risk to the 5-year rate, unless the global shock scenario develops. We suggest a 2.70-2.90% trading range over coming months, so current rates provide a good level to hedge for borrowers.

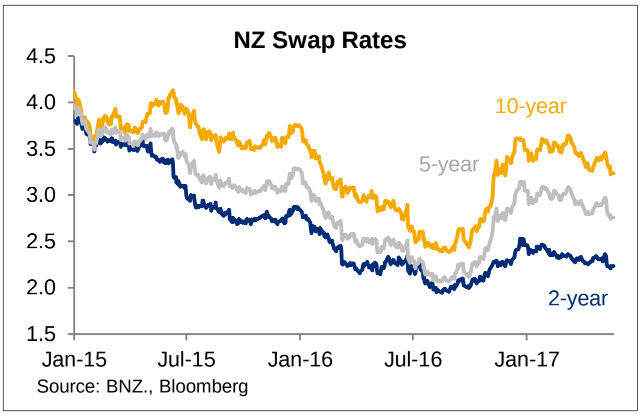
We offer a similar story for the long end of the curve. The combination of some softer than expected US data and US political shenanigans sees the US 10-year Treasury rate trade near the bottom of its range for this year, around 2.25%. We see more upside than downside risk to longer term rates, as the US Fed likely remains on track to hike rates in June. Recent CPI and GDP data have been dragged down by some one-off factors. Another hike in September and some balance sheet reduction before year-end could see the 10-year rate trade closer to the top of the range later in the year around 2.60%.

This week the economic calendar is light. The NZ Budget is the key local release, but should have little implication for the rates market. NZ's relatively strong fiscal position and the options it provides to the government in an election year is well acknowledged. There is only expected to be minor tweaks to the domestic bond programme, which already sees net bond issuance falling over the coming years.

Internationally, the calendar is light. A number of Fed speakers hit the circuit and Thursday morning's Fed minutes from its last meeting will be scrutinised. We don't expect the Fed's message to deviate from previous guidance – the Fed is likely to look through weakness in recent GDP and CPI data and continue on its path of cautiously raising rates.

But US politics is likely to hold more interest than the economic calendar. President Trump's first foreign tour has begun and he takes on the Middle East and Europe. In the absence of any further political hiccups, it ought to be a fairly quiet, range-trading week for the local rates market.

NZ Swap Rates…Limited Downside Risk From Here?



Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.97	1.97 - 2.00
NZ 2yr swap (%)	2.24	2.20 - 2.37
NZ 5yr swap (%)	2.76	2.73 - 2.99
NZ 10yr swap (%)	3.24	3.21 - 3.48
2s10s swap curve (bps)	100	100 - 112
NZ 10yr swap-govt (bps)	40	36 - 41
NZ 10yr govt (%)	2.84	2.80 - 3.10
US 10yr govt (%)	2.23	2.18 - 2.42
NZ-US 10yr (bps)	61	56 - 71
NZ-AU 2yr swap (bps)	42	40 - 49
NZ-AU 10yr govt (bps)	35	33 - 41

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

When one spends so much time staring at a Bloomberg screen, watching intra-day price movements and trying to keep up to date with what's driving the market, it is very easy to lose perspective. During May so far we have been buffeted by, amongst other things, a surprisingly dovish RBNZ MPS, US political shenanigans, a big swing in oil prices, and changing Fed hike expectations as every US data release is scrutinised. Through all that, a study of daily closes in the NZD for May offers a range of 0.6850-0.6940. Yes, less than a 1-cent range or 1.3%. The same analysis on the TWI shows a range of 74.9 to 76.0 or about 1½%.

This speaks to the current low volatility environment we are currently in. To be sure, we saw a spike up in the VIX index mid last week as the spotlight shone on Trump's questionable actions. But the VIX index is back down to 12 and remains at a historically low level. Bond and currency market volatility remains low.

With little top-tier data last week, US politics probably got more attention than it deserved, as fresh news emerged over Trump's role in the ongoing investigation of election meddling by Russia. Some suggested that a presidential impeachment could ensue, but the market's focus was on the increased challenge that Trump faced in getting his pro-growth policies enacted. This saw the USD major currency TWI under pressure, falling enough to now fully erase all of its gains since the Trump-election rally.

The increased focus on US politics has come at an opportune time for the NZD, and provided some support, after reaching a fresh low in the aftermath of the RBNZ's recent dovish Monetary Policy Statement. We continue to see 0.6850 as a key level of technical support. We don't expect the gap between spot and our short term fair value model estimate of around 0.74 to be closed anytime soon, with resistance likely to set in around 0.70-0.71. The USD majors index is looking oversold, and is expected to recover in the course of time. Eventually this is expected to see a weaker NZD, consistent with our year-end target of 0.67.

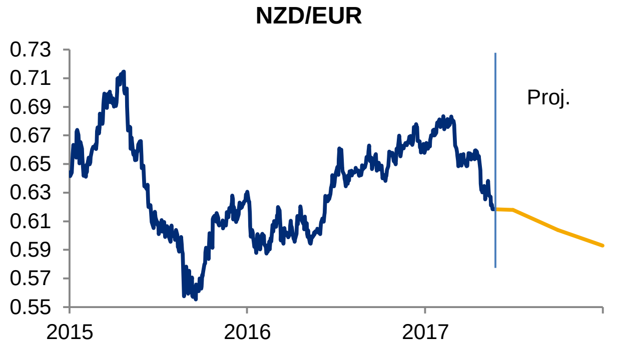
Investors have seemingly lost patience with their long USD positions and have been increasingly switching into long EUR positions as an alternative. The market-friendly first round French Presidential election result was the initial catalyst for a significant move higher in EUR. Now the market is focused on the likely shift in ECB policy guidance over coming months. A less dovish stance would support the recent move higher in EUR, although recent EUR strength has complicated the story a little, and likely means that the ECB needs to choose its words carefully.

EUR strength has seen NZD/EUR fall below 0.62, taking the tumble since the end of February to 9%. There will be a period of consolidation at some stage, but EUR's outperformance is likely to continue and we see the cross falling to around 0.59 towards the end of the year.

Looking at the calendar ahead, the NZ Budget is the key local release, but should have little implication for the NZD. NZ's relatively strong fiscal position and the options it provides to the government in an election year is well acknowledged. Fonterra's announcement of milk payouts around mid-week should pass with little marked reaction.

Internationally, the calendar is light. A number of Fed speakers hit the circuit and Thursday morning's Fed minutes from its last meeting will be scrutinised. But US politics is likely to hold more interest than the economic calendar. President Trump's first foreign tour has begun and he takes on the Middle East and Europe. In the absence of any further political hiccups, it ought to be another quiet, range-trading week for the NZD.

Further Downside Risk for NZD/EUR



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6921	0.6820 - 0.6970
NZD/AUD	0.9295	0.9160 - 0.9430
NZD/GBP	0.5318	0.5270 - 0.5390
NZD/EUR	0.6176	0.6160 - 0.6400
NZD/JPY	76.93	76.30 - 79.40

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7400	-6%
NZD/AUD	0.9310	0%

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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 the recent intra-day low of 0.6620 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

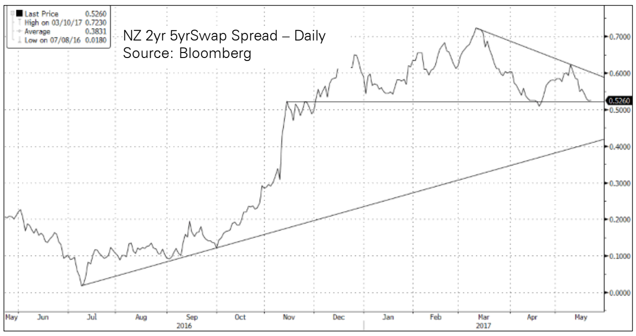
Outlook: Neutral
ST Resistance: 2.98
ST Support: 2.70

Await trigger to initiate new position. 200 day mvg at 2.70 is key now.

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

Outlook: Neutral
ST Resistance: +70
ST Support: +42

Close to near term support at +52. Should this be breached expect a move to +42.



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Key Upcoming Events

	Forecast	Median	Last
Monday 22 May			
Aus, RBA's Debelle Speaks, BIS Symposium			
China, Leading Index (Conference Bd), April			+0.9%
Jpn, Merchandise Trade Balance, April		+Y521b	+Y615b
US, Chicago Fed Nat Activity Index, April		+0.10	+0.08
US, Fed's Harker Speaks			
Tuesday 23 May			
Jpn, All Industry Index, March		-0.5%	+0.7%
Germ, IFO Index, May		113.1	112.9
Germ, GDP, Q1 2nd est		+0.6%	+0.6%P
UK, CBI Retailing Reported Sales, May		+10	+38
US, Markit PSI, May 1st est		53.3	53.1
US, New Home Sales, April		610k	621k
US, Fed's Evans Speaks			
US, Markit PMI, May 1st est		53.1	52.8
Wednesday 24 May			
NZ, Merchandise Trade, April	+$490m	+$267m	+$332m
NZ, Wheeler Speaks, Not Public			
NZ, Residential Lending, April y/y			-8.9%
Aus, Westpac Leading Index, April			+0.08%
Aus, Construction Work Done, Q1	-0.5%	-0.5%	-0.2%
Euro, PMI Manufacturing, May 1st est		56.5	56.7

	Forecast	Median	Last
Wednesday 24 May cont'd…			
Euro, PMI Services, May 1st est		56.4	56.4
US, Fed's Kaplan Speaks			
US, FOMC Minutes, 2/3 May meeting			
US, Existing Home Sales, April		5.65m	5.71m
Can, BOC Policy Announcement		0.50%	0.50%
Thursday 25 May			
NZ, Budget			
Aus, RBA's Debelle Speaks, FX Global Code			
UK, GDP, Q1 2nd est		+0.3%	+0.3%
US, International Goods Trade, April advance		-$64.7b	-$64.2b
US, Wholesale Inventories, Apr 1st est		+0.2%	+0.2%
Friday 26 May			
Jpn, CPI, April y/y		+0.4%	+0.2%
US, Durables Orders, April 1st est		-1.5%	+0.9%
US, GDP, Q1 2nd est		+0.9%	+0.7%P
Saturday 27 May			
China, Industrial Profits, Apr y/y			+23.8%
Sunday 28 May			
US, Fed's Williams Speaks			
Monday 29 May			
US, Holiday, Memorial Day			

Historical Data

	Today	Week Ago	Month Ago	Year Ago
Date heading				
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.86	1.87	1.84	2.27
2mth	1.91	1.93	1.91	2.30
3mth	1.97	1.99	1.97	2.34
6mth	2.01	2.01	2.02	2.36
GOVERNMENT STOCK				
12/17	1.81	1.81	1.84	2.03
03/19	1.95	1.94	2.10	2.06
04/20	2.13	2.15	2.25	2.08
05/21	2.27	2.32	2.36	2.11
04/23	2.54	2.61	2.65	2.21
04/25	2.76	2.83	2.90	2.45
04/27	2.86	2.93	2.96	2.59
04/33	3.14	3.23	3.27	2.90
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	83.71	82	89	136
N. AMERICA 5Y	63.57	63	68	83
EUROPE 5Y	63.09	63	77	77

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.25	2.21	2.29	2.19
3 years	2.45	2.42	2.49	2.23
5 years	2.77	2.77	2.82	2.40
10 years	3.25	3.29	3.31	2.82
FOREIGN EXCHANGE				
NZD/USD	0.6923	0.6868	0.7014	0.6763
NZD/AUD	0.9306	0.9296	0.9242	0.9308
NZD/JPY	77.24	77.82	76.47	73.42
NZD/EUR	0.6190	0.6285	0.6592	0.5976
NZD/GBP	0.5332	0.5328	0.5585	0.4712
NZD/CAD	0.9373	0.9417	0.9346	0.8761
TWI	75.16	75.09	76.34	72.64

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