17 July 2017

Those Annoying Headline Grabbers

- Q2 CPI likely to "disappoint" with 0.1% (1.8% y/y)
- As the May MPS expected 0.3%, 2.1% annual
- But core inflation probably firming like the economy
- June PSI (58.6) strong like the PMI (56.2)
- Migration, tourism, dairy price info later this week
- Bascand's talk; more financial than monetary policy?

There is a tension developing between headline and core inflation. Unless commodity prices stage another rebound, headline CPI inflation looks set to slow over the next 6-12 months or so. But core inflation is inclined to keep grinding higher. At least, that is, in respect to the New Zealand economy, with the capacity pressures it is running into. Tomorrow's June quarter CPI report should be judged with all of this in mind.

In terms of the headline, the median expectation from polls is that the Q2 CPI will increase 0.2%. This is seen slowing the annual rate of CPI inflation to 1.9%, from the 2.2% it got up to in Q1. There are no polls on core inflation measures in New Zealand (in contrast to Australia, where there are).

We have recently choked back our nearer-term CPI expectations, largely on account of the fall in petrol prices throughout June. The 0.2% increase in June's food prices (3.0% y/y), meanwhile, was in line with our priors. For the June quarter CPI this all means we are now picking an increase of 0.1%, which would slow the annual rate of CPI inflation to 1.8%.

Turning attention to the Reserve Bank, its May Monetary Policy Statement (MPS) expected a 0.3% increase in the Q2 CPI, for 2.1% y/y. So the market infers some "disappointment" for the Bank on this score, and we do so even more.

We would go on to point out that we forecast annual CPI inflation to slow to 1.6% in Q3 and all the way down to 1.1% by the March quarter of 2018. This is partly the ripple effect of oil prices but also recognition of the robust exchange rate. Coincidentally, the May MPS also forecast a dip to 1.1% by March 2018 – but that was before the latest sag in oil prices and wriggle up in the currency. This is why we think the Bank will remain (overly) cautious on the OCR for the foreseeable future.

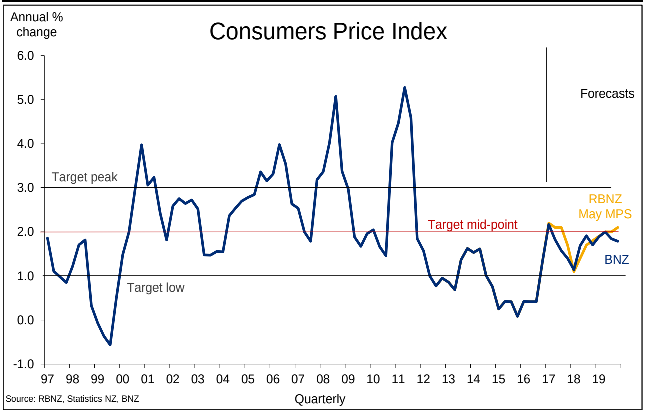
But, importantly, a prospective fall in headline CPI inflation would not suggest the economy is struggling, or at risk of losing the broader inflation plot. Indeed, by the time headline CPI inflation bottoms there's a good chance the economy will have picked up the pace and, with the effects of the presumed Family Incomes Package kicking in early next year, putting even more pressure on supply. The latter is not any recipe for renewed and sustained weakness in inflation expectations.

So, as this plays out, one shouldn't lose sight of the various core inflation measures (including via the wage and salary measures). Interestingly, many of them showed some spark in the March quarter CPI report.

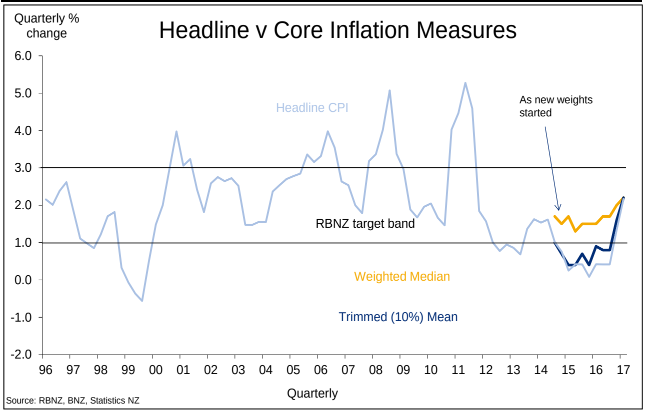
However, the version that the Reserve Bank computes and tends to promote – the sectoral factor model – remained at 1.5% y/y in Q1, where it's been since late 2015. But another way of checking the Bank's interpretation of core inflation is to note that the May MPS expected annual non-tradables inflation to be 2.6% in Q2, from the 2.5% it was in Q1. This at least gets around most of the oil and currency impacts.

As we await tomorrow's CPI, the NZ data week is already off to the races with this morning's BNZ/Business NZ Performance of Services Index (PSI). The big rebound it traced in May pretty much stuck fast in June. In terms of

Abating



Sparky



the seasonally adjusted index, we're talking 58.6, from 58.8 (after the big deceleration it posted in April, skidding down to 53.0).

The latest robustness is spread right across the main sub-indices. This includes another solid reading on employment (54.2), which was good to see considering the jobs index of June's Performance of Manufacturing Index was something of a weak spot, albeit an isolated one. The new orders/business index in June's PSI was on the charge again, at 64.1, while activity/sales were humming along at 59.4.

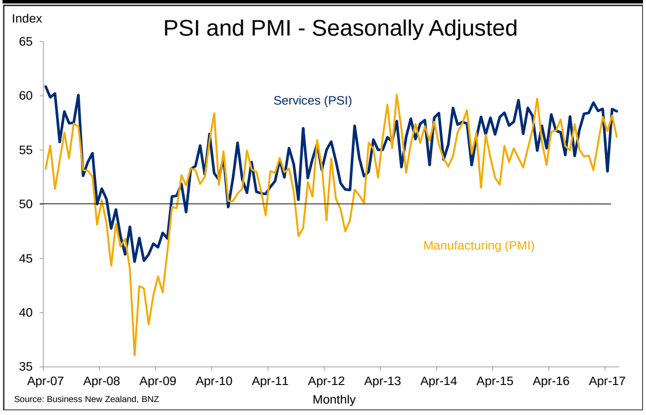
With respect to GDP, the recent results of the PSI are obviously supportive of ongoing solid expansion. The PMI has been saying the same thing, in also running above its long-term average. Combined, the PSI and PMI signal an above-trend rate of economic expansion through the course of the June quarter. This is consistent with our view that Q2 GDP growth will pick up to 0.8% (2.5% y/y), with upside risk.

Early this afternoon RBNZ Deputy Governor, Geoff Bascand is scheduled to deliver a speech, with the RBNZ issuing the text and an accompanying press release at 1:30pm. Entitled "New Zealand's net foreign liabilities: What lies beneath, and ahead?" it seems unlikely to push any monetary policy messages, although it might have something to say on financial stability (concerns?). When it comes to debt, what can matter is its composition, and who it's ultimately owed to.

For Wednesday's early morning dairy auction, we haven't seen anything perturbing in terms of prices. And to the extent they do keep holding about still, there will remain upside to our $6 forecast for the 2017/18 milk price.

Net inward migration was still extremely high in May, with a seasonally adjusted 5,910. June's number is scheduled for Friday (10:45am). As for short-term visitor arrivals in June, they will probably print annual percentage growth in the early teens, aided by the Lions rugby tour that was traipsing the country the entirety of the month. Credit card billing for June are also due Friday (3:00pm).

Robust



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Global Watch

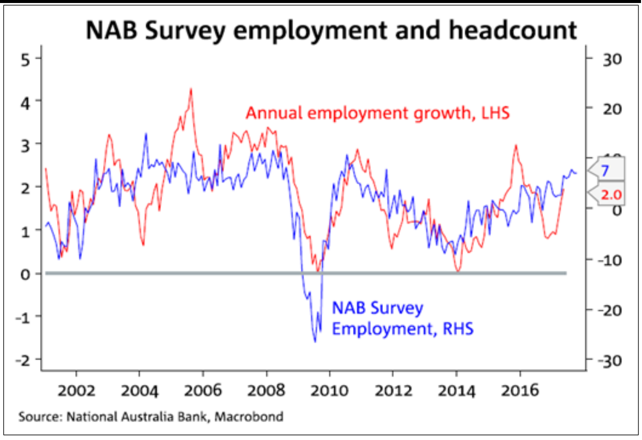
- ECB and BoJ policy meetings
- In Australia, a number of RBA speeches and employment on Thursday
- China data dump on activity today
- A low-key economic calendar in the US. Profit reporting season kicks into gear.

Australia

The initial local focus for the week will be the RBA Minutes on Tuesday. The post-Board Media release from the Governor was only incrementally more positive on the local economy but with absolutely no change from a neutral monetary policy bias. The Minutes will be scanned for further nuances on the economy and for any hints of Board's sensitivity to currency which has recently risen.

Following hawkish central bank rhetoric globally, markets will also be glued to three upcoming RBA speeches. RBA's Head of Economic Analysis Alex Heath is speaking at the Conference of Economists on Wednesday, though there is as yet no title for her address. She is slated to speak on the Women in Economics Panel. RBA Deputy Governor Debelle may prove to be more illuminating given his penchant for frank remarks, and he is speaking on Global Influences on Domestic Monetary Policy in Adelaide – a highly relevant market topic given recent hawkish rhetoric globally. RBA Assistant Governor Michelle Bullock is also speaking on Friday at the 11th Melbourne Institute-The Australian Economic and Social Outlook Conference "New Directions in an Uncertain World".

In Relative Alignment Now



As for Thursday's Labour Force report for June, following three stronger-than-expected reports, this report might be more in line with trend expectations if not a tad on the shy side. Alternative indicators of labour demand remain positive, pointing to likely continued trend growth in employment sufficient to act over time to lower the unemployment rate. NAB looks for 15k growth in employment and an unchanged unemployment rate. Consensus is similar in forecasting +15k employment, but expects the unemployment rate to tick up by a tenth to 5.6% despite an unchanged participation rate.

US

Only second-tier data this week including housing activity and sales. Profit-reporting season gets into full swing.

China

Monday's June quarter GDP is expected to confirm the mildest of slowing in GDP to a 6.8% pace together with steady solid growth in June month readings of Industrial Production, Retail Sales, and Fixed Assets Investment. June Property Prices are released on Tuesday.

Japan

The BoJ meets on Thursday, likely without any market fallout. The central bank stepped in recently to prevent the JGB 10-year rate from moving higher alongside the upward pressure on global rates. This was a signal that it wasn't ready to adjust its yield curve control policy, with its inflation mandate still far from being achieved. Generally quiet for data; the June Trade data is released on Thursday.

Euro-area

The ECB meets this week. Draghi is likely to remain steadfast in maintaining its ultra-accommodative policy stance, but again recognising a more balanced outlook. After removing its easing bias with regards to rates at the previous meeting, this time around the ECB is expected to remove the easing bias with regards to its quantitative easing programme. It's another step along the road towards policy normalisation. It's quiet week for data; June's final CPI is out Tuesday.

UK

On the datafront, Thursday's retail sales will be in focus. Brexit negotiations between the EU's Barnier and the UK's Davis continue.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The global backdrop for the bond market is finely poised. Upward pressure from higher European rates remains a force to be reckoned with. Germany's 10-year rate tacked on another 3bps last week to 0.60%, its highest level since the end of 2015. The euro area's dataflow remains positive, which is expected to encourage the ECB along the path of policy normalisation. This week's ECB meeting might show another step along that path, with the central bank expected to remove its easing bias with regards to the QE programme currently underway. Recall that at its last meeting it removed the easing bias with regards to rates.

Last week the US 10-year Treasury rate fell by 5bps to 2.33% and if not for the backdrop of higher European rates, the fall could well have been larger. Yellen's testimony to lawmakers was seen to be marginally more dovish than expected and this was followed by a trifecta of week data late in the week, including the fourth consecutive miss to the downside for core CPI inflation.

Over the course of the week, expectations for further Fed hikes this year softened a little, with the market now pricing in slightly less than a 50/50 chance of another 25bps hike before the end of the year. The broadly-based nature of the recent weakness in the core CPI raises some doubt about how "temporary" the slowdown is but there are still five more monthly releases before the December meeting along with another five potentially strong employment releases. Abandoning calls for further Fed tightening this year would therefore appear premature. We, along with the consensus, believe that a Q3 pause in the hiking cycle is likely anyway, as some reduction in the Fed's balance sheet takes priority.

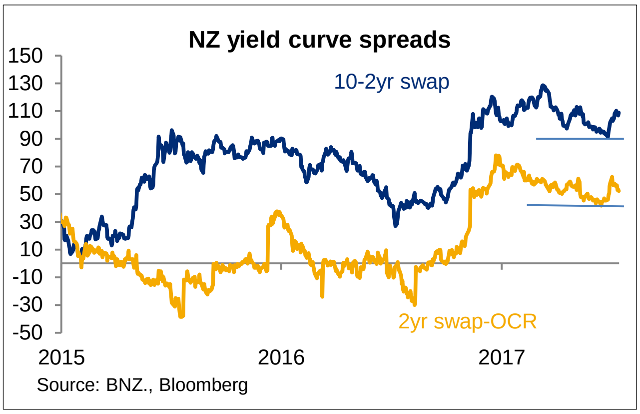
Lower US rates for the week, were the key factor behind the nudge lower in NZ long-term rates, with 5-yr and 10-yr swap rates down 5bps to 2.85% and 3.36% respectively. With the US economic backdrop, the near-term threat of a further push higher after the recent sell-off has reduced a little and we might well see a period of consolidation set in over the coming month. That said, we remain wary of the likely push higher in Germany rates over the rest of the year and we see the market underpricing the chance of further hikes through to the end of next year. This points to further upside pressure to global rates later in the year.

Locally this week the focus turns to tomorrow's Q2 CPI outturn. We expect a soft result of 0.1% q/q and 1.8% y/y (below the RBNZ's pick back in May of 2.1% y/y, which didn't have the benefit of knowing the recent tumble in oil prices). A soft result would support our view that the RBNZ isn't likely to do an about-turn like the Bank of Canada recently did. We see the data reinforcing the RBNZ's decisively neutral policy stance for some time. If anything, inflation is tracking below its projections, given the combination of a stronger NZD and lower oil prices.

We see the CPI data supporting the recent shift down in the 2-year swap rate, from as high as 2.38% two weeks ago to the current level of 2.25%. Receiving interest at that level is likely to predominate, given the positive carry and lack of threat from the RBNZ changing its policy stance anytime soon.

With short end rates underpinned by anchored monetary policy expectations, the slope of the curve will remain at the whim of global forces. The 2s10s curve spread is close to the middle of the 90-130bps range it has traded this year and we don't have a strong view either way for trading this over the coming month.

Higher Rates Across the Curve Over Last 2 Weeks



Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.96	1.95 - 1.99
NZ 2yr swap (%)	2.25	2.21 - 2.39
NZ 5yr swap (%)	2.82	2.68 - 2.94
NZ 10yr swap (%)	3.34	3.13 - 3.43
2s10s swap curve (bps)	109	91 - 110
NZ 10yr swap-govt (bps)	40	37 - 41
NZ 10yr govt (%)	2.94	2.72 - 3.05
US 10yr govt (%)	2.33	2.12 - 2.39
NZ-US 10yr (bps)	61	59 - 74
NZ-AU 2yr swap (bps)	32	32 - 45
NZ-AU 10yr govt (bps)	22	23 - 38

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

Last week saw broad USD weakness after some soft data and perceptions of a slightly more dovish Yellen at her testimony to lawmakers. This helped the NZD close just under the 0.7350 mark, an important area of technical resistance. The NZD has failed to sustainably break through this mark over the past four weeks.

Rising risk appetite has pushed our fair value estimate up to 0.7590, but we still have some doubt over whether the NZD will reach such a height this year. The NZD remains vulnerable to any negative news, with net speculative long positioning remaining near a four-year high. The last time speculative positioning was this one-sided, in April 2013, the NZD fell from 0.86 to 0.77 or around 10% over the subsequent three months.

The big surprise last week was the strength of the AUD, which gained over 3% against the USD to reach its highest level in over a year. NZD/AUD fell over 2% for the week, closing at a 7-week low of 0.9380. There was little NZ or Australia specific news that drove the result, although a strong recovery in iron ore prices over the past month has been in play. The cross is close to fairly priced at current spot and our projections show a range-trading environment over the rest of the year, centred about the mid 0.90s.

Looking at the week ahead, locally the focus turns to tomorrow's Q2 CPI release. We expect a soft result of 0.1% q/q and 1.8% y/y (below the RBNZ's pick back in May of 2.1% y/y, which didn't have the benefit of knowing the recent tumble in oil prices). While a soft result is widely anticipated, speculative positioning in the NZD has been increasing on the view that the RBNZ will be soon following the Bank of Canada in moving to a tightening bias and then tightening. We don't buy that view and see the RBNZ maintaining a neutral stance for some time. If anything, inflation is tracking below its projections, given the combination of a stronger NZD and lower oil prices. The CPI data should confirm this view.

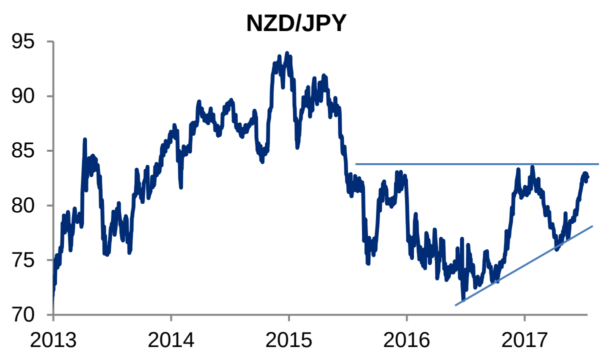
Central bankers will remain in the spotlight over the coming week, with the ECB taking centre-stage on Thursday night. After removing its easing bias with regards to rates at the previous meeting, this time around the ECB is expected to remove the easing bias with regards to its quantitative easing programme. It's another step along the road towards policy normalisation.

In theory, the move should be well-anticipated by the market and be EUR-neutral, but the market is hyper-sensitive to any moves by the ECB and the scope for a communications misstep or misunderstanding is high. The ECB is expected to be the key player in helping drive NZD/EUR sub-0.60 later in the year and towards the mid-0.50s next year on our projections.

The BoJ follows on Friday. The central bank stepped in recently to prevent the JGB 10-year rate from moving higher alongside the upward pressure on global rates. This was a signal that it wasn't ready to adjust its yield curve control policy, with its inflation mandate still far from being achieved. So no surprises are expected from the BoJ. NZD/JPY has approached an important technical level around 83.5 which we think will be hard to break. The cross has had a steaming run and is due for a period of consolidation.

The RBA's minutes from its early-July meeting will be released and should pass without reaction, as the Statement was little changed. We aren't expecting the three RBA speeches this week (none by the Governor) to rock the market either. The volatile employment report on Thursday gives the best opportunity for some AUD volatility on the day.

NZD/JPY Close to Technical Resistance



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7345	0.7200 - 0.7370
NZD/AUD	0.9387	0.9370 - 0.9650
NZD/GBP	0.5605	0.5590 - 0.5760
NZD/EUR	0.6401	0.6290 - 0.6560
NZD/JPY	82.60	80.90 - 83.30

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7590	-3%
NZD/AUD	0.9370	0%

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Technicals

NZD/USD

Outlook: Downward channel
ST Resistance: 0.7350 (ahead of 0.7400)
ST Support: 0.7200 (ahead of 0.7100)

The NZD has met resistance around the 0.7350 mark over the past four weeks. Failure to move sustainably above that level would confirm that the 9-month downward channel remains in play. The first area of support is 0.7200, ahead of the 200-day moving average around 0.7100.

NZD/AUD

Outlook: Trading range
ST Resistance: 0.9600 (ahead of 0.9700)
ST Support: 0.9255 (ahead of 0.9150)

A messy technical picture, with last week's 2% fall not helping. After the big drop, resistance is now some way up around 0.96. The first area of support looks like kicking in around 0.9255.

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NZ 5-year Swap Rate

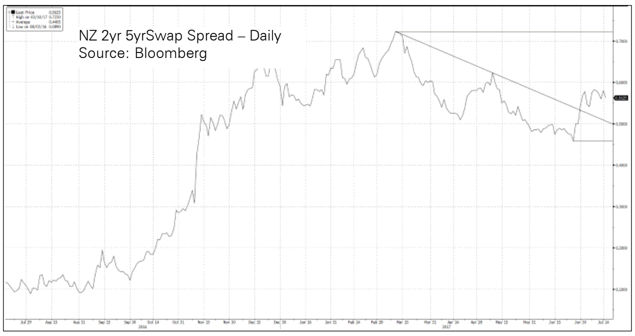
Outlook: Neutral
ST Resistance: 2.94
ST Support: 2.68

Mid-range and right on 200 day moving average. Stay neutral until more technical evidence of a trend.

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

Outlook: Steeper
ST Resistance: +72
ST Support: +45

Break of trendline signals move higher/steeper. Target +72 any pullback should be limited to +51.



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Key Upcoming Events

	Forecast	Median	Last
Monday 17 July			
NZ, RBNZ's Bascand Speaks, International Liabilities			
NZ, BNZ PSI (Services), June			58.8
China, GDP, Q2 y/y		+6.8%	+6.9%
China, Industrial Production, May y/y		+6.5%	+6.5%
China, Fixed Assets (ex rural), May ytd		+8.5%	+8.6%
China, Retail Sales, May y/y		+10.6%	+10.7%
US, Empire Manufacturing, July		+15.0	+19.8
Tuesday 18 July			
NZ, CPI, Q2 y/y	+1.8%	+1.9%	+2.2%
Aus, RBA Minutes, 4 July Meeting			
China, Property Prices, June			
Euro, CPI, Jun y/y 2nd est			+1.3%P
Germ, ZEW Sentiment, July			+18.6
UK, CPI, June y/y			+2.9%
US, NAHB Housing Index, July		68	67
Wednesday 19 July			
NZ, Dairy Auction, GDT Price Index			-0.4%
Aus, Westpac Leading Index, June			-0.02%

	Forecast	Median	Last
Wednesday 19 July cont'd…			
US, Housing Starts, May		1,160k	1,092k
Thursday 20 July			
Aus, Employment, June			+42k
Aus, Unemployment Rate, June			5.5%
Aus, NAB Business Survey, Q2			+6
Jpn, Merchandise Trade Balance, June			-Y203b
Jpn, All Industry Index, May			+2.1%
Jpn, BOJ Policy Announcement, Policy Rate		-0.1%	-0.1%
Euro, Consumer Confidence, July 1st est			-1.3
Euro, ECB Policy Announcement, Refi	0.00%	0.00%	0.00%
Germ, PPI, June y/y			+2.8%
UK, Retail Sales vol., June			-1.2%
US, Leading Indicator, June		+0.4%	+0.3%
US, Philly Fed Index, July		+21.5	+27.6
US, Jobless Claims, week ended 15/07			247k
Friday 21 July			
NZ, Credit Card Billings, June			+0.9%
NZ, External Migration, June s.a.			+5,900

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.81	1.85	1.85	2.34
2mth	1.89	1.91	1.89	2.38
3mth	1.96	1.97	1.94	2.42
6mth	2.00	2.02	1.99	2.44
GOVERNMENT STOCK				
12/17	1.81	1.81	1.80	2.01
03/19	1.96	2.05	1.94	2.00
04/20	2.19	2.27	2.09	1.99
05/21	2.34	2.40	2.18	2.00
04/23	2.62	2.69	2.45	2.13
04/25	2.83	2.90	2.65	2.25
04/27	2.94	3.02	2.76	2.55
04/33	3.28	3.35	3.06	2.00
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	81.00	86	85	121
N. AMERICA 5Y	58.25	62	60	73
EUROPE 5Y	54.46	57	59	76

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.25	2.33	2.20	2.24
3 years	2.47	2.55	2.39	2.23
5 years	2.82	2.90	2.69	2.25
10 years	3.34	3.41	3.17	2.51
FOREIGN EXCHANGE				
NZD/USD	0.7356	0.7276	0.7207	0.7301
NZD/AUD	0.9387	0.9574	0.9569	0.9651
NZD/JPY	82.65	82.95	79.53	73.48
NZD/EUR	0.6405	0.6382	0.6433	0.6608
NZD/GBP	0.5607	0.5646	0.5656	0.5640
NZD/CAD	0.9295	0.9373	0.9695	0.9521
TWI	78.35	78.46	77.80	78.10

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