23 January 2018

An Inflationary Basis

- **We expect the Q4 CPI to repeat at 1.9% y/y**
- **But it looks set to slow in H1 2018**
- **Fostering a RBNZ bias to lag?**
- **Housing pressure real now…looking at rents**
- **PSI holds up well (as PMI slows a lot)**
- **Does the basis for a 1.75% OCR still hold?**

Capacity pressures are intensifying, and remain intense in the housing and construction markets. But annual CPI inflation is likely to look barely middling in Thursday's Q4 report, and seems biased to slow into the first half of 2018. The latter could encourage the Reserve Bank to further delay a normalisation of the Official Cash Rate, after the precautionary easing it carried out over 2015 and 2016.

For Thursday's Q4 CPI report, we are in line with the market, in expecting a 0.4% increase for the quarter, leaving annual inflation at 1.9%.

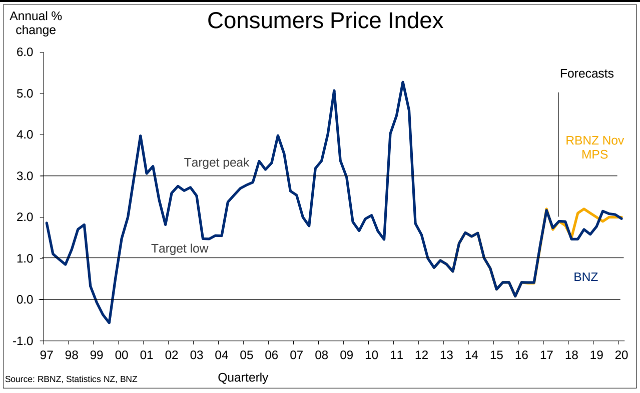
The central bank, in its November Monetary Policy Statement, expected annual CPI inflation of 1.8% (based on 0.3% for the December quarter itself). This involved non-tradables inflation decelerating to 2.4%, from 2.6% in Q3, and tradables inflation remaining at 1.0% y/y.

It will also pay to check the range of core inflation measures for Q4, especially the sectoral factor model version produced and favoured by the RBNZ, which, at 1.4% y/y in Q3, was obviously lagging the many others. Better-understood measures of underlying inflation such as trimmed-mean, and weighted-median, have been travelling closer to 2.0% of late, for example.

Providing the NZ CPI doesn't shock for Q4, the debate will turn to how it will go in the early stages of 2018. In particular, that there is a good chance its annual rate of inflation will slow in Q1 – simply because a stocky quarterly result from Q1 last year will be dropping out of the calculations. Increased subsidies for tertiary fees will also be a drag on the CPI in Q1 2018. We expect annual inflation to dip to 1.5% in this quarter, and stay there in Q2. It will belie much of the capacity pressure in the economy, but could yet engender more delay with respect to OCR normalisation.

There is certainly pressure in the housing market. Even though the Real Estate Institute sales number largely marked time in December, it was enough to have sale

Through The Valley

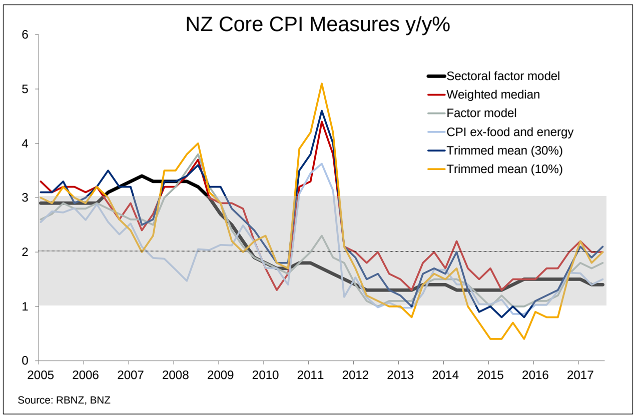


prices trending up again, after a pause around the election. Nonetheless, the real test of the post-election pulse will come in the March quarter data.

For all the scaremongering about a housing "crisis" over the years – which probably aggravated the buy-side – there does look to be some genuine pressure on the housing stock now, as population pressures mount. This is evident in rent inflation. Well, at least in most of the anecdote we're picking up. It remains to be seen how much rental inflation shows up in the CPI (but note that Statistics NZ is busy thinking about how to better measure this component).

Of course, residential land prices haven't been including in the CPI for ages. However, they are still relevant to thinking about inflation. We mention this as we continue

Take Your Pick



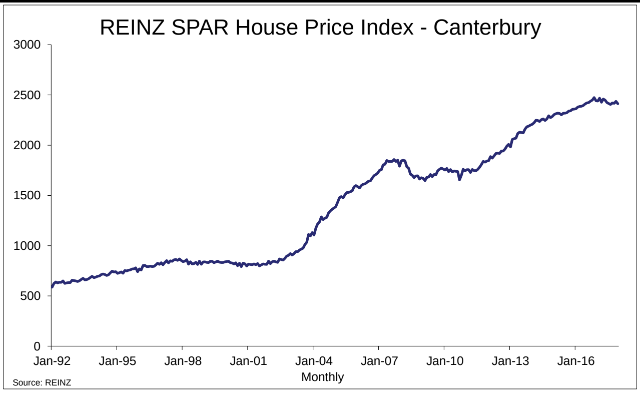
to hear the argument that house prices are so high essentially because of a lack of supply, including in the land component of new builds. While we don't deny the price of residentially-zoned land is very high we also note that it has remained so in areas that are presumed to have had relatively better land supply response.

In this vein, we are reminded of Graeme Wheeler, a number of years ago, pointing to a responsive building sector as a factor in keeping Tauranga's house price inflation under control (at the time), inferring New Zealand's house price inflation problem was simply an Auckland one, involving a lack of supply. If only Auckland could be like Tauranga? But over the weekend we hear that Tauranga's house price ratios (to income) are now worse that Auckland's. Indeed, most of the country has seen a surge in such multiples over just the last few years.

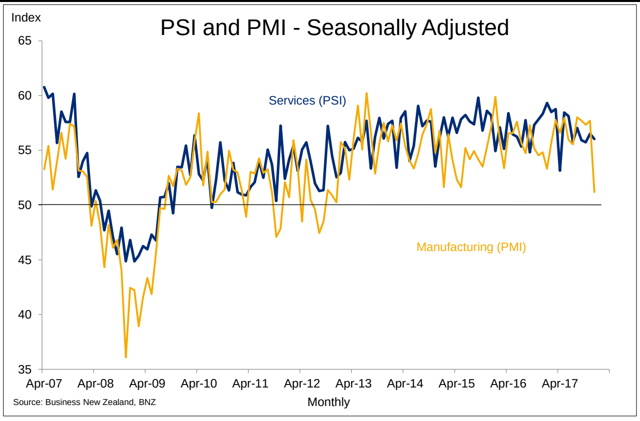
In thinking about the role of land supply in all of this, it's worth noting the example of Christchurch (including Selwyn and Waimakiriri). Have the oodles upon oodles of new sections on offer there caused a big correction in the price at which they are being sold? Not that we are aware of. Sure, house prices in Canterbury have been coming off a bit lately. But they are still about 40% above levels that transpired in 2011. So why should land supply be a silver bullet for Auckland house prices either?

With respect to the real economy, New Zealand's Performance of Services Index (PSI) remained patently expansive for December, in figures published this morning. Index-wise it came in at 56.0, compared to the 56.5 level it strengthened to in November.

What Correction?



Mixed Messages



This above-average outcome was doubly significant, considering the Performance of Manufacturing Index (PMI), as was published last Friday, decelerated sharply in December (to 51.2, from 57.7). Had the PSI done so too, we would have been more concerned that the economy might be choking back a bit, following the election. As it is, we judge the weakness in the PMI to be related to business investment caution in the run-up to the holiday period, while the ongoing robustness in the PSI suggests the more day-to-day business keeps ticking over relatively well.

The other monthly indicators of the coming week are relatively minor, namely credit card billings for December, due Wednesday, and the Crown Financial Accounts for November, scheduled for Thursday.

But with Thursday's CPI report focussing our minds on inflation, it's also worth remembering that the policy easing the Reserve Bank conducted during 2016 was largely based on its fear that inflation expectations were sagging, and might stay down. That scenario is now surely behind us. As is the collapse in dairy income, which was the other main reason the RBNZ carried on cutting its cash rate during 2016. Meanwhile, Statistics NZ has judged that the economy was growing a lot better in 2015/16 than was first estimated to be the case.

If the Reserve Bank can be excused for cutting its OCR when inflationary factors change for worse, should it therefore be expected to lift its policy rate back up when things change for the better? We should hope so, in the fullness of time.

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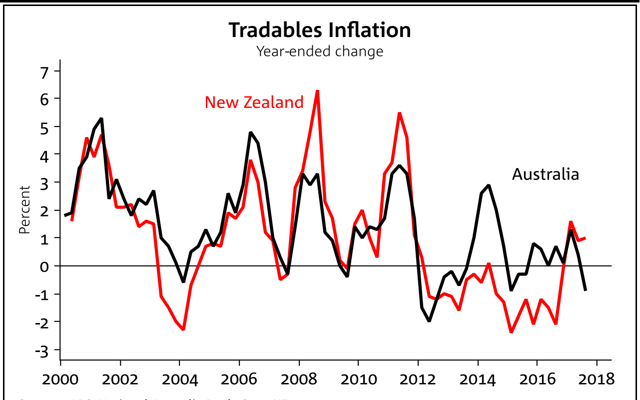
Global Watch

- **ECB meets Thursday**
- **No change expected from BoJ today**
- **US government looks set to reopen**
- **GDP due in US, UK**

Australia

There are no significant data releases this week. Australian markets are closed on Friday for the Australia Day public holiday. The next major release is the Q4 CPI on Wednesday 31 January. NAB's preliminary forecast is 0.8% q/q / 2.2% y/y for headline and 0.5% q/q / 1.9% y/y for core rates of inflation. This forecast will be finalised next week after the publication of the NZ CPI, as a number of variables map closely to the Australian CPI.

AU And NZ Tradables Inflation Tends To Be Linked



Sources: ABS, National Australia Bank, Stats NZ

Eurozone

The ECB meeting on Thursday is the key event to watch for global markets this week. While the expectation is that the ECB will leave their policy rate unchanged, markets will be paying close attention to the message of the statement and Mario Draghi's press conference for any signs of a shift in policy guidance on QE. Market watchers will also be looking out for indications that the impact of EUR strength on inflation is becoming a concern for policymakers.

Japan

The BoJ meets today. As with the ECB, the market expects no change to the policy stance, particularly given that Japanese inflation remains below target. That said, markets will be looking for any clues on the BoJ's intention for QE over the next year, particularly given the BoJ's reduction in long-dated bond purchases last week.

US

The US Senate has passed a stopgap funding bill through to February 8 that would reopen the federal government. The house will vote on it today. For the week ahead, Q4 GDP data on Friday will be closely watched. Market economists expect a print of 2.9% (previous 3.2%). The Atlanta Fed's GDPNow forecast is at 3.4%.

UK

This week sees two major data releases: UK jobs data on Tuesday and Q4 GDP on Friday. For GDP the market is looking for growth of 0.4% q/q, a touch below the BoE's forecast of 0.5% q/q.

Canada

Two significant pieces of data this week for Canada, November retail sales on Thursday and the December CPI on Friday. Canada has recorded a strong improvement in its economy over 2017, and these datapoints are expected to confirm the trend. Following the recent rate hike by the Bank of Canada last Wednesday, two additional hikes are priced for 2018.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

NZ interest rates moved higher last week, again following global moves. The 10 year US Treasury yield hit 2.67%, its highest level since 2014. Meanwhile, the Bank of Canada raised rates a third time and amid strengthening global growth (overnight the IMF raised its forecasts for this year and next) markets are speculating that more central banks will join the global tightening cycle this year.

While the larger moves in NZ yields were seen in the longer end, the short-end was not immune to the move higher in global rates. The 2 year swap hit 2.27% yesterday, although it has since fallen back a few basis points. The market now prices a 50% chance of a rate rise in August and a full rate rise by November.

We think the risk-reward for receiving the front-end of the NZ swap curve on a tactical basis is getting stronger given the back-up in rates and increased carry. While we expect the RBNZ to start a gradual tightening cycle in August, we see the risks to that being pushed back. Over the next few months there seems little risk that the RBNZ rhetoric around rate rises will change materially, at least until the new Governor takes the helm in March, and in that environment we don't think the front-end will factor in significantly more tightening than it does already.

The major event this week is New Zealand CPI, where we expect a 0.4% increase for the December quarter, in line with the consensus. The market will also pay attention to the RBNZ's Sector Factor Model estimate of underlying inflation, which has been going sideways for 5 years. We would view a rise in NZ 2 year swap towards 2.30%, either on a further rise in global rates or a stronger CPI, as a tactical receiving opportunity.

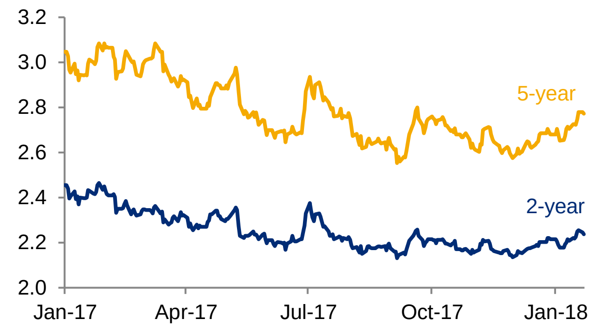
The DMO resumed its bond tenders last week, issuing $200m 2025s with a bid-to-cover ratio of over 3. Most NZGBs have been trading special in repo, implying the market is short, and that remains the case after last week's tender. This week the DMO issues $150mn 2033s and we would expect the tender to go similarly well, although that shouldn't prevent longer-dated NZGBs following global rates if US yields can push higher.

Kauri issuance has been very strong to start the year. IBRD printed a $700m 5 year deal last week, bring year-to-date issuance to almost $2b (vs. full year issuance in 2017 of ~$3b). The strong Kauri issuance YTD has arguably been one factor that has contributed to the narrowing in NZGB swap spreads this year, as issuers always swap the proceeds.

Offshore, the main focus will likely be on the ECB's meeting Thursday and the BoJ today. We expect the BoJ to push back on any speculation it is considering altering its Yield Curve Control policy (CPI ex-food and energy is close to 0%). Although the minutes to the ECB's December meeting signalled that the central bank intended to change its guidance around QE in the coming few months, we'd be surprised if it made that change this meeting; March seems like a more likely candidate to us given the Governing Council will have an updated set of economic projections at that point. If anything, we think the risk is that President Draghi might sound a bit more dovish as several ECB members have signalled some unease at the continued rise in the EUR.

In the US, the highlight is the advance estimate of Q4 GDP Friday night in a week of mostly second-tier data. We will be watching to see if 10 year US Treasury yields can consolidate above their 2017 highs of 2.63%.

NZ swap rates dragged higher by moves offshore



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.88	1.87 - 1.89
NZ 2yr swap (%)	2.24	2.17 - 2.27
NZ 5yr swap (%)	2.77	2.65 - 2.80
NZ 10yr swap (%)	3.29	3.11 - 3.31
2s10s swap curve (bps)	106	95 - 106
NZ 10yr swap-govt (bps)	31	31 - 41
NZ 10yr govt (%)	2.99	2.72 - 2.99
US 10yr govt (%)	2.65	2.43 - 2.67
NZ-US 10yr (bps)	33	30 - 34
NZ-AU 2yr swap (bps)	13	13 - 20
NZ-AU 10yr govt (bps)	12	6 - 15

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The past week or so has been fairly uneventful for currency watchers, marked by still-low volatility and modest currency changes. The prevailing theme remains a soft USD, despite US-global rate spreads widening further. The US government shutdown debacle had little impact on the currency. The widely followed DXY Index broke through September lows but the broader BBDXY and USD TWI-majors indices are hanging in there close to the September low.

The weak USD sees the NZD trading near 0.73, back to September levels, before the mood for the NZD turned sour after the election and a notable discount to fair value emerged. There is fundamental support for the NZD, with our risk appetite index near levels not seen since 2014 and the recent gain in dairy prices helping lift the overall NZ commodity price index. Our short term fair value estimate is 0.7230.

CFTC data still show net speculative short positioning in the NZD, although this has been wound back over the past few weeks, from as high as a net 17.5k contracts as at the end of last year down to 8k contracts.

Looking at the charts we see technical resistance near 0.7370, while the relative strength indicator continues to track above 70, signalling an over-bought NZD or, more appropriately put, an oversold USD.

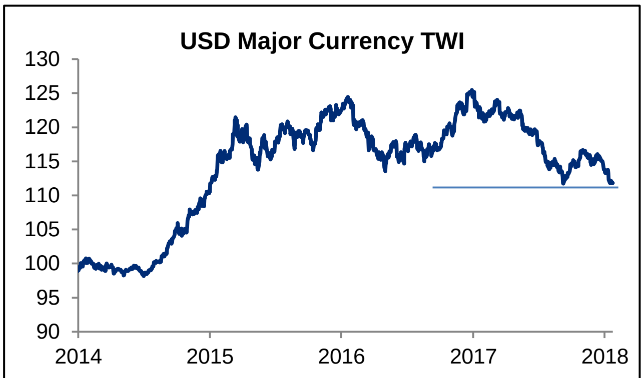
Thursday's NZ CPI release is the key event on the local calendar. Our 0.4% q/q estimate is in line with consensus, with the range of estimates showing a slight skew to the upside. We aren't expecting the data to have any more than a passing impact on the NZD. We expect core inflationary pressure to gradually increase over the coming year, leading to tighter NZ monetary policy in the second half but implications for the NZD are fairly modest, with other central banks also expected to be guiding policy tighter as well.

The ECB meeting on Thursday night is expected to see the central bank sit on its hands. "Sources" suggest that the ECB will wait until March before changing policy guidance. President Draghi is likely to be careful with his choice of words to prevent further EUR strength and a taper tantrum in the European bond market.

There will also be more interest than usual in the BoJ's policy meeting today, given the recent move to reduce purchases of long-term Japanese government bonds. However, we don't see the BoJ changing its policy guidance yet, with rising core inflationary pressure still proving to be elusive.

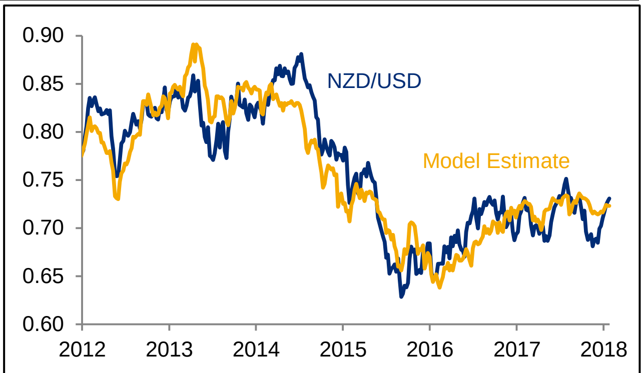
The US data calendar is fairly light this week, with GDP data at the end of the week the key release. It's a fairly uneventful week in Australia, culminating in its national holiday on Friday. NZD/AUD has traded most of the time in a 0.90-0.92 zone over the past couple of months, close to our range of short-term fair value estimates. We don't have any strong view on this cross for the coming months. Commodity price gyrations provide the best scope for any volatility, with relative interest rates expected to be fairly steady for much of the year.

USD Tracking Near Sep-2017 Low



Source: BNZ, Bloomberg

NZD Fairly Priced – Late 2017 Discount Full Closed



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7319	0.7070 - 0.7330
NZD/AUD	0.9133	0.9050 - 0.9220
NZD/GBP	0.5234	0.5200 - 0.5370
NZD/EUR	0.5970	0.5870 - 0.6050
NZD/JPY	81.20	79.50 - 81.30

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7230	1%
NZD/AUD	0.8990	2%

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Technicals

NZD/USD

Outlook:	Trading range
ST Resistance:	0.7370 (ahead of 0.7430)
ST Support:	0.7125 (ahead of 0.7055)

The strong NZD recovery since mid-December has seen previous resistance levels one by one. We see the next area of resistance around 0.7370. There is weak support around the 200-day moving average of 0.7125.

NZD/AUD

Outlook:	Trading range
ST Resistance:	0.9230 (ahead of 0.9400)
ST Support:	0.9035 (ahead of 0.8975)

Resistance is at 0.9230 which matches both the 200-day moving average and resistance levels broken in place since September. The first area of weak support kicks in around 0.9035.

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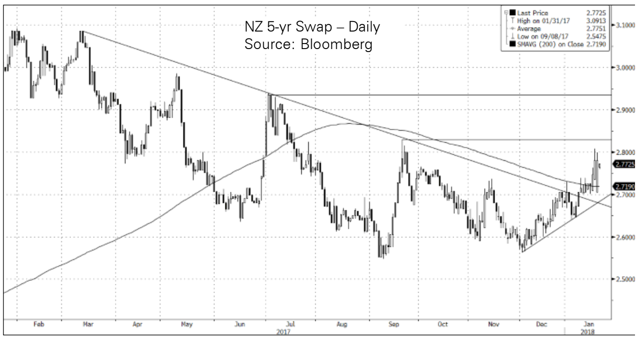
NZ 5-year Swap Rate

Outlook:	Higher
ST Resistance:	2.93
ST Support:	2.62

Break of 2.73 confirmed move higher. Expect move to 2.83 en route 2.93. Pullbacks should be limited to 2.68, trendline support.



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

Outlook:	Steeper
ST Resistance:	+72
ST Support:	+48

Breaking higher expect a move towards +72. Trendline support now comes in at +48.

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Key Upcoming Events

	Forecast	Median	Last
Tuesday 23 January			
NZ, BNZ PSI (Services), December			56.4
Jpn, All Industry Index, November		+0.8%	+0.3%
Jpn, BOJ Policy Announcement, Policy Rate		-0.1%	-0.1%
Germ, ZEW Sentiment, January		+17.7	+17.4
UK, CBI Industrial Trends, January		+12	+17
Wednesday 24 January			
NZ, Credit Card Billings, December			+0.8%
Jpn, Merchandise Trade Balance, December		+¥535b	+¥113b
Euro, PMI Services, Jan 1st est		56.4	56.6
Euro, PMI Manufacturing, Jan 1st est		60.3	60.6
Euro, Consumer Confidence, Jan 1st est		+0.6	+0.5
UK, Unemployment Rate (ILO), November			4.3%
US, Markit PSI, Jan 1st est		54.3	53.7
US, Existing Home Sales, December		5.70m	5.81m
US, Markit PMI, Jan 1st est		55.0	55.1
Thursday 25 January			
NZ, Crown Financial Statements, 5m-to-Nov 2017			
NZ, CPI, Q4 y/y	+1.9%	+1.9%	+1.9%
Euro, ECB Policy Announcement, Refi	0.00%	0.00%	0.00%

	Forecast	Median	Last
Thursday 25 January*...continued*			
Germ, IFO Index, January		117.0	117.2
UK, CBI Distribution Reported Sales, January			+24
US, Jobless Claims, week ended 20/01		235k	220k
US, Leading Indicator, December		+0.5%	+0.4%
US, Wholesale Inventories, Dec 1st est		+0.4%	+0.8%
US, New Home Sales, December		675k	733k
US, International Goods Trade, Dec advance		-$68.9b	-$70.0b
Friday 26 January			
China, Industrial Profits, December y/y			+14.9%
Jpn, CPI, December y/y		+1.1%	+0.6%
Euro, M3, December y/y		4.9%	+4.9%
UK, GDP, Q4 1st est		+0.4%	+0.4%
UK, Carney Speaks, Davos			
US, Durables Orders, Dec 1st est		+0.9%	+1.3%
US, GDP, Q4 1st est		+3.0%	+3.2%
Monday 29 January			
NZ, Residential Lending, December y/y			-16.6%
NZ, Holiday - partial, Auckland Anniv.			
US, Personal Spending, December			+0.6%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	1.75
1mth	1.78	1.78	1.78	1.83
2mth	1.83	1.83	1.83	1.90
3mth	1.88	1.89	1.89	1.97
6mth	1.93	1.92	1.94	2.04
GOVERNMENT STOCK				
03/19	1.81	1.78	1.79	2.27
04/20	2.04	1.99	1.90	2.47
05/21	2.24	2.16	2.05	2.63
04/23	2.51	2.42	2.28	2.89
04/25	2.77	2.68	2.58	3.14
04/27	2.98	2.88	2.75	3.22
04/33	3.29	3.21	3.10	3.56
04/37	3.44	3.36	3.29	3.88
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	55	54	60	96
Nth America 5Y	47	48	49	65
Europe 5Y	44	44	45	70

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.24	2.22	2.20	2.42
3 years	2.45	2.41	2.39	2.65
4 years	2.62	2.58	2.54	2.83
5 years	2.77	2.73	2.69	2.99
10 years	3.29	3.23	3.16	3.48
FOREIGN EXCHANGE				
NZD/USD	0.7319	0.7268	0.7040	0.7247
NZD/AUD	0.9132	0.9129	0.9109	0.9559
NZD/JPY	81.21	80.28	79.70	82.46
NZD/EUR	0.5970	0.5928	0.5936	0.6754
NZD/GBP	0.5234	0.5270	0.5264	0.5789
NZD/CAD	0.9118	0.9037	0.8931	0.9536
TWI	75.3	75.1	73.9	79.0

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