18 September 2017

Q2 GDP Growth Likely Solid, Weak and Massive

- We expect Q2 GDP lifted 0.8% (2.5% y/y)
- Per capita growth weak, nominal huge
- PSI/PMI suggest annual GDP growth of 3-4%
- Dairy prices still consolidating recent gains
- Party night Saturday…but which one(s)?

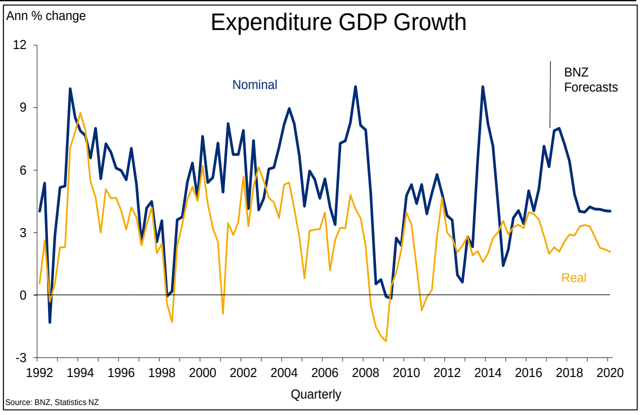
Thursday's June quarter GDP report will have more eyes on it than usual, given it comes out two days before New Zealand's down-to-the wire General Election. We expect activity to be up 0.8% in real terms. This is stoked by a big recovery in primary production and exports, for an annual increase in GDP of 2.5%. In terms of risk, we sense a result below 0.8% is slightly more likely than one above. Having said this, our expenditure GDP measure is champing at 1.1% for the quarter.

The market's median expectation is also for quarterly increase of 0.8, for 2.5% y/y. The other reference point is that in its August Monetary Policy Statement the RBNZ anticipated a 0.9% increase in Q2 GDP.

To be sure, our Q2 GDP expectation infers next to no growth in per capita terms. This is considering the working-age population expanded 2.4% in the year to Q2 2017 – boosted, as it has been, by record high net inward migration. However, Thursday's NZ GDP report also needs to be assessed in the context of nominal growth – which we believe will hit a cracking 8% in Q2 – reflecting the terms-of-trade related flush of commodity income starting to course through the economy. So take your pick.

Ahead of the GDP report, we'll check in on Wednesday's Q2 Balance of Payments to see if its exports and imports detail gel with our economic growth expectation and stories. It's not usually cause for tweaks, but you never know. Other than that, we believe the current account

Modest yet Massive

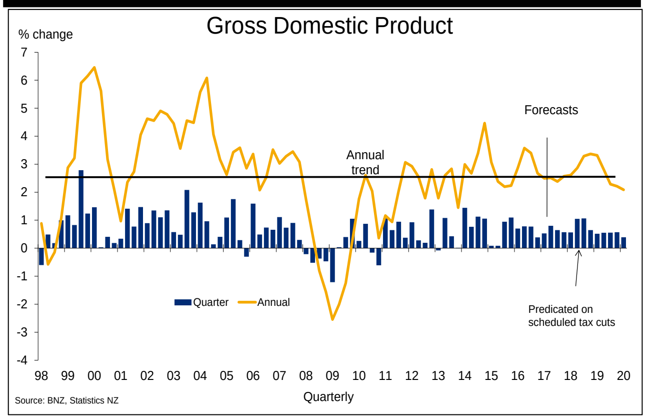


data will keep being a non-issue. Indeed that its deficit will probably slim to 2.9% as a proportion of nominal GDP for the year to June, compared to the 3.1% it logged for the year to March (on its way to just 2.0% by early next year, we believe). The market expects a steady deficit of 3.1% for the year to June 2017 current account.

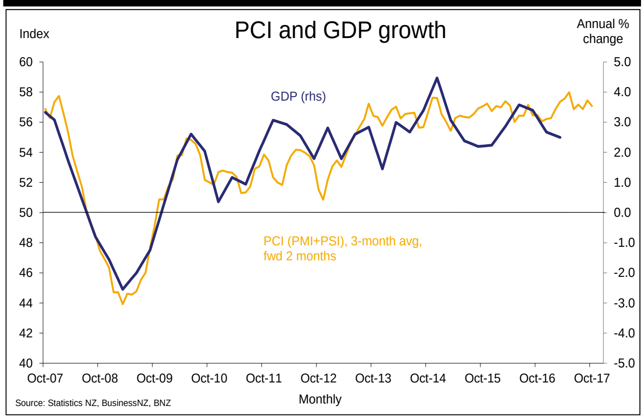
For more on New Zealand's rate of economic expansion, this morning's BNZ Business New Zealand Performance of Services Index (PSI) had encouraging things to say regarding Q3. It acquitted itself very well in August, posting a seasonally adjusted reading of 57.3, from 56.0 in July. In this, like we saw in the PMI, there appeared little in the way of election nerves, with production retaining strong momentum and new orders pumping.

Melded with the also-strong PMI (57.9), the latest PSI forms a picture of rude growth in the NZ economy, overall. Indeed, the composite index continues to point to annual GDP growth running in the order of 3 to 4%. This is more

Poised for a Pickup



A Solid Pointer



than we are forecasting for the near term, which is more in the region of 2.5 to 3.0%.

With respect to tomorrow's Q3 Westpac McDermott Miller consumer confidence index, this seems biased to record more of a lift if the rip-roaring monthly ANZ Roy Morgan index is anything to go by. The latter strengthened to 129.9 in September, from 126.2 in August. It was better still after we adjusted it for seasonality, yielding an index of 132.9, following 131.0. The long-term average is 119.2, and anything above 130 has typically denoted a purple patch.

In particular, the recent altitude in consumer confidence – especially facing into an election and a slowing housing market – gives us confidence that the dip we're likely to see in Q3 retail trade will simply be a technical payback from its big surge in Q2, such that solid growth will resurface in Q4.

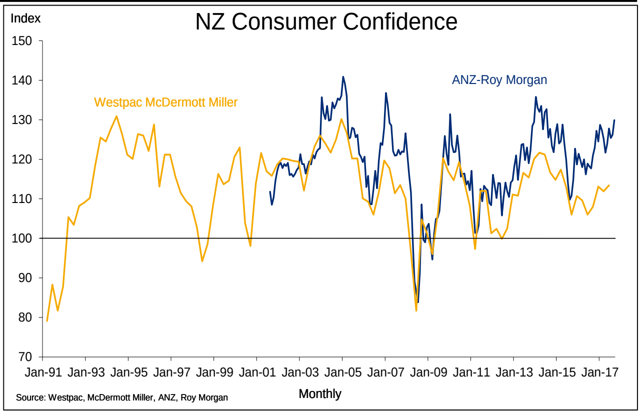
In terms of the commodity income driving rapid growth in New Zealand's (nominal) GDP, we believe Wednesday morning's GDT dairy auction will continue to show a broad consolidation of recent price gains. This, by the way, suggests little pressure – one way or the other – for Fonterra to significantly alter its milk price and dividend guidance when it announces its full-year financial results next Monday.

In terms of the population growth flattering NZ GDP growth, Friday's net immigration number for August will be instructive. It will help us judge if its dip in July, to 5,810 was just a head fake downwards, like we have seen so many times before, or the start of a bona fide pullback. As for August's short-term visitor numbers we anticipate their annual growth to settle around the mid-single digits. Credit card billings for August are due Friday 3:00pm.

Then it's a matter of settling in and seeing how the election vote count goes on Saturday. The very latest polls are converging on a close-run outcome, where coalition options may yet prove the deciding factor. One thing is for sure - we'll all lose sleep after the result. New Zealand shifts to Daylight Saving early Sunday morning, with clocks moving forward one hour, to ZULU +13:00.

craig_ebert@bnz.co.nz

More than Resilient



Global Watch

- Fed balance sheet and new dots in focus Thursday
- BoJ to sit pat
- Several central bank speakers to monitor
- RBA minutes due Tuesday
- Limited data: EU CPI, PMIs of most interest

Australia: It's an almost vacant calendar as far as economic data is concerned. The Statistician's measure of house prices for the June quarter might get a side glance at the most, as might Skilled Vacancies. The market though will be paying much closer attention to Tuesday's RBA Minutes, then a speech from the RBA's Luci Ellis to the Australian Business Economists lunchtime briefing in Sydney on Wednesday. It's the speech from RBA Governor Lowe ("The Next Chapter") to the American Chamber of Commerce in Australia Business Briefing lunchtime event in Perth on Thursday that will be the larger interest, we expect. That speech title offers lots of latitude for the Governor to speak about the outlook including some reference to encouraging signs of economic renewal for the WA economy would not surprise.

The RBA Minutes will be examined for more detail on the economy, signs of increasing confidence in the Bank's growth and labour market forecasts and that the next move in the cash rate will be up.

In its post-meeting release, the Bank noted that forward-looking indicators of the labour market suggested 'solid' growth in employment in the period ahead. This expectation was given more force by last week's August Labour Force report revealing solid employment pointing to further inroads into unemployment and underemployment.

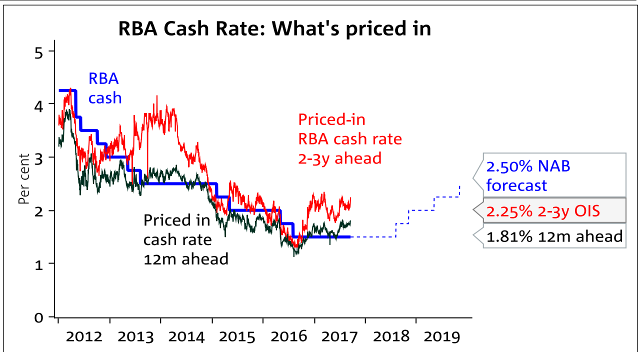
The Bank's assessment was the strongest assessment of the labour market for some time, aligning with a strengthening in employment intentions in the NAB Business Survey and a pick-up in SEEK job advertisements over the past 6-9 months. This week's NAB Business Survey also added another confirmatory data point to the strongest level of net business recruitment for 7½ years.

The market is always on the lookout for any change in the language on the $A, though the AUD/USD has changed little in the past month. The post-Board statement repeated the caution that a stronger $A could result in a slower pick-up in economic activity and inflation, noting the preference of the central bank for a lower currency.

China: Very quiet with only Monday's Property Prices likely to draw interest.

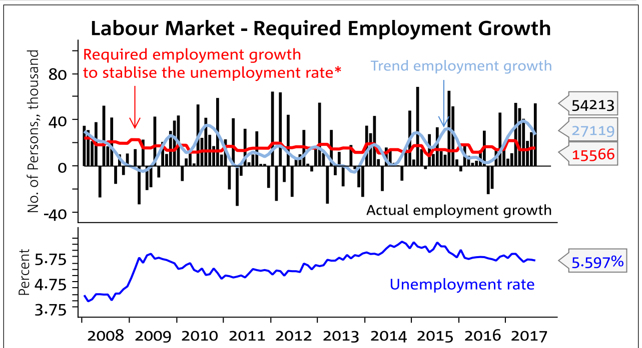
US: Unless market stability is derailed between now and when the FOMC meets Thursday morning, the Fed seems likely to formally announce the start to its program of running down its balance sheet while leaving rates on hold. Market attention will be first on the Statement and

Chart 1: NAB forecasts a higher cash rate next year



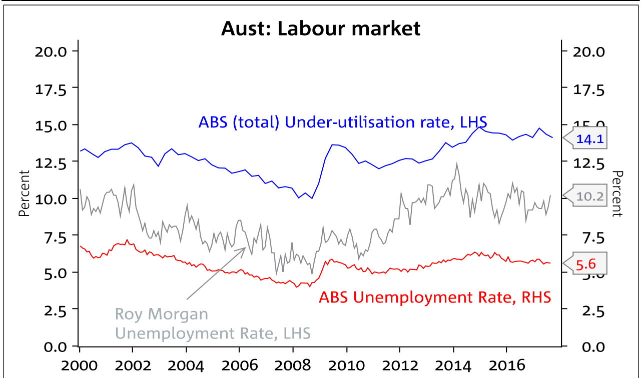
Source: National Australia Bank, Macrobond
OIS is Overnight Indexed Swaps, where the interest payment is compounded from the (overnight/daily) central bank rate

Chart 2: Stronger trend employment growth evident



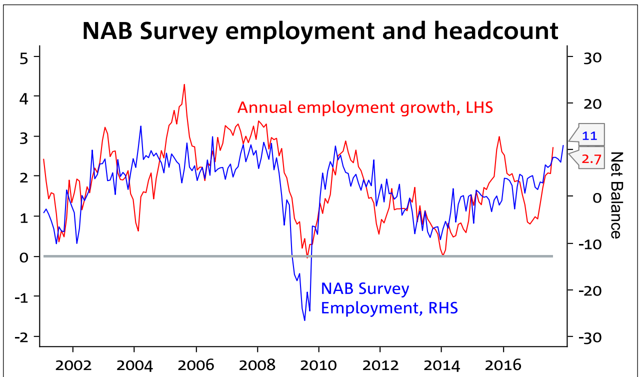
* Calculated so that the unemployment rate is unchanged each month with a constant participation rate
Source: National Australia Bank, ABS

Chart 3: Making inroads into un/underemployment



Source: National Australia Bank, Macrobond

Chart 4: Business hiring trend continues rising



Source: National Australia Bank, Macrobond the FOMC's new forecasts - especially the Fed funds dot points with the risk of the outer years being pulled down a notch - ahead of Chair Yellen's press conference 30 minutes later. Data this week focuses more on housing with the NAHB Housing Index, Housing Starts, Existing Home Sales, and House prices. The Fed's Williams, George, and Kaplan all speak on Friday.

Japan: Another agreement to stick with the BoJ program of highly accommodative monetary policy beckons Thursday. It's quiet for data: Trade out Thursday.

Eurozone: First there's Monday's CPI, core CPI expected to be steady at 1.2% y/y then all quiet until Friday's prelim. September PMIs. There's several ECB speakers scheduled, including at an ECB "Understanding Inflation" conference from Thursday. Draghi gives welcoming remarks to the European Systemic Risk Board annual conference. Germany holds its election on Sunday 24 September.

UK: Consumer spending, public finances and "industry" are under the economic microscope, Retail sales on Tuesday the most sensitive. BoE Governor Carney speaks Monday at the IMF in Washington.

Canada: BoC Deputy Governor speaks Monday, then it's a hiatus until Friday's CPI and Retail Sales double, both expected to be higher in headline terms.

david.degaris@nab.com.au

Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

Over the last couple of weeks we've raised the question about whether a turning point had been reached for US bond rates. A week ago we felt a bit sheepish, after US rates had just reached (another) fresh low for the year, but last week's price action is looking more like it.

The combination of fading risks around the twin US hurricanes, US-North Korea provocations losing their market impact and a more hawkish Bank of England helped drive a significant sell-off in global 10-year government yields last week: UK +32bps, US +15bps, Germany +12bps, and NZ +17bps.

The BoE's more hawkish stance of indicating a rate hike over coming months, assuming the data comes in as projected, came as a big shock to the market, given the softer UK economic backdrop. Come November, the odds favour the Bank of England becoming the third major central bank to kick off a tightening cycle, following the US and Bank of Canada.

It's another piece of evidence to suggest that we're at a major inflexion point in central bank policy. The BoJ is tapering its asset purchases to keep its 10-year rate at target and the ECB is widely expected to announce a tapering of its asset purchase programme next month.

This week, the US FOMC is expected to announce the start of its balance sheet reduction programme (known as quantitative tightening), but more interest will lie in the new dot-plot projections of the Fed Funds rate. There will be some downside pressure on the median "dots" with some FOMC members likely to reduce their expectation for rate hikes ahead. But market pricing of the Fed Funds curve is significantly flatter than the Fed's dot-plot and the market is still long US 10-year futures. Thus, the risks are still seen skewed towards higher bond yields, even if the Fed's rate outlook is moderated a touch.

These global forces are spilling over onto the NZ curve. NZ's 2-year swap rate is up to 2.22%, from a low of 2.13% less than two weeks ago. The market is now pricing in the first full rate hike around September 2018, which in practice means a toss-up between the August MPS (BNZ economists' view) and the November MPS. This is understandable. In a world where the major central banks are tightening policy it would be highly unusual for the RBNZ to be standing pat. It's all looking like a repeat of the late-June sell-off in rates, with global central banks in the driving seat.

We don't see local economic data or even the forthcoming general election to have much influence on the market. Thursday's Q2 GDP data is too dated to get excited about and it won't influence the path of policy.

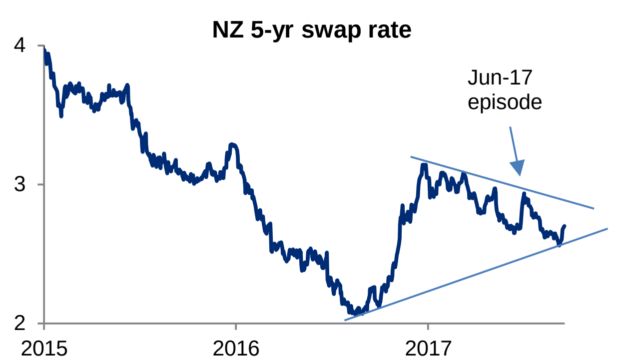
A Labour-led government creates a more uncertain economic outlook, and fiscal policy will be slightly easier versus a National-led government. In an economy near fully employed, that adds to inflation risk at the margin and might bring forward any RBNZ policy tightening, but the devil will be in the details and it's too early to jump to conclusions.

One can point to a larger bond issuance programme under Labour compared to National (about $7b over four years), but Labour's fiscal projections still show modestly growing fiscal surpluses over the years ahead and track not much different to National. About half of that extra borrowing is to restart contributions to the NZ Super Fund. In our view, the NZ bond market could easily absorb that extra issuance without any noticeable impact on pricing.

NZ's long end of the curve remains hostage to global forces. Despite the sell-off, long dated yields still look a bit on the low side relative to economic fundamentals. In the June sell-off episode we saw the 5-year swap rate rise from 2.65% to as high as 2.94%. In the current sell-off, we wouldn't be surprised to see 5-year swap reach the 2.80-2.85% mark.

jason.k.wong@bnz.co.nz

A June-like Sell-off in the Rates Market Underway?



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.94	1.94 - 1.97
NZ 2yr swap (%)	2.22	2.12 - 2.22
NZ 5yr swap (%)	2.71	2.55 - 2.71
NZ 10yr swap (%)	3.22	3.03 - 3.22
2s10s swap curve (bps)	100	89 - 100
NZ 10yr swap-govt (bps)	25	24 - 28
NZ 10yr govt (%)	2.97	2.74 - 2.97
US 10yr govt (%)	2.20	2.01 - 2.22
NZ-US 10yr (bps)	77	66 - 77
NZ-AU 2yr swap (bps)	16	13 - 24
NZ-AU 10yr govt (bps)	19	16 - 22

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD performed well last week, despite the uncertainty about the forthcoming election. It was a reminder that bigger forces are in play and that quite rightly whether fiscal surpluses average 1.1% under National or 1.0% under Labour over the next two years doesn't matter.

Our risk appetite measure reached its highest level this year at 82%, so it's not surprising to see our short term fair value estimate up to the USD 0.76 mark and the NZD was the second best performing major currency last week. NZD strength couldn't match GBP, which has surged after the surprisingly hawkish tone from the Bank of England. This has caught the market off-guard with its heavy short GBP positioning. NZD/GBP fell 2.5% last week to 0.5370 and threatens to head lower as the positioning shake-out continues.

The key focus for the week ahead is the FOMC Statement due early Thursday morning NZ time. The Fed is expected to announce the start of its balance sheet reduction programme, but more interest will lie in the new dot-plot projections of the Fed Funds rate. There will be some downside pressure on the median "dots" with some FOMC members likely to reduce their expectation for rate hikes ahead. Market pricing of the Fed Funds curve is significantly flatter than the Fed's dot-plot, the USD is near a multi-year low and short positioning in the USD remains heavy. In theory, risks are skewed towards a stronger USD, but the reality is that it's a key risk event that could go either way.

In other central bank events this week, the BoJ's meeting on Thursday should pass with little reaction while in Australia Governor Lowe's speech on Thursday on the "Next Chapter" holds more interest than tomorrow's RBA minutes. NZD/AUD is back to the 0.91 mark as the inevitable turnaround in hard commodity prices gets underway, after a significant (somewhat speculative) run higher. A further downward correction in these commodities would support further recovery in the cross rate.

Locally, we expect Thursday's Q2 GDP outturn to show a result better (0.8% q/q) than the last couple of quarters, but not flash in the context of the Lions' tour and its recent mediocre run considering strong population growth. So a fairly neutral impact on the NZD expected overall.

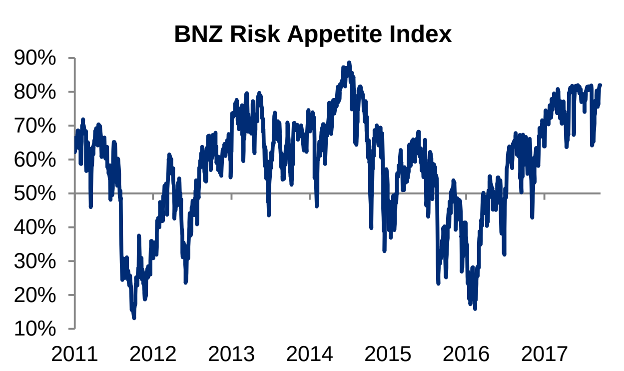
Local attention is expected to be fixated on what is looking to be a very close election contest this Saturday. As our opening paragraph suggested, under most scenarios we don't see any significant implication for the NZD. Our view has been to fade any knee-jerk movements driven by political developments. Judged by recent market movements, the market sees a Labour-led government as negative for the NZD, and sees a National-led government as positive. However, we see this as an overly simplistic market reaction, and the reality is that the NZD will be driven over coming weeks and months by global forces, swamping any domestic political factors.

A Labour-led government creates a more uncertain economic outlook, and fiscal policy will be slightly easier versus a National-led government. In an economy near fully employed, that adds to inflation risk at the margin and might bring forward any RBNZ policy tightening, but the devil will be in the details and it's too early to jump to conclusions. Labour's fiscal projections still show modestly growing fiscal surpluses over the years ahead.

Thus, we certainly don't believe that the NZD will necessarily track lower on a change of government. But some slightly increased market volatility this week and, depending on the outcome, in the weeks ahead as coalition negotiations get underway seems plausible.

jason.k.wong@bnz.co.nz

Risk Appetite At a Fresh High for the Year



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7283	0.7130 - 0.7340
NZD/AUD	0.9106	0.8970 - 0.9150
NZD/GBP	0.5366	0.5340 - 0.5630
NZD/EUR	0.6103	0.5990 - 0.6120
NZD/JPY	80.89	78.10 - 81.10

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7620	-4%
NZD/AUD	0.9100	0%

Technicals

NZD/USD

Outlook: Trading range

ST Resistance: 0.7350 (ahead of 0.7400)
ST Support: 0.7200 (ahead of 0.7140)

We put initial support around 0.72 ahead of the 200-day moving average of 0.7140. A breach of the latter would open up significant downside risk. An area of resistance is building around 0.7350.

NZD/AUD

Outlook: Downside threat

ST Resistance: 0.9150 (ahead of 0.9200)
ST Support: 0.8975 (ahead of 0.8875)

Some consolidation through September is providing a little more clarity on technical levels. Support at 0.8975 has been built, while resistance levels are less secure and are around the 0.9150-0.92 mark. A break to the downside would open up significant downside risk and remains the greater threat at this juncture.

NZ 5-year Swap Rate

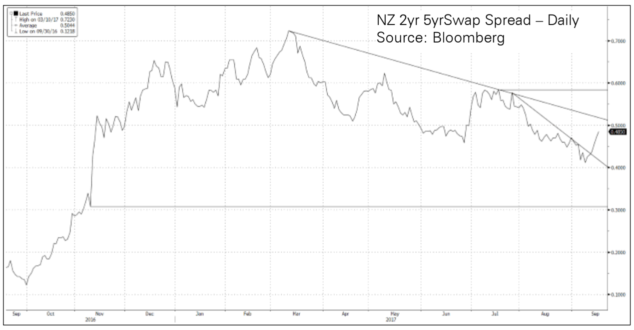
Outlook: Higher
ST Resistance: 2.83
ST Support: 2.61

Break lower didn't reach our target of 2.5%, however move higher has broken trends and signals a move to 2.83.

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

Outlook: Neutral
MT Resistance: +59
MT Support: +31

Curve steeper last week should +52 be breached, we will head to +59.



pete_mason@bnz.co.nz

Key Upcoming Events

	Forecast	Median	Last
Monday 18 September			
NZ, BNZ PSI (Services), August			56.0
China, Property Prices, August			
Euro, CPI, August y/y 2nd est		+1.5%	+1.5%P
UK, Carney Speaks			
US, NAHB Housing Index, September		67	68
Tuesday 19 September			
NZ, WMM Consumer Confidence, Q3			113.4
Aus, House Prices, Q2 y/y		+9.2%	+10.2%
Aus, RBA Minutes, 5 September Meeting			
Germ, ZEW Sentiment, September		+12.0	+10.0
US, Housing Starts, August		1,174k	1,155k
US, Current Account, Q2 s.a.		-$115.0b	-$116.8b
Wednesday 20 September			
NZ, Balance of Payments, Q2	-2.9%	-3.1%	-3.1%
NZ, Dairy Auction, GDT Price Index			-0.3%
Aus, Westpac Leading Index, August			+0.12%
Jpn, Merchandise Trade Balance, August		+¥109b	+¥419b
Germ, PPI, August y/y		+2.5%	+2.3%
UK, Retail Sales vol., August		+0.2%	+0.3%
US, Existing Home Sales, August		5.46m	5.44m

	Forecast	Median	Last
Thursday 21 September			
NZ, External Migration, August s.a.			+5,810
NZ, Credit Card Billings, August			+0.9%
NZ, GDP, Q2	+0.8%	+0.8%	+0.5%
Aus, Lowe Speaks			
Jpn, BOJ Policy Announcement, Policy Rate		-0.1%	-0.1%
Euro, ECB Economic Bulletin			
Euro, Consumer Confidence, Sept 1st est		-1.5	-1.5
US, Leading Indicator, August		+0.2%	+0.3%
US, Philly Fed Index, September		+17.0	+18.9
US, Jobless Claims, week ended 16/09		300k	284k
US, FOMC Policy Announcement,	1.25%	1.25%	1.25%
Friday 22 September			
Euro, PMI/PSI, September 1st est		57.2/54.8	57.454.7
UK, CBI Industrial Trends, September		+13	+13
US, Markit PMI/PSI, September 1st est		53.0/55.8	52.8/56.0
Saturday 23 September			
NZ, General Election			
Sunday 24 September			
NZ, Daylight Saving Begins, +1hr to +13:00GMT			
Germ, Election			

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.84	1.84	1.82	2.19
2mth	1.88	1.88	1.88	2.21
3mth	1.94	1.95	1.95	2.24
6mth	1.99	2.00	2.00	2.25
GOVERNMENT STOCK				
03/19	1.91	1.87	1.90	1.96
04/20	2.05	1.99	2.03	2.03
05/21	2.19	2.11	2.18	2.09
04/23	2.52	2.40	2.46	2.24
04/25	2.79	2.65	2.72	2.44
04/27	2.94	2.79	2.87	2.58
04/33	3.29	3.14	3.24	2.92
04/37	3.52	3.38	3.49	3.20
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	67	68	77	98
Nth America 5Y	56	57	62	75
Europe 5Y	50	52	58	69

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.22	2.16	2.18	2.09
3 years	2.40	2.30	2.34	2.12
4 years	2.56	2.45	2.50	2.18
5 years	2.71	2.58	2.65	2.26
10 years	3.22	3.07	3.15	2.62
FOREIGN EXCHANGE				
NZD/USD	0.7295	0.7254	0.7326	0.7293
NZD/AUD	0.9117	0.9034	0.9228	0.9681
NZD/JPY	81.03	79.35	79.84	74.33
NZD/EUR	0.6107	0.6068	0.6201	0.6526
NZD/GBP	0.5371	0.5510	0.5679	0.5598
NZD/CAD	0.8891	0.8784	0.9201	0.9630
TWI	76.2	75.8	77.2	78.1

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 Market 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
Global Co-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