24 July 2017

RBNZ Will Judge Reserve from Local News

- June's goods trade to test Q2 GDP thoughts
- TWI points to robust economy but lower inflation
- So RBNZ likely to see increased cause for reserve
- High immigration meets strong demand for staff

This week is bereft of meaningful economic data for New Zealand. The only release of any note for financial markets is Wednesday's Overseas Merchandise Trade but these figures would have to be outlandish to have any impact on market pricing.

As it is, we are forecasting a steady-as-you-go outcome for June. The $200m surplus we expect for the month (compared to market expectations of +$100m) would deliver an annual merchandise trade deficit of $3.7b. This, in turn, should hold the overall current account deficit in at around 3.0% of GDP. This proportion poses no threat to New Zealand's credit rating and, at the margin, is NZD positive.

Of more interest to us will thus be the report's trends in exports and imports individually. For goods export values, we are looking for annual growth to strengthen to 12% in June, from 9% in May. This is predicated on the commodity price lifts we've seen, along with improved farming output this calendar year to date. We expect goods imports to slow to 10% y/y, however. This is after a May result (+15%) that was spiked by oil and vehicles.

With the June trade figures logged, Statistics NZ will also publish its June quarter estimates of nominal exports and imports in seasonally adjusted form, as well as quarterly volume estimates for some export components. These will provide a cross-check on our view that net export volume growth will turn decidedly positive in Q2 (after a couple of negative quarters in Q4 and Q1) and that the merchandise terms of trade will strengthen further in the quarter. The terms of trade will likely exceed the early 1970s peak, and thus become the highest since (annual) records on this began, way back in 1861.

This is important context to the recent robustness of the exchange rate.

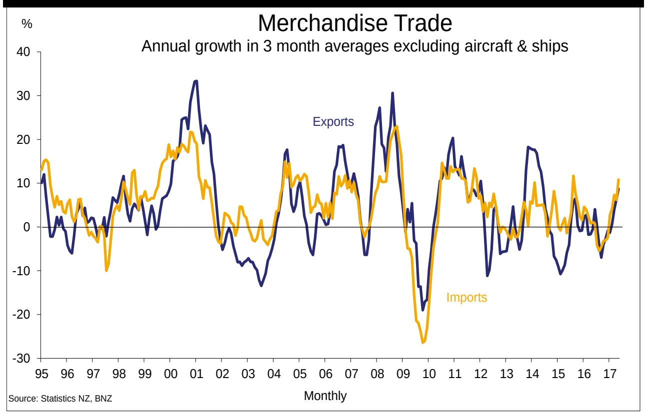
Yet the high (and rising) currency will also be acting as a dampener on CPI inflation. Sure, the trade-weighted index (TWI) is only marginally higher than it was at the time of the late-June OCR review – when the Reserve Bank again refrained from using its earlier language of "higher than is sustainable for balanced growth". Nevertheless, the TWI is more than 4% above the level the Bank assumed for the September quarter, as per its May Monetary Policy Statement (MPS). If it stays up around this level it will thus be a major suppressor to the Bank's CPI inflation forecasts when it does its August MPS.

And this is from a weaker starting point in CPI inflation, with the clear undershoot that we saw for the June quarter. And this was not only in terms of headline inflation, but also the fact that many of the core inflation measures softened in Q2, after strong showings in Q1.

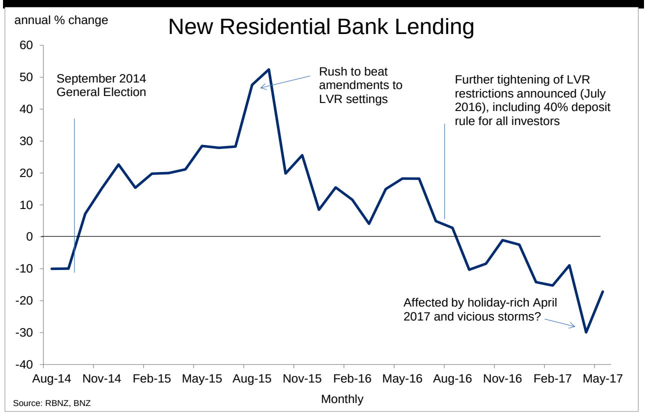
In relation to consumer prices, note that on Thursday Statistics New Zealand releases its June Quarter Household Living-cost Price Index (HLPI). This is a relatively new series which has been generated to "provide new insights into the inflation experienced by 13 different household groups". This index includes mortgage interest rate payments in place of construction of newly built houses. The index is helpful in terms of understanding household budget pressures but does not appear to be monitored particularly closely by the Reserve Bank (in terms of setting monetary policy) or, in turn, financial markets.

As well as slower running CPI inflation, the other factor that

Better Again?



Constricted



will probably be encouraging the RBNZ along its reserved ways is the housing market. While it's difficult to know how much of the recent slowing (and flattening in respect to Auckland's house prices) is owing to election uncertainty, we'll have to wait until after the event to be sure.

Meantime, we'll continue to gauge the extent of slowdown that's occurring in the housing market. Wednesday's new residential lending figures for June will provide further insight. Recall that, for May, lending was down 17.2% on the same month a year ago. This was arguably a cleaner read on the underlying slowdown (and LVR imposts), considering March (-8.9% y/y) and April (-29.9% y/y) were in turns flattered/compromised by holiday timings.

Also on Wednesday we'll get the June quarter working-age population estimate, courtesy of Statistics New Zealand. This, in turn, will reflect the still-high levels of net inward migration, which were still obvious in June figures published last week. This is sustaining very strong expansion in labour supply. While this maintains the risk of indigestion for the labour market, the fact is that high immigration has thus far failed to drive the jobless rate higher. Indeed, it has drifted lower, consistent with firms reporting increased difficulty in finding appropriate staff – as the hunt for employees remains fervent.

But even with such signs that the real economy continues to perform relatively well, the prospect of slowing CPI inflation, aided and abetted by a cooling in the housing market, will only feed the reserved stance that the Reserve Bank reiterated last month. This is something for international punters to take most note of, even though the broader argument for rate hikes remains valid in our view.

craig_ebert@bnz.co.nz

Global Watch

- FOMC expected to pause Wednesday
- RBA's Lowe talks labour market
- Australia's Q2 CPI also in focus

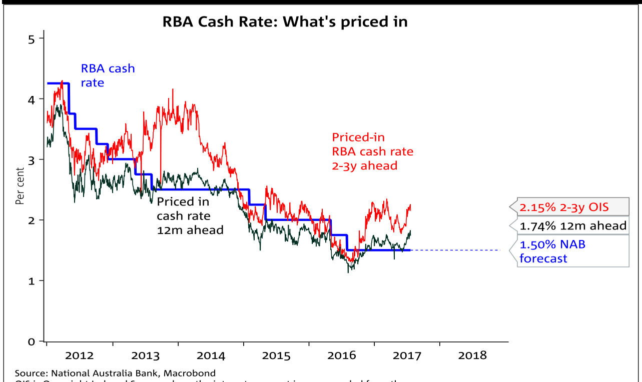
Australia: There will be two main local focus points this coming week and they are both on Wednesday and within 90 minutes of each other. First comes the CPI report for Q2, expected to be close to both last quarter's year-to readings and also within close sight of the RBA's May Statement on Monetary Policy forecasts. Second is a speech from RBA Governor Lowe, speaking Wednesday on "The Labour Market and Monetary Policy" at the NAB-Anika Foundation lunch in Sydney. This is presumably another opportunity to draw out the RBA's assessment of how much slack there is in the labour market and hence the medium-term outlook for policy, wages and inflation.

As for the Q2 inflation report, NAB estimates headline inflation of 0.4%/2.1%, not that different from market expectations, with core inflation expected to print at 0.5%/1.6%, again not only right in line with the consensus but the RBA's May forecast of 1¾%. Holding back headline inflation has been a 2.6% decline in automotive fuel prices, still subdued growth in rental rates (though these are higher than previous quarters which reduces the risk of a downside core surprise), flat to declining Recreation and Culture prices with cuts to audio visual, computing, and domestic holiday travel. Against those drags, Food prices are expected to have risen 0.8% overall, fruit and vegetable prices sharply higher on the back of lower post-Cyclone Debbie supplies.

There is a smattering of other releases due. The pick is merchandise export and import prices for Q2, out Thursday. This provides a good lead on the likely change in the somewhat wider goods and services terms or trade and what prospects are for a modest positive contribution from net export volumes in Q2.

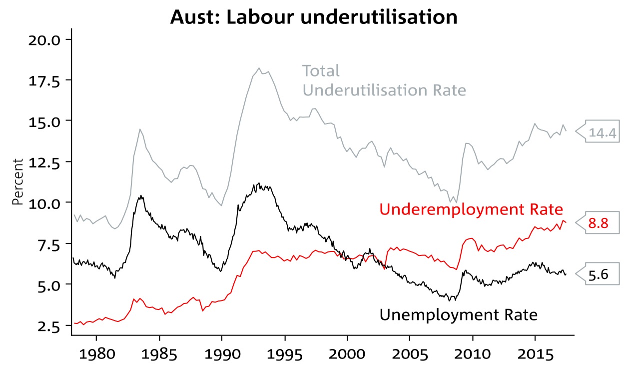
China: It's a quiet week, the official (and Caixin) PMIs coming the week after.

Overcooked



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

Watch (still high) Underemployment



Source: National Australia Bank, Macrobond

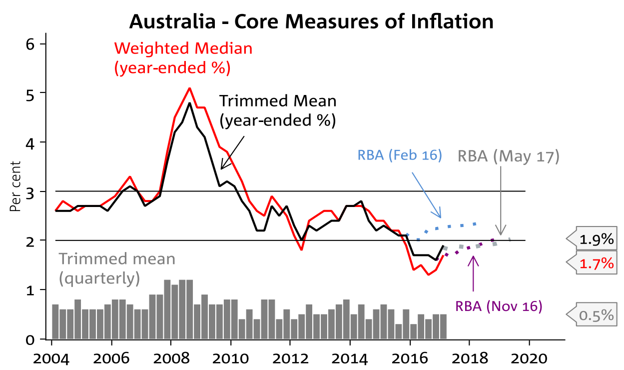
US: The FOMC meets and is odds on to leave rates on hold. The first cut of Q2 GDP (Friday) is expected to reveal 2.5% growth after 1.4% in Q1. (Also keep an eye out for benchmark growth revisions). Also, there's Existing/New Home Sales, Consumer Confidence, Durable Goods Orders and Employment Costs. The Fed's Kashkari speaks (always very thoughtful), Fed Governor nominee Quarles has a Senate confirmation hearing and Donald Trump Jr appears before the Senate (Wednesday).

Japan: It's quiet ahead of the monthly inflation report out Friday. Virtually no change in headline and core inflation is tipped from virtually zero inflation. BoJ Deputy Governor Nakaso speaks in Hiroshima on Wednesday. There may be some interest in Friday's BoJ Summary of Opinions from this week's BoJ meeting when the 2% inflation forecast was pushed out, again.

Eurozone: The preliminary Markit PMIs are due on Monday, again expected to be strong, followed Tuesday with the German Ifo Survey. The various Eurozone confidence indicators, out Wednesday are also tipped to be upbeat. The ECB's Smets (Director General of Economics) speaks on Tuesday on "The ECB's Monetary Policy since 2014", an opportunity to speak on QE, negative rates and the economy.

UK: Wednesday's GDP will take most of the data attention, another quarter of softer growth, 0.3% the consensus, almost a repeat of the low 0.2% print.

Still Lagging



Source: National Australia Bank, ABS, RBA

david.degaris@nab.com.au

Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

Offshore, markets closed last Friday with similar themes prevailing over the course of the week. Bond yields continued to grind lower. US 10-year Treasury yields dropped nearly 10bps over the week, German 10-year Bund yields fell 9bps and UK 10-year Gilt yields lost more than 13bps.

In the US, political headlines continue to dominate. The President's health care effort foundered in the Senate and on Friday, the White House Press Secretary Sean Spicer resigned. It all keeps any hope of the Trump reflation trade at bay and downward pressure on yields. US 10-year Treasuries ended the week yielding 2.24%, a long way down from near 2.40% a couple of weeks ago.

In Europe, a Reuters story gained plenty of focus through the London session on Friday. The story suggested the ECB sees October as the most likely date to decide on the future of the ECB's asset buying program. It saw December, an option flagged by staff, as too late, according to four sources with direct knowledge of the discussion. This week's European data such as preliminary Markit PMIs on Monday, Germany's IFO Survey and various Eurozone confidence indicators are expected to remain upbeat. But it is the ECB's reaction to a run of strong activity data that is of more interest. The ECB's Smets (Director General of Economics) speaks on Tuesday this week on "The ECB's Monetary Policy since 2014", an opportunity to share the central bank's latest thinking on QE, negative rates and the economy.

Lower global rates weighed on local rates across the curve through last week, with a softer NZ Q2 CPI print playing a supporting role. We see the CPI data supporting the recent shift down in the NZ 2-year swap rate to 2.22% from as high as 2.38% a few weeks ago. At the same time, we are wary of a material push higher in the NZ TWI over recent weeks. This is dampening the local inflation outlook. The NZ TWI, at 78.95, currently sits more than 4% above what the RBNZ projected in its most recent (May) MPS. It is one factor that strongly opposes the RBNZ following some other central banks in becoming more hawkish. Indeed, on its own it suggests the exact opposite. It certainly does nothing to suggest that the RBNZ will bring forward its previously signalled late 2019 OCR tightening. The liklihood of a mid-2018 tightening is diminishing. The market currently prices a first full 25 bp hike by August 2018, having nearly fully priced this for May 2018 less than two weeks ago.

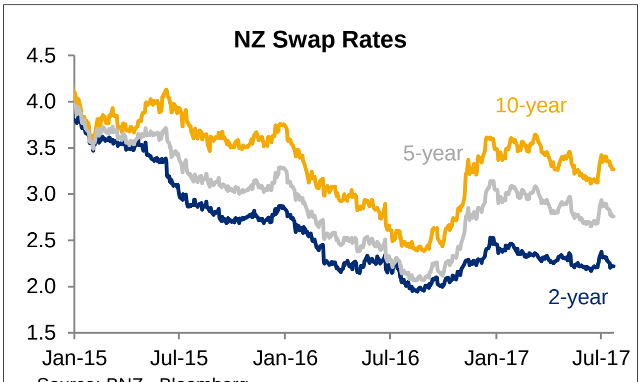
With next to nothing on the local calendar this week to cause a stir, any direction looks likely to stem from elsewhere.

In terms of global risk events, in the US, in addition to political headlines, the FOMC meets Wednesday and is widely expected and priced to keep rates on-hold. Expect comments to suggest balance sheet normalisation is on the way relatively soon – we think the announcement will come in September. Friday sees the first cut of US Q2 GDP – the Atlanta Fed GDPNow model suggests 2.5% (annualised) growth after a dismal 1.4% in Q1. This shouldn't cause too much market reaction given that is also the market consensus.

Wednesday brings Q2 CPI for Australia. Our NAB colleagues expect the CPI to show headline inflation at 2.1% y/y and underlying inflation at 1.7% y/y, so close to market consensus and in line with RBA expectations. If this occurs, it shouldn't ruffle the markets. RBA Governor Lowe's speech may well be the bigger risk factor. The speech could have an upbeat tone given the recent positive run of jobs figures. However, we think a more enduring issue keeping the RBA on-hold for an extended period is the elevated level of underemployment - a key driver of low wage growth. And as the RBA has noted before, the elevated AUD is unhelpful for the economy's adjustment- a view that was reiterated by Deputy Governor Debelle last Friday.

Doug.steel@bnz.co.nz

Rates Pullback



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.94	1.94 - 1.99
NZ 2yr swap (%)	2.22	2.20 - 2.37
NZ 5yr swap (%)	2.76	2.75 - 2.93
NZ 10yr swap (%)	3.27	3.26 - 3.43
2s10s swap curve (bps)	105	103 - 111
NZ 10yr swap-govt (bps)	36	36 - 40
NZ 10yr govt (%)	2.91	2.90 - 3.04
US 10yr govt (%)	2.24	2.22 - 2.39
NZ-US 10yr (bps)	67	61 - 67
NZ-AU 2yr swap (bps)	28	23 - 45
NZ-AU 10yr govt (bps)	25	21 - 37

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ

Last week saw a continuation of broad USD weakness as political headlines continued to dominate in the US. The President's health care effort foundered in the Senate and on Friday, the White House Press Secretary Sean Spicer resigned. It all keeps any hope of the Trump reflation trade at bay and downward pressure on US yields and the US dollar. The DXY US dollar index fell 0.5% on Friday, taking the loss for the week to 1.4%. There looks to be no respite this week with Donald Trump Jr. and son-in-law due to testify before Congress on questions about their contacts with Russia. It all threatens to keep the USD on the back foot.

The FOMC meets this week and is almost certain to leave rates on hold, the only question being whether the Fed decides to firm up guidance on when they expect to commence the process of balance sheet shrinkage, albeit unlikely.

The NZD has benefited from USD weakness, with Finance Minister Joyce's comments last Friday that he is unperturbed by the NZD's strength adding support. Meanwhile, volatility is extremely low with the VIX index making a new post-1993 low of 9.36 last week. High risk appetite has helped propel the NZD through previous resistance at 0.7350 and up to around 0.7450. Last September's high of just under 0.7490 is now in view, as the next area of resistance.

Low volatility and rising risk appetite has pushed our NZD/USD short-term fair value estimate up to 0.7600. Despite a gap between our short term model estimate and actual currency value existing all year, the model has proved insightful to the NZD's punch higher. It remains upbeat. But the NZD is vulnerable to any disappointing news given that speculative long positioning has pushed out to record levels. With next to nothing on the local calendar this week, however, there is nothing to really disappoint so the NZD will likely take direction from offshore.

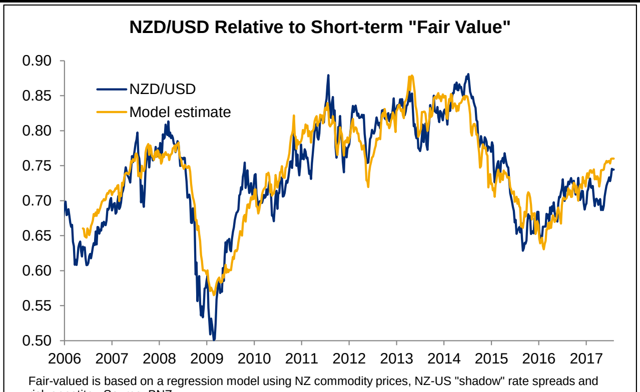
The AUD continued its march higher up just over 1% in the week, despite a 0.6% dip on Friday following comments from the RBA's Deputy Governor Debelle noting a rising AUD is not welcome and a lower exchange rate would be more helpful. AUD/USD closed the week at 0.7916. We wonder how long the containment of strength can last, especially if the USD continues to drift lower. This week Wednesday will be important for the AUD's progress with RBA Governor Lowe's speech in Sydney on 'Labour Market and Monetary Policy' in focus along with AU Q2 CPI data. Our NAB colleagues expect the CPI to show headline inflation at 2.1% y/y and underlying inflation at 1.7% y/y, so close to market consensus and in line with RBA expectations.

NZD/AUD bounced back strongly late last week, following heavy downward pressure over the previous two weeks. Having dipped below 0.9250 around the middle of last week the pair closed at 0.9416. The cross has been oscillating around our short term fair value estimate currently around 0.9300. Our projections show a range-trading environment over the rest of the year, centred about the mid-0.90s.

EUR remains a beneficiary of USD weakness, but is ably assisted by positive economic news and the prospect of the ECB starting discussions on winding back its QE program. EUR/USD gained a further 1.7% last week and opens around 1.1670 this morning. This week's data is likely to continue support for the EUR, starting with Monday's PMI and PSI advance estimates. The ECB's Smets (Director General of Economics) speaks on Tuesday on "The ECB's Monetary Policy since 2014", providing an opportunity to talk on QE, negative rates and the economy. 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.

Doug.steel@bnz.co.nz

NZD/USD Closer to Fair Value



Fair-valued is based on a regression model using NZ commodity prices, NZ-US "shadow" rate spreads and risk appetite. Source: BNZ

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7443	0.7200 - 0.7460
NZD/AUD	0.9416	0.9220 - 0.9620
NZD/GBP	0.5727	0.5560 - 0.5740
NZD/EUR	0.6381	0.6290 - 0.6470
NZD/JPY	82.71	81.70 - 83.30

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7600	-2%
NZD/AUD	0.9290	1%

Technicals

NZ 5-year Swap Rate

Outlook: Neutral
ST Resistance: 2.91
ST Support: 2.71

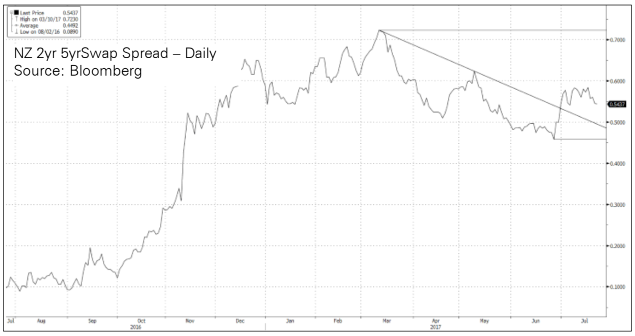
Still no clear trend. Support and resistance are narrowing. I would respect them with a tight stop.

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

pete_mason@bnz.co.nz



Key Upcoming Events

	Forecast	Median	Last
Monday 24 July			
China, Leading Index (Conference Bd), June			+1.3%
Euro, PMI Manufacturing, July 1st est		57.2	57.4
Euro, PMI Services, July 1st est		55.4	55.4
US, Markit PSI, July 1st est		54.0	54.2
US, Existing Home Sales, June		5.57m	5.62m
US, Markit PMI, July 1st est		52.2	52.0
Tuesday 25 July			
Jpn, BOJ Minutes, 15/16 Jun Meeting			
Germ, IFO Index, July		114.9	115.1
UK, CBI Industrial Trends, July		+12	+16
US, Consumer Confidence, July		116.0	118.9
US, Shiller Home Price Index, May y/y		+5.5%	
Wednesday 26 July			
NZ, Merchandise Trade, June	+$200m	+$100m	+$103m
NZ, Residential Lending, June y/y			-17.2%
Aus, Lowe Speaks, Labour Market			
Aus, CPI, Q2	+0.4%	+0.4%	+0.5%
Aus, CPI Weighted Median, Q2	+0.4%	+0.5%	+0.4%
Aus, CPI Trimmed Mean, Q2	+0.5%	+0.5%	+0.5%
UK, GDP, Q2 1st est		+0.3%	+0.2%
US, New Home Sales, June		615k	610k

	Forecast	Median	Last
Wednesday 26 July cont'd…			
US, FOMC Policy Announcement, Upper 1.25%		1.25%	1.25%
Thursday 27 July			
Aus, Terms of Trade, Q2			+8.2%
China, Industrial Profits, June y/y			+16.7%
Euro, M3, June y/y		+5.0%	+5.0%
UK, CBI Distribution Reported Sales, July		+15	+17
US, Wholesale Inventories, June 1st est		+0.3%	+0.4%
US, Chicago Fed Nat Activity Index, June		+0.35	-0.26
US, International Goods Trade, June advance		-$65.0b	-$66.3b
US, Durables Orders, June 1st est		+3.5%	-0.8%
Friday 28 July			
Aus, Producer Prices, Q2 y/y			+1.3%
Jpn, Household Spending, June y/y (real)		+0.5%	-0.1%
Jpn, BOJ Summary of Latest Meeting, 19/20 July Meeting			
Jpn, CPI, June y/y		+0.4%	+0.4%
Jpn, Unemployment Rate, June		3.0%	3.1%
Euro, Economic Confidence, July		110.8	111.1
Germ, CPI, July y/y 1st est		+1.5%	+1.6%
US, Employment Cost Index, Q2		+0.6%	+0.8%
US, GDP, Q2 1st est		+2.5%	+1.4%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.81	1.81	1.84	2.31
2mth	1.87	1.89	1.89	2.34
3mth	1.93	1.96	1.93	2.38
6mth	1.98	2.00	1.98	2.37
GOVERNMENT STOCK				
12/17	1.79	1.81	1.81	1.98
03/19	1.92	1.96	1.94	1.99
04/20	2.11	2.19	2.10	2.00
05/21	2.26	2.34	2.19	2.05
04/23	2.56	2.62	2.46	2.09
04/25	2.77	2.83	2.67	2.23
04/27	2.91	2.94	2.77	2.34
04/33	3.25	3.28	3.08	2.65
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	78.25	81	83	112
N. AMERICA 5Y	56.95	58	62	72
EUROPE 5Y	51.75	54	57	71
SWAP RATES				
2 years	2.22	2.25	2.20	2.16
3 years	2.42	2.47	2.38	2.17
5 years	2.76	2.82	2.68	2.26
10 years	3.26	3.34	3.15	2.58

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7441	0.7316	0.7255	0.7074
NZD/AUD	0.9407	0.9387	0.9518	0.9332
NZD/JPY	82.52	82.65	80.45	74.64
NZD/EUR	0.6376	0.6405	0.6476	0.6396
NZD/GBP	0.5720	0.5607	0.5680	0.5342
NZD/CAD	0.9335	0.9295	0.9585	0.9165
TWI	78.87	78.35	78.19	75.65

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