24 October 2017

Similar Growth, More Inflation?

- **Awaiting the full policies of the new government**
- **Net growth impacts moot but reinforcing for inflation**
- **Suggesting RBNZ can't/won't be more relaxed**
- **Immigration already abating**
- **Merchandise trade the main NZ data this week**

Now that we know the shape of the next NZ government we await the full policy prescriptions that stem from it. From "the partials" we've seen and heard to date, the net implications for GDP growth are open for debate (including around the details of what will effectively replace the 1 April "tax cuts" that are to be cancelled). But the indicated new policies do look likely to reinforce the upside we expect around inflation.

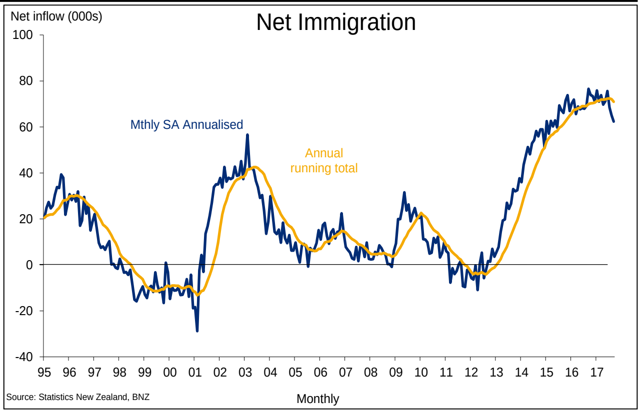
For this reason, we wouldn't be quick to assume, as some in the market appear to be doing, that the new government's policies, including on the monetary framework, will only encourage a relaxed attitude from the Reserve Bank. The lower than anticipated exchange rate is already relevant to this debate, and will be worth keeping tabs on over the coming weeks and months.

Ahead of the (imminent?) release of the government's full coalition agreement, the Labour party's 100-day plan serves as a useful touch point. Of all the things it lists, it doesn't say anything about prospective changes to the Reserve Bank's Policy Targets Agreement or the Reserve Bank Act itself. Changes will happen but, perhaps, not with urgency, and, we suspect, not obvious cause for the RBNZ to set policy much, if any, differently than it would have otherwise? Any changes to the RBNZ framework will, of course, need to work in with the impending personnel changes at the Bank, including a new Governor coming in next March.

Nor is Labour's 100-day plan specific about immigration policy. However, the understanding is that the new government will commit to a reduction in net numbers not as low as the NZ First party alone had been talking about. But as the new rules are being sorted out in this area we note that the net migrant inflow is already abating. It decreased over the course of July, August and September – on a seasonally adjusted monthly basis - although remains relatively high in the grand scheme of things.

Another point in the 100-day plan is to "Ban overseas speculators from buying existing houses". However, we are left wondering how "speculators" will be defined and what restrictions on overseas buyers will be confirmed around other types of NZ property.

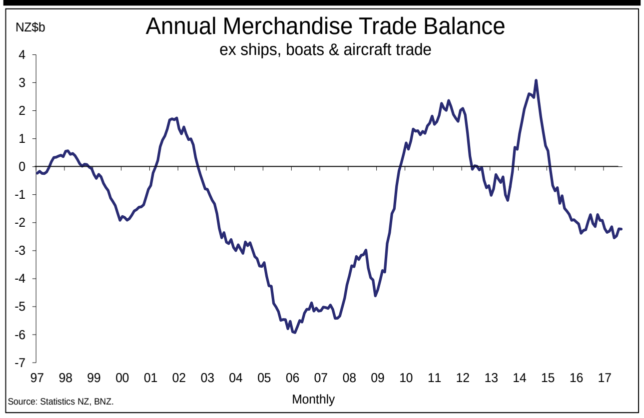
Abating Already



As we await the new government's full policy prescriptions, there is not too much in the way of local economic data this week to distract us. Thursday's merchandise trade for September is the most of it. Bear in mind the trade balance is seasonally weak at this time of the year. So the monthly deficit of $1,360m we anticipate will simply hold the 12-month running deficit at around $3.2b, no worse. This is based on September's goods exports being 12% up on a year ago and imports 8% higher. In this we are in line with the market on exports but higher on imports (the market expects a lesser deficit, of $900m, for September).

As part of this monthly trade report Statistics NZ will also be publishing the September-quarter trade summaries.

Steadying



For these we expect nominal exports to infer a small correction in Q3 volumes and in the case of imports a moderate rise in real terms.

August's new residential lending by local banks was down 16.4% on a year ago. Yet it wasn't as negative as July's (-23.8%) or June's (-25.1%). In this there were signs that the worst of the (LVR-driven?) slowdown in residential lending might well be passing. For September, however, there was the added headwind of the general election taking place. Those results are due Thursday afternoon. Bumpy as such housing market data have been, they will be important to monitor over the coming months, as the market reveals its response to the new government, and its policies. The housing market could yet turn to being a key deflationary force, to offset the more inflationary ones we envisage for the macro-economy more generally.

That's about the limit of the meaningful data on offer in the coming week. However, for those with a keen interest, there are also the;

- Q2 2017 population figures (published this morning), to highlight the role of immigration;

- Q3 2017 working-age population statistics, due tomorrow. These will be relevant to our expectations for the September quarter Household Labour Force Survey, as is due 1 November; and

- New Household Living-costs Price Indexes for Q3 (due Friday) – not to be confused with the CPI.

craig_ebert@bnz.co.nz

Global Watch

- **US Q3 GDP in focus Friday**
- **Australian Q3 CPI tomorrow**
- **ECB meeting Thursday to outline tapering**

Australia

CPI on Wednesday is the main domestic focus. We may be able to see what the RBA thinks of it by the next day with the RBA Deputy Governor giving a speech on Thursday evening (6.45pm AEDT) on "Uncertainty". Outside of this there are plenty of second-tier data including Trade Prices on Thursday and the PPI on Friday.

As for the CPI, hefty increases in electricity and gas prices are expected to lift headline CPI by 0.8% q/q and 2.0% y/y. This is also the market consensus. Acting as some offset is a fall in petrol prices and a decline in vegetable prices – a mild winter and early spring has led to bumper crops for tomatoes, broccoli, beans and zucchinis. There may be slight downside risks to the consensus and our forecasts if vegetable prices fall as far as indicated by wholesale prices; wholesale vegetable prices fell some 16% in Q3 which we have moderated to a 4% decline in the CPI.

Core inflation in contrast is expected to remain stable, with Trimmed Mean at 0.5% q/q and 2.0% y/y. The Weighted Median is likely a touch softer at 0.4% q/q and 1.9% y/y. While we do not expect a lift in the rate of core inflation, the important point is that inflation looks to have

Table 1: Consumer Price Index, Component Forecasts

		Sep-16	Dec-16	Mar-17	Jun-17	Expectations NAB Sep-17
Headline CPI						
CPI - NSA	Index	109	110	111	111	111.6
	%q/q	0.7	0.5	0.5	0.2	0.8
	%y/y	1.3	1.5	2.1	1.9	2.0
Core Measures						
Trimmed Mean		111	111	112	112	112.8
	%q/q	0.4	0.5	0.5	0.5	0.5
	%y/y	1.7	1.6	1.8	1.8	2.0
Weighted median		110	111	111	112	112.5
	%q/q	0.3	0.4	0.5	0.5	0.4
	%y/y	1.2	1.3	1.7	1.8	1.9

Source: National Australia Bank, ABS

Chart 1: CPI the main focus; headline likely higher

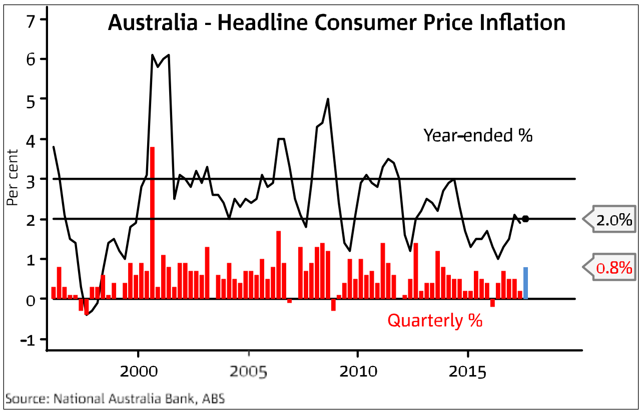


Table 2: Consumer Price Index - Component Expectations

	Actual Sep-16	Jun-17	Expectations NAB Sep-17	NAB Qtr contrib	Weight in CPI Basket
Food and non-alcoholic beverages	1.7	-0.2	-0.3	-0.1	16.8
Fruit	*19.5*	*-4.4*	*-0.4*	*0.0*	*1.6*
Vegetable	*5.9*	*0.3*	*-4.2*	*-0.1*	*1.3*
Alcohol and tobacco	1.1	0.8	1.1	0.1	7.1
Clothing and footwear	0.3	-0.3	-0.5	0.0	4.0
Housing	1.0	0.3	2.5	0.6	22.3
Rents	*0.3*	*0.2*	*0.2*	*0.0*	*6.7*
New dwellings	*0.4*	*0.9*	*0.8*	*0.1*	*8.7*
Water and sewerage	*-1.8*	*0.0*	*2.2*	*0.0*	*0.9*
Electricity	*5.4*	*-0.2*	*16.5*	*0.3*	*2.0*
Furnishings, household equipment and services	1.1	0.7	0.4	0.0	9.1
Health	-0.2	2.7	0.0	0.0	5.3
Transport	-0.5	-0.6	-0.3	0.0	11.6
Automotive fuel	*-2.9*	*-2.5*	*-2.1*	*-0.1*	*3.6*
Communication	-2.3	-0.5	-2.2	-0.1	3.1
Recreation and culture	0.6	-0.6	0.8	0.1	12.6
Audio, visual and computing equipment	*-1.8*	*-0.8*	*-1.4*	*0.0*	*1.6*
Domestic holiday travel and accommodation	*0.3*	*-3.2*	*1.0*	*0.0*	*2.5*
International holiday travel and accommodation	*1.9*	*0.9*	*3.0*	*0.1*	*2.3*
Education	0.2	0.0	0.2	0.0	3.2
Insurance and financial services	0.9	-0.1	0.7	0.0	5.1
Headline CPI	**0.7**	**0.2**	**0.8**	**0.8**	--
Trimmed Mean	0.4	0.5	0.5	--	70
Weighted Median	0.3	0.5	0.4	--	--

bottomed as the steady core figures over the past three quarters suggest. If so, inflation should then gradually lift as the labour market tightens. For further details, please see attached NAB's full preview note which was released earlier today.

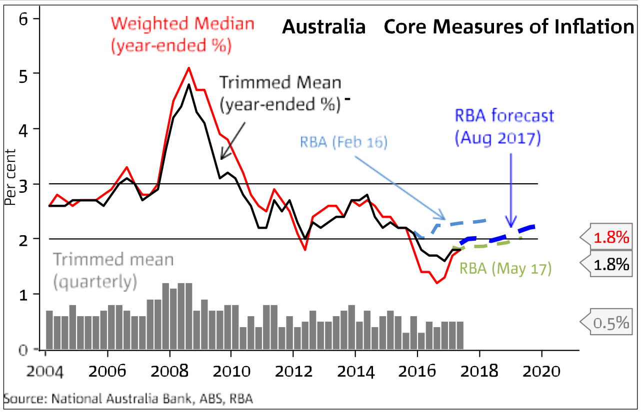
China

The 19th Party Congress continues until Tuesday where the meeting then wraps up with the appointment of Central Committee members. There is little in the way of data with only Industrial Profits Friday.

US

Q3 GDP on Friday is the main focus with the market looking for a 2.5% outcome, down from last quarter's 3.1%. The Atlanta Fed GDP Now is similar and expects a 2.7% outcome. Before then we get Durable and Capital Goods on Wednesday. There is also plenty of second tier data including the Markit PMIs on Tuesday and Jobless Claims on Thursday. Fed talk meanwhile recedes ahead of the FOMC meeting the following week. Speculation on the next Fed chair is also likely to continue, though press reports suggests Powell is now the clear front runner – he is seen as willing to accommodate some of Trump's financial deregulation agenda, while being slightly more hawkish than Yellen.

Chart 2: Core measures still subdued, but stable now



Japan
With Japan's election over the weekend delivering a clear-cut result for Shinzo Abe, data wise, the main touch points are the Nikkei PMI on Tuesday and then the CPI on Friday. For the CPI, the market looks for a similar pace of growth in September to last month at 0.7% y/y. The Tokyo measure for October is expected to be softer at 0.1% y/y from 0.5%, core though is expected to remain at 0.5%.

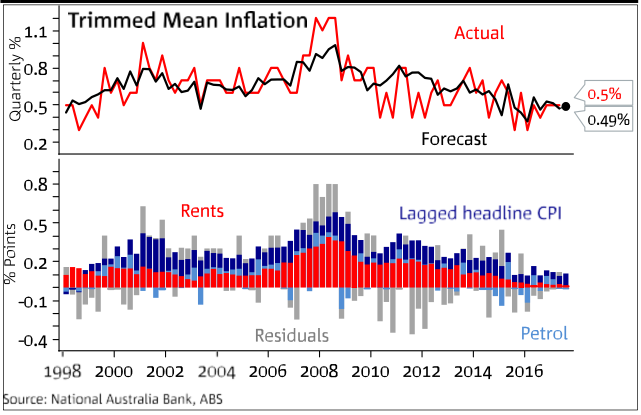
Eurozone
The ECB meeting is the clear focal point with the market expecting a tapering announcement of the asset purchase program which would begin in January. While the amount is unknown, a recent poll suggests the program could fall from the current level of €60bn a month to as low as €20bn a month. Datawise, the Markit PMIs will capture the most attention on Tuesday, while the German IFO is on Wednesday — expect still solid reads.

UK
Wednesday's Q3 GDP figures will capture the most attention with the market looking for a still subdued 1.5% y/y pace of growth. Outside of this it is very quiet.

Canada
The Bank of Canada meets Wednesday and while they are expected to be on hold, the market looks for a rate hike in the following months — 53% priced by December and 100% priced by January.

tapas.strickland@nab.com.au

Chart 3: Models suggest stable core inflation



Source: National Australia Bank, ABS

Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

Inflation will be higher but the RBNZ will be more tolerant of this and delay any possible tightening because of forthcoming changes to the RBNZ Act. That's the implied market reaction to the formation of a new government and that assessment is probably wrong.

We don't see changes to the RBNZ Act – a new committee structure, possible outside members deciding on rates and including employment as an objective – as materially changing the RBNZ's reaction function to higher inflationary pressure. The RBNZ fully understands its limits as to what it can and can't achieve and what its focus should be on. It'll be hard to knock price stability from its number one goal. To be sure, it can have regard to employment and the exchange rate, as it currently does, but the interest rate lever is best used to achieve its inflation goal.

Since the formation of government, we've seen a steeper yield curve, with downside pressure to short rates, including a pushing out of RBNZ rate hike expectations to February 2019 (for the first full hike), and upside pressure to longer-dated yields, albeit global factors have played some role in the latter. Yields on inflation-indexed bonds have fallen, implying higher break-even inflation rates.

The new Labour-led government's policies add to inflationary pressure, which the market recognises. A greater-than-otherwise increase in the minimum wage, easier fiscal policy and increasing costs to doing business are all in the mix.

What is more uncertain at this juncture is how the policies impact on economic growth. Lower short rates would suggest that the market sees the economy hitting a pothole, perhaps as business confidence slumps and the housing market takes a more significant lurch down. That might well be the case, but it is a little early in the process to jump to conclusions. At the time of writing we were awaiting the release of the coalition agreement which should provide further detail on the policy concessions made.

What we can be more certain of is that uncertainty about the economic outlook has increased, which might well create a more volatile trading environment. But at face value the fall in 2-year swap rates to 2.17% and the pushing out of rate hike expectations look a little misplaced. That only seems valid if the economy is about to hit a major speed-bump. We'd note that the global economic backdrop remains highly supportive and a weaker NZD post-election will also support the economy. We'd be alert to paying 2-year swap on any further reduction. It also seems like an opportune time for corporate Treasurers to consider paying 5-10- year swap rates to mitigate the medium-term risk of higher long-term interest rates.

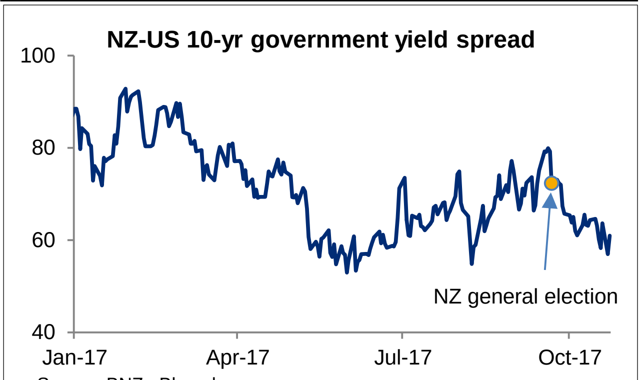
A risk we see ahead is an increase in the key NZ-US 10-year bond spread, which is still trading near the lower end of the recent range, around 61bps as we write. More bond issuance, higher inflation and an increased risk premium suggest that the spread should widen. It seems that narrower short-end spreads (pushing out of RBNZ rate hikes, Fed still on track for a December hike) might be holding that back for now, but over coming months we'd see the path of least resistance being an increased NZ-US 10-year spread, with initial resistance around 80bps.

In terms of the week ahead, we'll be focused on the publication of the coalition agreement due soon and any policy announcements that will be drip-fed this week. Local data, not that much is due this week anyway, will take a backseat.

Australian rates will be sensitive to any upside or downside surprise to tomorrow's CPI release, which could spill over into the local market. But the highlight on the global calendar this week will be the ECB's tapering announcement, due late in the week. The end-point of the asset purchase programme matters for the timing of the ECB's first rate hike, which will come later.

jason.k.wong@bnz.co.nz

NZ-Global 10-year Spread Too Narrow?



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.94	1.92 - 1.95
NZ 2yr swap (%)	2.17	2.16 - 2.22
NZ 5yr swap (%)	2.68	2.68 - 2.76
NZ 10yr swap (%)	3.21	3.17 - 3.28
2s10s swap curve (bps)	104	98 - 106
NZ 10yr swap-govt (bps)	23	23 - 30
NZ 10yr govt (%)	2.98	2.89 - 3.02
US 10yr govt (%)	2.37	2.27 - 2.40
NZ-US 10yr (bps)	61	57 - 66
NZ-AU 2yr swap (bps)	17	15 - 24
NZ-AU 10yr govt (bps)	20	14 - 20

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD came under pressure with the formation of a Labour-led government with much of the damage coming within the first 12 hours. Since then, the currency has shown signs of basing out, down about 2-2½% on the key crosses.

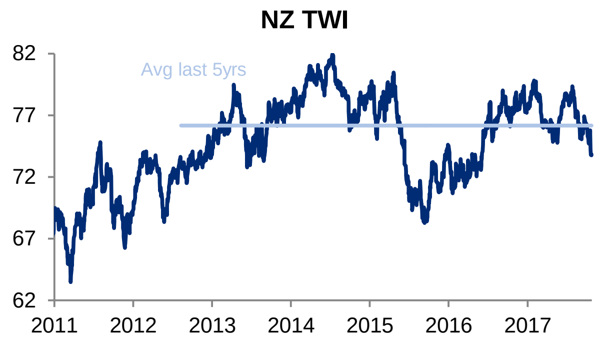
That fall is a little bit more than we expected, given the NZD's underperformance in the lead-up to the coalition announcement, suggesting that the eventual outcome was half-expected. So we wouldn't be surprised to see a mild bounce-back, but we are still awaiting details on the coalition agreement, which will shed some light on policy details.

Certainly, there deserves to be some "sticker-shock" to the result. NZ First leader Winston Peters attempted to talk down the economy in his coalition announcement speech and talked of winding back capitalism. You can imagine how bad this sounds to an investor sitting in their office in New York or London. But for all the talk of a major change in economic direction even by PM-elect Ardern, in reality we are only likely to see a subtle shift in direction, certainly nothing like the changes we saw in the mid-late 1980s.

It is easy to become hysterical about what lies ahead, but a lot of the policy agenda doesn't have material implications for the NZD. A glance at Labour's priorities for the first 100 days in government doesn't raise any red flags for the currency market. Domestic policy and economic uncertainty over coming months will do the NZD no favours but we'd see global forces back in charge soon. In the meanwhile, be prepared for some increased volatility in the NZD over the very short-term, providing some trading opportunities.

In the coming week there is a dearth of local economic data and in any case there is more interest in government policy details that will be released during the course of the week.

NZ TWI Now Trading Below its 5-yr Average



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6969	0.6930 - 0.7210
NZD/AUD	0.8927	0.8880 - 0.9170
NZD/GBP	0.5280	0.5260 - 0.5450
NZD/EUR	0.5932	0.5900 - 0.6120
NZD/JPY	79.06	78.80 - 81.10

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7310	-5%
NZD/AUD	0.9130	-2%

In Australia, CPI data tomorrow is the focus, with headline inflation expected to be driven up by gas charges, but core inflation expected to continue to show rates near the bottom of the target range. The AUD is likely to be sensitive to both upside and downside surprises, with the market on tenterhooks wondering how soon the RBA will move to a tightening bias.

The highlight on the calendar this week is the ECB's policy decision due in the early hours of Friday morning (NZ time). A tapering of the asset purchase programme is widely expected to be announced – the choice between a jump down from €60bn per month to €20bn from January and the programme extended perhaps to the end of 2018, or a more gradual taper, but earlier end to the programme. With rates not to be increased until well after the end of the programme, the EUR will be sensitive to the end-point of the programme. We remain positive on the year-ahead outlook for EUR, but with significant long speculative positions at present, there is skewed risk to the downside if the message is more dovish than expected.

For the USD, we've seen the market sensitive to whom the next Fed chair will be, and an announcement is expected to come this week. The odds favour Powell, who is already on the Board of Governors, and under that scenario the currency reaction would be limited. GDP data at the end of the week are expected to show an economy growing a little above trend, supportive of further Fed tightening.

jason.k.wong@bnz.co.nz

Technicals

NZD/USD

Outlook: Down
ST Resistance: 0.7200 (ahead of 0.7350)
ST Support: 0.6830 (ahead of 0.6670)

The NZD has broken through long-term trend support which opens up further downside potential, with initial support around the 0.6830-0.6860 mark. After the recent sharp fall, resistance levels are well north of spot, beginning from 0.72.

NZD/AUD

Outlook: Down
ST Resistance: 0.9170 (ahead of 0.9230)
ST Support: 0.8875 (ahead of 0.8825)

After the sharp fall, some key support levels are in play, with the 0.8825-0.8875 mark a crucial level. Resistance is well north of spot.

jason.k.wong@bnz.co.nz

NZ 5-year Swap Rate

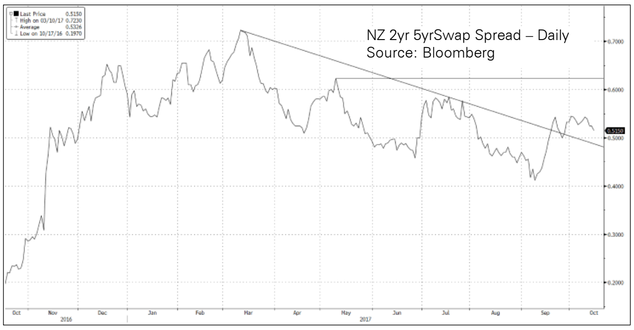
Outlook: Neutral
ST Resistance: 2.83
ST Support: 2.61

Range remains intact. We continue to await a break to initiate a new position.

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

Outlook: Steeper
ST Resistance: +62
ST Support: +48.5

Trendline breached, so expect a move to +62.



pete_mason@bnz.co.nz

Key Upcoming Events

	Forecast	Median	Last
Tuesday 24 October			
China, Leading Index (Conference Board), Sept			
Euro, PMI Manufacturing, Oct. 1st est		57.8	58.1
Euro, PMI Services, Oct 1st est		55.6	55.8
US, Markit PSI, Oct 1st est		55.2	55.3
US, Markit PMI, Oct 1st est		53.5	53.1
Wednesday 25 October			
NZ, Working-age Population, Q3			3.8030m
Aus, CPI Weighted Median, Q3	+0.4%	+0.5%	+0.5%
Aus, CPI Trimmed Mean, Q3	+0.5%	+0.5%	+0.5%
Aus, CPI, Q3	+0.8%	+0.8%	+0.2%
Germ, IFO Index, October		115.1	115.2
UK, GDP, Q3 1st est		+0.3%	+0.3%
US, New Home Sales, September		555k	560k
US, Durables Orders, Sept. 1st est		+1.0%	+2.0%
Can, BOC Policy Announcement			1.00%
Thursday 26 October			
NZ, Business Demography Statistics, As at February 2017			
NZ, Residential Lending, September y/y			-16.4%
NZ, Merchandise Trade, Sept	-$1,360m	-$900m	-$1,235m
Aus, Terms of Trade, Q3		-2.5%	-5.7%

	Forecast	Median	Last
Thursday 26 October cont'd			
Aus, RBA's Debelle Speaks			
Euro, M3, September y/y		+5.0%	+5.0%
Euro, ECB Policy Announcement, Refi	0.00%	0.00%	0.00%
UK, CBI Distribution Reported Sales, October			+44
US, Wholesale Inventories, Sept. 1st est		+0.4%	+0.9%
US, Jobless Claims, week ended 21/10		235k	222k
US, International Goods Trade, Sept advance		-$64.0b	-$63.3b
US, Pending Home Sales, September		+0.4%	-2.6%
Friday 27 October			
Aus, Producer Prices, Q3 y/y			+1.7%
China, Industrial Profits, September y/y			+24.0%
Jpn, CPI, September y/y		+0.7%	+0.7%
US, Mich Cons Confidence, October 2nd est		100.7	101.5P
US, GDP, Q3 1st est		+2.5%	+3.1%
Monday 30 October			
Jpn, Retail Sales, September y/y			+1.7%
Euro, Economic Confidence, October			113.0
Euro, Consumer Confidence, Oct 2nd est			-1.0P
Germ, CPI, Oct y/y1st est			+1.8%
US, Personal Spending, September		+0.8%	+0.1%

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.80	1.81	1.83	2.13
2mth	1.87	1.87	1.89	2.13
3mth	1.94	1.93	1.96	2.14
6mth	1.98	1.98	1.98	2.11
GOVERNMENT STOCK				
03/19	1.89	1.91	1.92	1.94
04/20	2.04	2.06	2.10	2.02
05/21	2.19	2.22	2.25	2.08
04/23	2.49	2.51	2.55	2.27
04/25	2.78	2.78	2.81	2.46
04/27	2.96	2.94	2.95	2.59
04/33	3.30	3.28	3.29	2.92
04/37	3.50	3.49	3.50	3.18
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	65	68	73	102
Nth America 5Y	53	54	59	75
Europe 5Y	54	55	58	72

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.17	2.20	2.19	2.10
3 years	2.35	2.38	2.37	2.17
4 years	2.52	2.55	2.54	2.24
5 years	2.68	2.70	2.69	2.33
10 years	3.21	3.20	3.18	2.72
FOREIGN EXCHANGE				
NZD/USD	0.6975	0.7171	0.7208	0.7163
NZD/AUD	0.8931	0.9141	0.9139	0.9370
NZD/JPY	79.14	80.46	80.91	74.66
NZD/EUR	0.5936	0.6094	0.6111	0.6579
NZD/GBP	0.5283	0.5436	0.5354	0.5879
NZD/CAD	0.8819	0.8980	0.8900	0.9565
TWI	73.9	75.8	76.0	77.1

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 Markets 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
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