25 September 2017

Politics Won't Derail the Expansion

- Election over but we're none-the wiser
- NZ First in the box seat
- But don't discount the priorities of the Labour and National leadership
- Labour Government would, relatively, put modest upward pressure on rates
- RBNZ on hold

Saturday's General Election outcome has little impact for financial markets mainly because we still don't know who the Government is. That said, a Labour-Greens Government has been all but ruled out and that was the outcome most likely to cause market volatility.

As we had intimated going into the election, New Zealand First holds the balance of power and will decide, in due course, which way it will lean. It is true that 15% of the total vote still hasn't been counted. And it is expected that these "special" votes will tend to favour Labour and the Greens. But, whatever happens, NZ First will still decide what's what.

The final result will be delivered on October 7. We don't expect any decision on coalition building before then but do expect a decision within a week of the final outcome.

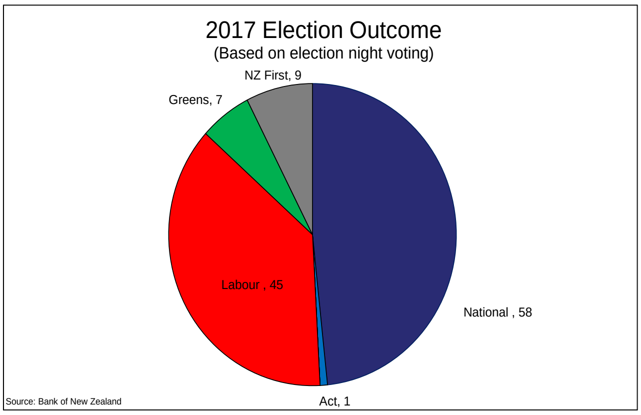
We maintain our view that it is more likely that Winston Peters will align New Zealand First with National but this is a line ball call. Importantly, while Peters ultimately makes the call, all the balls are not in his court. It is equally important to ponder the risks and benefits to National and Labour of any arrangement. For example, the chances of the electorate voting in the same Government for five consecutive terms is very small indeed so, from Jacinda Ardern's perspective, it might be better to sit on the sidelines and build a very strong opposition, targeting a 2020 victory, rather than try to manage a three headed coalition which would inevitably necessitate compromises that a new leader might not want to make. Ardern is young, has plenty of time on her side, hasn't had much time to develop her leadership potential and might like to go into an election with her own policy agenda rather than one she has inherited. Similarly, Bill English is far from ancient. He might also think that three years in a very strong opposition, facing into a potentially fragmented Government, might be a better option?

We are not advocating for any particular course of action but what we are saying is that it is inappropriate to view this process solely through the eyes of New Zealand First.

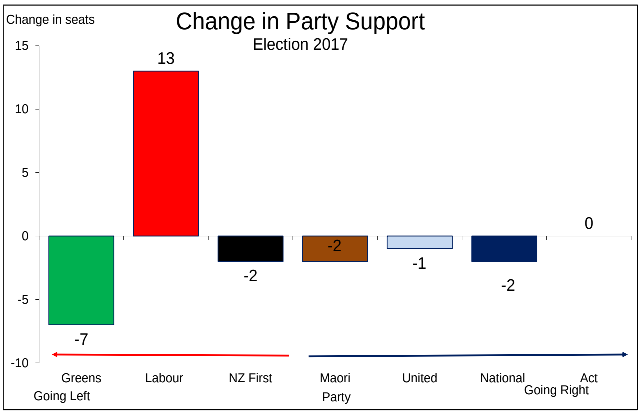
If New Zealand First does end up with Labour then it is likely to veto some of the policies that businesses are concerned about. In particular:
- NZ First might be happy to charge bottlers for their water but would not support charging the agriculture sector for its use;
- New Zealand First advocates an even greater increase in minimum wages than does Labour but is unlikely to support Labour's wider workforce policies;
- NZ First will not support Labour's tighter environmental regulation;
- It will not support Labour's defense force capex reduction plans;
- Nonetheless, National's tax cuts will still be off the cards so retailers may not get the boost currently built into our forecasts.

However, generally, there would be agreement on:
- Reduction in net migration;
- Increased fiscal expenditure;
- Increased benefit payments for over 65s;

Election night outcome



Change in Party Support



- Ending private provision of services; and the
- Targeting of tax avoidance by multinationals.

In our opinion, any Government led by Labour means:
- Government debt will be higher. Labour has already said that its policies would, compared to PREFU, add $7.0 billion to Government debt over the next four years. We believe that you will eventually look at a number higher than this;
- Inflationary pressures will be higher due to increased wage costs and higher fiscal spending;
- The combination of higher debt and higher inflation means that interest rates would be, at the margin, higher than would otherwise be the case;
- The outlook for the NZD is unclear. It would be bolstered by higher interest rates but concerns over increased Government debt and, generally, heightened policy uncertainty could see it go the other way.

Any Labour-led Government will also result in a change in the Policy Targets Agreement such that the Reserve Bank will be asked to adopt a dual objective of both inflation and employment. It is also likely that future monetary policy decisions would be made by a committee comprising both RBNZ staff and outsiders. In the end, we doubt that any decisions made would be any different to those currently made especially given that any such committee would be RBNZ-dominated.

If, on the other hand, you end up with a National-NZ First Government, we doubt that a lot would change. National would have to make some concessions, however. In particular:
- We think National could adopt stricter rules on net migration and the overseas ownership of property;
- Reversing its decision to raise the age of superannuation entitlement to 67 would be a relatively costless giveaway;
- Increasing benefits for the retired would be an easy compromise too;
- As would increased spending on regional development.

It is unlikely that National would substantively change the Policy Targets Agreement but it might agree to throw in some extra (relatively meaningless) words about the currency and adopt a committee decision making process – albeit a committee full of RBNZ folk.

Note that while we think a Labour-led Government would be more inflationary, we still believe a National-led Government would add to current inflationary pressures via fiscal easing. It's just that such easing is, largely, already incorporated into our forecasts.

All this is very interesting but, perhaps most importantly, we think that there is sufficient momentum in the economy currently to ensure that New Zealand continues to experience solid growth for the next three years even if politicians, of all colours, try to mess things up.

Oh, and by the way, the RBNZ delivers its September OCR review on Thursday morning. The chances of there being any change in tack with this release are very low indeed. With a new acting Governor in place, policy uncertainties in abundance, and nothing much changed since the MPS, it would be a real surprise if there was any hint of a change. If there is, it would have to be to the more hawkish side with the NZD lower than expected, the world outlook improving, commodity prices robust, fiscal policy easing and inflation forecasts likely to be revised higher (albeit that they won't be published). The market has already priced in a full hike by September 2018 – more than a year in advance of the RBNZ – but any suggestion of a hawkish tilt would still likely see fixed interest markets sell off and the NZD rally. The RBNZ will do its best to avoid this even if its sentiment is shifting.

Tomorrow sees the release of ANZ's latest business confidence survey. Confidence is likely to be bolstered by the ongoing strength in the agriculture sector (supported by this morning's confirmation by Fonterra that it is on track with its forecast milk-fat payout of $6.75) and the generally positive momentum in the economy. However, the survey may also have been adversely impacted by political uncertainty in the run up to the election. What we will be most interested in are the pricing indicators which, to date, have shown no sign of a significant pick up in inflationary pressure.

There are a few other bits and pieces to keep an eye on over the week ahead:

- Tuesday sees the merchandise trade figures for August. The annual balance has been improving for several months now and we expect a continuation of the same with this year's August month deficit expected to be better than last year's $1.24 billion shortfall.

- Residential lending data are also released Tuesday. In July the annual decline in residential lending was 24%. We are looking for a similar fall in the August data.

- We get the full suite of credit data on Friday. With the pressure evident in lending for housing, we expect a further deterioration in the annual pace of housing credit from the 7.1% reported in July.

- Not surprisingly, house building activity is also under pressure from the combination of lending constraints and capacity issues. We get a further update on developments in the construction sector with Friday's building consents issued data. We expect August new dwelling units issued to be down a couple of percent on year earlier levels. Non-residential consents have been under-the-pump of late. We will be looking for any glimmer of improvement but are not expecting to see such yet.

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Global Watch

- Mega Fed-speak this week including Yellen
- BoE conference on central bank independence
- US PCE deflator Friday

Australia: The pace from the local calendar eases off further this week with only Friday's RBA Credit report for August of real interest and two RBA speeches, though these may come and go without too much market fanfare.

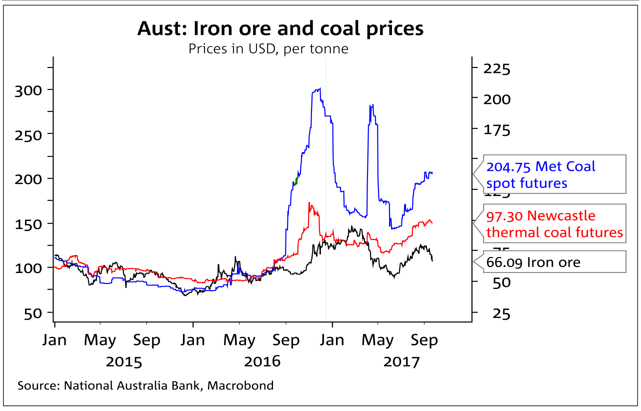
RBA Assistant Governor (Financial Stability) Michelle Bullock is on a panel at a "Where to from here" conference early Tuesday. RBA Deputy Governor Guy Debelle is speaking at the BoE "20 years on" independence from Government conference on Thursday evening AEDT, his speech titled "Central Bank Independence In Retrospect".

As for credit, the interest will be whether the recent moderate-to-slowing pattern of housing credit continues along with the pace of re-emerging business credit growth. NAB expects housing credit to be steady to somewhat lower and we are alert to the possibility that business credit will be broadly steady in August. NAB expects overall credit growth in August at 0.4% m/m after 0.5% in July, mainly from further easing in housing credit on the heels of the further APRA lending guidance released at the end of March.

China: Very quiet ahead of Friday's Caixin Manufacturing PMI (steady expected) then the official PMIs on Saturday. Industrial profits are out too, on Wednesday.

US: With the FOMC out of the way, this week offers an almost complete array of Fed speakers to discern any shift in individual views. Elevated interest may be in new Atlanta Fed President Bostic's first Fed speech, an address from Yellen on Tuesday, along with Dudley's address. There are speeches also from Williams, George, and Kaplan tonight then Dudley, Evans, Kashkari, Mester, Bullard, Rosengren, Brainard, George, Harker, and Kaplan. Fed Vice Chairman Fischer is speaking at the BoE in possibly his last at the Fed before he steps down October 13. Key data points are durable goods Wednesday, revised Q2 GDP Thursday, and the PCE deflators on Friday.

Chart 2: Bulk commodity prices pulling back



Japan: The market is alert to speculation PM Abe call a snap election Monday. The data flow is very light ahead of Friday's monthly CPI, IP, unemployment, and retail/household spending, ex-fresh food CPI expected to rise to 0.7 y/y. BoJ Governor Kuroda speaks in Osaka on Monday, the July BoJ Minutes are out Tuesday and Summary of Opinions from last week's meeting (with its one dissent) on Friday.

Eurozone: If you're holding out hope Draghi might lay some ECB QE tapering cards on the table before the October 26 ECB meeting (we're not), there's his address to the EU Parliament on Monday and a speech at the BoE conference Friday. Dovish ECB Chief Economist Praet speaks twice. After last Friday's Sep PMIs, there's the German Ifo Survey Monday, then Germany CPI Thursday and the Ezone CPI's Friday.

UK: Quiet for top tier data. There'll likely be more interest in the restart of Barnier/David Brexit negotiations and the BoE "20 years on" independence from the government conference Thursday/Friday, with BoE visitors Carney, Fischer, Debelle and others speaking.

Canada: BoC Governor speaks Wednesday.

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Chart 1: Market pricing for higher cash rate

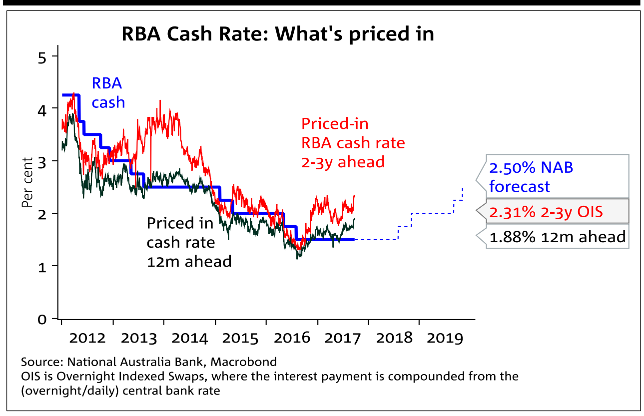
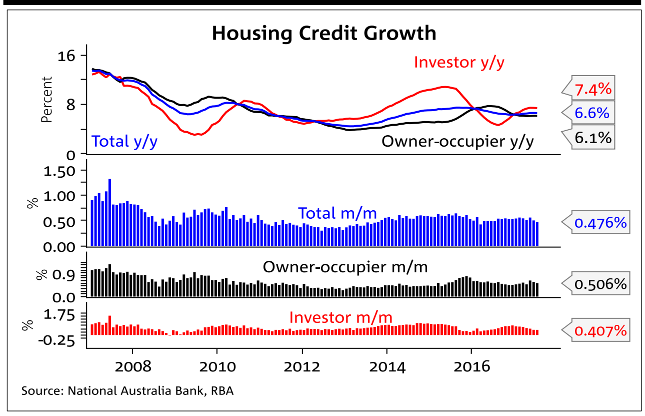


Chart 3: Housing credit growth – slowing of late



Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The NZ rates market has given a collective yawn to the as-expected election result, with little change in rates and nothing much traded. It is too early to jump to conclusions about the market impact of NZ First supporting either a National-led or Labour-led government. The only positive the market will take from the election result is that the most market-unfriendly Labour-Greens coalition government permutation has been avoided.

Fiscal policy is set to be easier relative to the status quo no matter what the make-up of the next government. NZ First having a say would ensure an easier stance even with National in charge. Government bond issuance will be higher under a Labour-led government, given the slightly easier fiscal settings and the party's desire to give more money to the NZ Super Fund to invest. This is all "at-the-margin" stuff, with no material implication for the market, in our view.

The RBNZ will be watching fiscal policy developments closely, but won't be able to incorporate those into its view until a lot more clarity is given – likely at least several months away and possibly as far away as the next Budget in May 2018.

Until then, the market impact of the new government will be limited. Coalition negotiations will drag on for at least a couple of weeks, so the domestic focus this week will turn to the RBNZ's OCR review on Thursday. We think that this should pass without much market reaction, with the Bank's key policy message remaining unchanged, suggesting that "monetary policy will remain accommodative for a considerable period".

With a new (acting) Governor in charge, Spencer has the opportunity to stamp his mark on the Statement, which could see more of a re-write than usual, but we don't think the core messages will change.

NZ's 2-year swap rate has moved from a low of 2.12% to as high as 2.28% intra-day last week, driven by global forces, which also sees the first full NZ rate hike priced in by September 2018. It has been a mini version of the June-July sell-off. For rates to push much higher from here, we would need to see some global inflation surprises. In the absence of that, the 2.20-2.25% mark is likely to be the anchor point for NZ's 2-year swap rate.

On the global calendar, there are numerous Fed speakers hitting the circuit following last week's FOMC announcement. The highlight will be Chair Yellen's speech early Wednesday morning. Last week the Fed kept a steady course for policy, with another hike projected for this year and three more next year. Ultimately, it'll be the dataflow that drives the policy decision, and we think US inflation can tick higher and support further Fed tightening and, eventually, another push higher in the US 10-year rate. The US PCE deflator this week is expected to show a pick-up, as indicated by previously released CPI inflation for the same month, but the different weighting scheme should moderate the gain.

Given the big move in the US 10-year rate from a low of 2.01% to the current 2.25%, we would expect to see some consolidation over coming weeks, but with the bias still towards higher rates later in the year. For NZ long rates, this means some short-term resistance near 2.80% for the NZ 5-year swap rate and 3.30% for the 10-year rate, but possible upside pressure returning later in the year.

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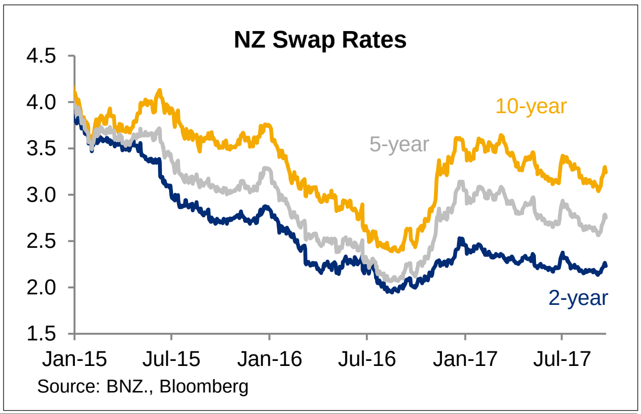
Current Rates/Spreads and Recent Ranges

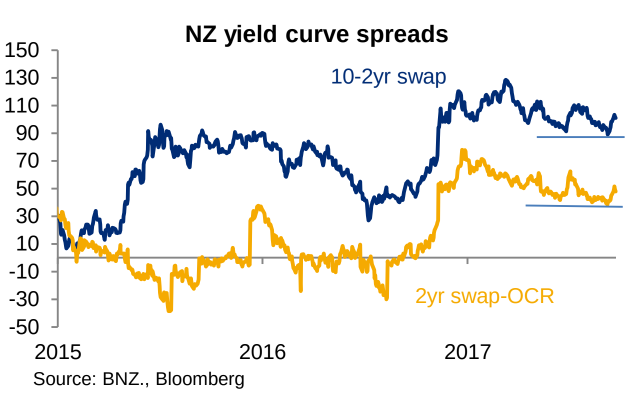
	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.95	1.93 - 1.95
NZ 2yr swap (%)	2.22	2.12 - 2.28
NZ 5yr swap (%)	2.74	2.55 - 2.82
NZ 10yr swap (%)	3.23	3.03 - 3.32
2s10s swap curve (bps)	101	89 - 104
NZ 10yr swap-govt (bps)	23	23 - 28
NZ 10yr govt (%)	3.01	2.74 - 3.08
US 10yr govt (%)	2.25	2.01 - 2.29
NZ-US 10yr (bps)	76	66 - 80
NZ-AU 2yr swap (bps)	18	13 - 22
NZ-AU 10yr govt (bps)	21	16 - 23

*Indicative range over last 3 weeks

Downward Trend Broken?



Steeper Curve Bias Recently



Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD closed last week on a good note, making it higher on all the crosses for the week, ranging from +0.5% on NZD/USD to +1½% on NZD/JPY. Stronger risk appetite was a supporting factor, with the VIX index down to a risk-loving 9.6.

The NZ election result was in line with expectations, with the polls proving to be an accurate guide and NZ First holding the balance of power. While it is still likely going to be 2-3 weeks before we know the form of the next government, the least market-friendly outcome of a Labour-Greens majority coalition has been avoided. This saw the NZD nudge higher on the open, but with no follow-through, and the NZD has since slipped.

We've long believed that NZ political factors are not particularly significant for the NZD, with global forces ultimately much more important. Whether NZ First ends up supporting a National-led government or a Labour-led one will not have a bearing on our forecasts for the NZD.

Whether the NZD can push on higher over coming weeks will depend on the global backdrop. We think that risk appetite is due for a fall and that would ultimately see downward pressure return for the NZD.

In the coming week, the key domestic release is the RBNZ's OCR review on Thursday. We think that this should pass without much market reaction, with the Bank's key policy message remaining unchanged, suggesting that "monetary policy will remain accommodative for a considerable period".

New Acting Governor Spencer has the opportunity to stamp his mark with a freshly re-written Statement and we hope he does, particularly with regards to the NZ dollar. Last month Governor Wheeler reintroduced the notion that "a lower NZD is needed", a statement we found ill-advised and unnecessary. Governor Spencer would do well to just stick to the facts. The NZ TWI is below its average for the past year and in line with the average of the past 5 years, despite NZ's terms of trade near a record high. Certainly a weaker NZD would help the Bank achieve its inflation and there's nothing wrong with making a factual statement like that, but Spencer would be wise to stay away from making indefensible value judgements.

On the global calendar, there are numerous Fed speakers hitting the circuit following last week's FOMC announcement. The highlight will be Chair Yellen's speech early Wednesday morning. Last week the Fed kept a steady course for policy, with another hike projected for this year and three more next year. Ultimately, it'll be the dataflow that drives the policy decision, and we think US inflation can tick higher and support further Fed tightening, a positive USD influence, given the market's scepticism. The US PCE deflator this week is expected to show a pick-up, as indicated by previously released CPI inflation for the same month, but the different weighting scheme should moderate the gain.

Elsewhere, the ECB's Draghi speaks tonight and again at the end of the week alongside the BoE's Carney. Datawise, euro-area CPI and Japan CPI are worth noting.

It's an uneventful week in Australia. We've been watching iron ore prices tumble over recent weeks, which has helped lift our NZD/AUD short term fair value model estimate to 0.92, in line with the current spot rate. If the recent fall in hard commodity prices continues, then that would help NZD/AUD recover further.

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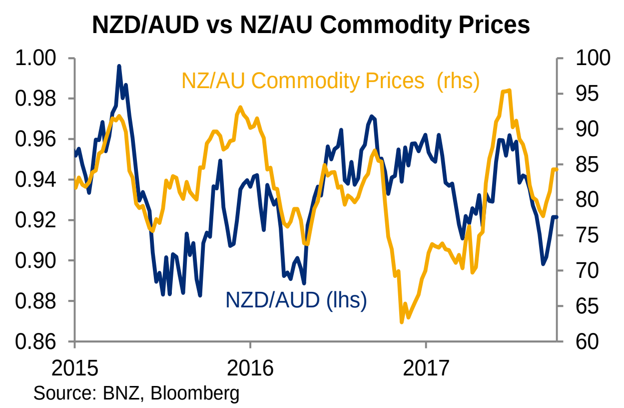
NZD/AUD Higher as NZ/AU Commodity Prices Higher



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7298	0.7170 - 0.7430
NZD/AUD	0.9179	0.8970 - 0.9240
NZD/GBP	0.5410	0.5340 - 0.5580
NZD/EUR	0.6131	0.5990 - 0.6190
NZD/JPY	81.90	78.20 - 82.80

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7630	-4%
NZD/AUD	0.9200	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 0.7145. A breach of the latter would open up significant downside risk. An area of resistance is building around 0.7350.

NZD/AUD

Outlook: Trading range

ST Resistance: 0.9300 (ahead of 0.9420)

ST Support: 0.9075 (ahead of 0.8975)

The recovery in this cross is seeing weak resistance levels broken through, one by one. Stronger resistance doesn't really kick in until just above the 0.94 mark. Initial support is 0.9095.

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NZ 5-year Swap Rate

Outlook: Neutral

ST Resistance: 2.83

ST Support: 2.61

Market reached our target of 2.83 and we now expect some consolidation. Await a break to initiate new position.

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

Outlook: Steeper

ST Resistance: +62

ST Support: +51

Broke trendline last week so expect a move to +62.

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Key Upcoming Events

	Forecast	Median	Last
Monday 25 September			
NZ, Fonterra Full-year Results			
China, Leading Index (Conference Board), August			
Germ, IFO Index, September		116.0	115.9
Tuesday 26 September			
NZ, Merchandise Trade, August	-$1,170m	-$825m	+$85m
NZ, Residential Lending, August y/y			-23.8%
NZ, ANZ Business Survey, September			+18.3
Jpn, BOJ Minutes, 19/20 July Meeting			
US, New Home Sales, August		588k	571k
US, Consumer Confidence, September		112.0	122.9
US, Yellen Speaks, Monetary Policy			
Wednesday 27 September			
China, Industrial Profits, August y/y			+16.5%
Euro, M3, August y/y		+4.7%	+4.5%
UK, CBI Distribution Reported Sales, September			+2
US, Durables Orders, August 1st est		+1.0%	-6.8%
Thursday 28 September			
NZ, RBNZ OCR Review	1.75%	1.75%	1.75%
Aus, RBA's Debelle Speaks, CB Independence			
Euro, Economic Confidence, September		112.0	111.9
Germ, CPI, Sep y/y 1st est		+1.8%	+1.8%

	Forecast	Median	Last
Thursday 28 September cont'd			
US, Wholesale Inventories, August 1st est		+0.4%	+0.6%
US, International Goods Trade, August		-$65.1b	-$63.9b
US, GDP, Q2 3rd est		+3.1%	+3.0%P
Friday 29 September			
NZ, Building Consents, August (res, #)			-0.7%
NZ, Credit Aggregates, August (housing y/y)			+7.1%
Aus, Private Sector Credit, August	+0.4%	+0.5%	+0.5%
China, PMI (Caixin), September		51.5	51.6
Jpn, Unemployment Rate, August		2.8%	2.8%
Jpn, Household Spending, August y/y (real)		+0.9%	-0.2%
Jpn, CPI, August y/y		+0.7%	+0.4%
Jpn, Industrial Production, August 1st est		+1.8%	-0.8%
Jpn, BOJ Summary of Latest Meeting, 20/21 Sept Meeting			
Euro, CPI, Sept y/y 1st est		+1.6%	+1.5%
Germ, Retail Sales, August		+0.5%	-1.2%
UK, GDP, Q2 3rd est		+0.3%	+0.3%P
US, Personal Spending, August		+0.1%	+0.3%
US, Chicago PMI, September		58.7	58.9
Saturday 30 September			
China, PMI (NBS), September		51.7	51.7
China, Non-manufacturing PMI, September			53.4

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	1.83	2.19
2mth	1.89	1.88	1.89	2.20
3mth	1.95	1.94	1.97	2.21
6mth	1.98	1.99	1.99	2.21
GOVERNMENT STOCK				
03/19	1.97	1.94	1.89	1.87
04/20	2.14	2.10	2.04	1.92
05/21	2.30	2.24	2.18	1.96
04/23	2.60	2.57	2.47	2.09
04/25	2.87	2.85	2.73	2.25
04/27	3.01	3.00	2.89	2.36
04/33	3.35	3.35	3.28	2.69
04/37	3.56	3.58	3.53	2.95
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	72	65	72	104
Nth America 5Y	60	56	60	79
Europe 5Y	59	50	56	73

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.23	2.23	2.19	2.01
3 years	2.43	2.41	2.36	2.03
4 years	2.60	2.58	2.51	2.09
5 years	2.75	2.73	2.65	2.15
10 years	3.24	3.24	3.13	2.50
FOREIGN EXCHANGE				
NZD/USD	0.7318	0.7263	0.7256	0.7274
NZD/AUD	0.9206	0.9123	0.9111	0.9527
NZD/JPY	82.10	81.01	79.27	72.98
NZD/EUR	0.6144	0.6076	0.6057	0.6464
NZD/GBP	0.5424	0.5384	0.5611	0.5607
NZD/CAD	0.9027	0.8929	0.9075	0.9622
TWI	76.7	76.1	76.1	77.2

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