Markets Outlook

26 June 2017

Capacity, Commodities and Construction

- Businesses still upbeat?
- As capacity issues press
- Oil to dent near term inflation
- And add to already strong terms of trade
- May exports expected higher
- Building consents to bounce in May?

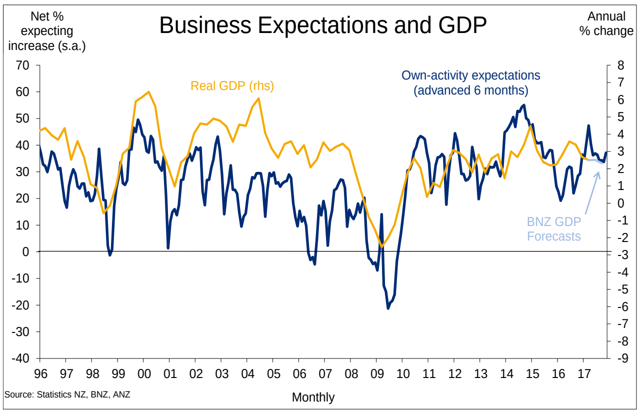
Data releases in New Zealand are relatively sparse this week. But what is on offer will provide more fodder to contemplate the growth and inflation implications of three important current themes namely capacity constraints, commodity price movements and construction activity.

Thursday's ANZ business survey will be the focus. Recall that May's issue bolstered its positivity, including around inflation. Business confidence lifted to +14.9 and firms' own activity edged up to a strong +38.3. Inflation expectations and pricing intentions pushed higher. It was consistent with GDP growth running above trend and CPI inflation close to middling. We would expect this to be broadly repeated in June's update. However, we are alert to any election nerves that may start to creep into the survey.

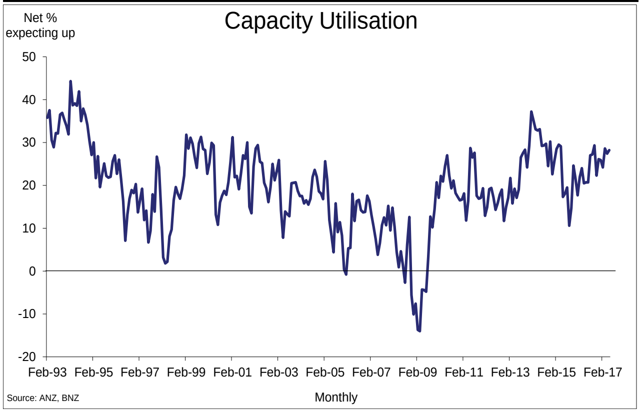
Also important will be firms' assessment of capacity utilisation as we see evidence of increasing resource tightness in other data; all as a guide to core inflationary pressure. In May, capacity utilisation at 28.2 was well above its long term average of 19.5. Capacity constraints may well prevent real GDP growth from exceeding 3% over the coming year or so.

Firms' recent upbeat assessment of activity also likely reflects higher terms of trade. A lift in export commodity prices over the past year and more recently lower oil prices is providing a real income boost, over and above inferred from real GDP. Indeed, latest figures show real gross national disposable income (which accounts for terms of trade gains) rose nearly a full percentage point more than the 2.5% expansion in real GDP over the year to March 2017. The additional source of real income is likely to support demand ahead.

Businesses Upbeat



Elevated

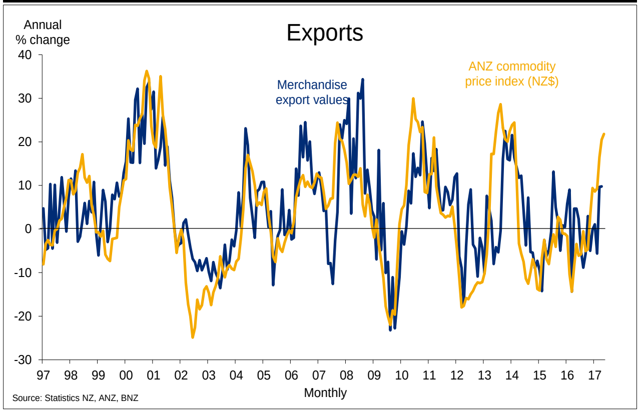


We look for the recent strong export price gains to show up in May's merchandise trade figures on Tuesday. They will test our view that net exports will bounce back well in Q2, having failed to do so in Q1. We expect the value of merchandise exports to be 12% up on year-ago levels. While this is stronger than the market's median expectation, we actually wonder if our pick is too conservative. We say this with May's commodity export prices, in NZ dollar terms, up 22% y/y, with gains widespread across the major categories of dairy, sheepmeat, beef, venison, forestry, and horticulture.

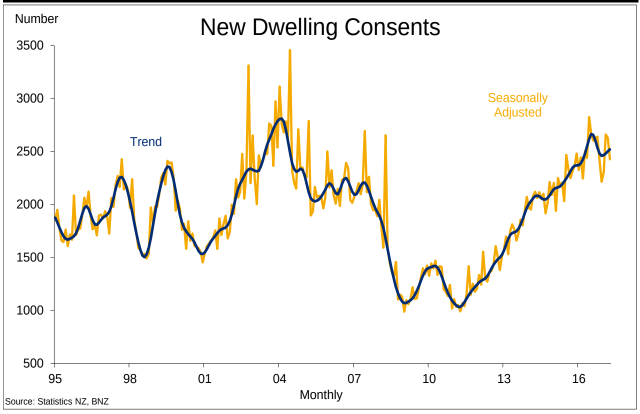
For imports we estimate a 4% gain y/y in May, a little under market expectations. In combination with our view on exports, this would deliver a monthly surplus of $721m (versus market +$419m) – good enough to lessen the annual trade deficit to $3.1b, from $3.5b in April, and $3.8b back in February 2017. Of course, monthly trade data can be volatile so we wouldn't be too perturbed by something different to expectations on the day given that the outlook is looking increasingly positive.

We suspect it is too early for the recent large drop in crude oil prices to have any major impact in May, but it is something to watch for over coming months. Crude oil prices have dropped around 17% over the past month. While that is a further boost to real incomes via the terms of trade, in combination with a firm NZD it also directly pulls

More Upside



Wiggly



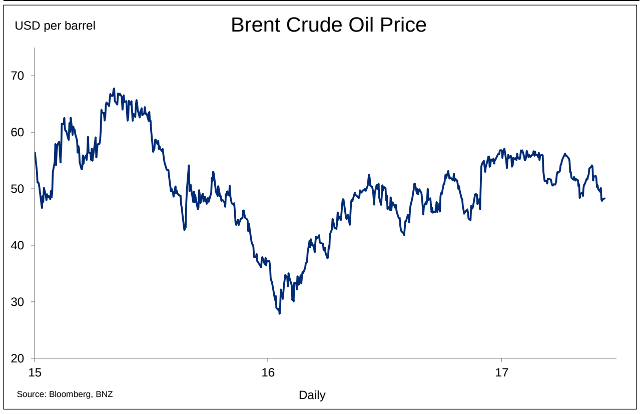
down our near term estimates of CPI inflation. Local petrol prices have declined a hefty 14c/litre over recent weeks.

On account of the oil price changes, we now see annual CPI inflation at 1.8% for Q2, down from the 1.9% we had recently tweaked it up to on account of May's food price spike. The more significant impact starts in Q3 (even assuming some mild bounce in petrol prices over coming months), with annual CPI inflation now expected at 1.7% for that quarter from 2.1% previously. Looking further ahead, annual inflation in Q1 2018 is now seen at 1.2%, from 1.6%. But as the recent petrol price declines drop out of the annual CPI calculations, inflation is seen lifting to 2.0% in Q2 2018 and 2.3% in Q3 2018.

Given the petrol price changes, it is more likely that near term headline CPI comes in lower than the RBNZ projected in its May MPS given the Bank expected fuel prices 'to remain stable over the rest of 2017'. One potential consequence of this surprise is that the Bank's future CPI projection (when it next puts them together in the August MPS) could dip back below 1% in early 2018, obviously depending on, among other things, how petrol prices are expected to evolve from here.

While core inflation and the medium term outlook should be much more important for monetary policy, a softer near term outlook for headline inflation is worth noting among all other developments as we continue to monitor the case for pushing out our February 2018 OCR rate hike call.

Downward Lurch



Speaking of the RBNZ, we don't expect any monetary policy guidance to stem from tomorrow morning's speech from Head of Communications and Board Secretary, Mike Hannah, which is entitled 'Engaging with our stakeholders to promote understanding, accountability and dialogue.'

As for other data due this week, May's new residential lending data are scheduled for Tuesday afternoon and are also worth noting considering the increased interest in housing market trends and inherent vulnerabilities. At face value, April's new residential lending looked awful; down 30% on the same month last year, having posted an annual fall of just 9.0% in March. However, this likely reflects the timing of Easter. The true rate of moderation, as the latest LVR screws hit home, is probably somewhere in between, which May's results might well expound.

Friday delivers building consents for the month of May. Their residential number disappointed for April, with a seasonally adjusted decline of 7.6%. We expect a rebound for May. There seems no let-up in demand for construction. So if there are signs of slower building activity then it could well be reflecting resource and cost pressures.

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Global Watch

- Yellen speaks in London on global issues
- Fed's Williams downunder, and other central bankers in Portugal at the annual ECB Central Bankers' Forum
- Key data limited to US PCE deflators and Euro/ China PMIs

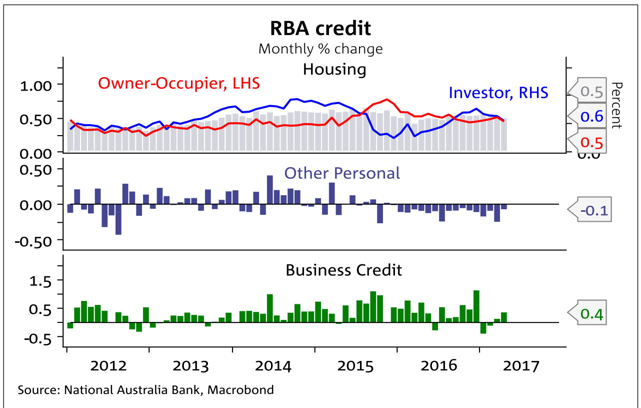
Australia

It's another very quiet week with Friday's RBA Credit report for May the main and quite possibly the only interest. The pattern evident in recent months has been the return to some growth in Business Credit in March and April, if subdued. Monthly growth in both owner-occupied and investor lending has continued at moderate rates, a pattern expected to be repeated in May. Owner-occupied housing credit growth has continued to grow at around 0.5% per month, investor lending by 0.6%, easing back in the wake of some rises in investor mortgage rates of around 20-25 bps.

On Tuesday, the Statistician releases the first cut of housing-related data from the 2016 Census. This should enable economists to update their estimates of underlying demand for dwellings and the scale of pent-up demand – important given the high levels of residential building occurring in the eastern states.

With little local data on offer, the local interest rate and currency markets may well take the lead from offshore with a deluge of central bank speakers on offer. RBA Deputy Governor Debelle is speaking at the Global FX Code of Conduct on Thursday. Prominent Fed views will get an airing locally with no less than three speeches from visiting San Francisco Fed President John Williams speaking in Sydney twice on the US then the global economy on Monday and Tuesday, followed by another address in Canberra on Wednesday, when he's expected to repeat his Tuesday address on the global economy.

Chart 1: Moderate Credit Growth



China

All quiet on the data front ahead of the key official Manufacturing and Non-manufacturing PMIs for June being released on Friday, the market expecting only a marginal dip in the Manufacturing Index to 51.0 from 51.2, suggesting solid average growth continues. Tuesday's Industrial Profits report for May provides further insights into industrial financial health (L: +14.0% y/y). China's first quarter Current Account Balance report is also scheduled, out Thursday.

US

Two key releases bookend the week, durable goods orders on Monday and the Personal Income, Spending and PCE deflators report on Friday, both expected to be neutral-to-negative for the USD. There's more housing reports but the main interest may well be on evolving Fed views with no less than 12 speeches, including Yellen Wednesday on global issues in London.

Japan

BoJ Governor Kuroda is at the ECB central bankers' forum in Portugal, Monday through Wednesday. The BoJ also publishes the Summary of Opinions from its June 15-16 meeting on Monday and Policy Board member Harada speaks on Thursday. The main data interest will be on Friday's May Labour Market, CPI and Industrial Production reports, headline and core inflation expected to tick higher by one tenth.

Eurozone

The main data interest is tonight's preliminary June PMIs (again expected to be upbeat) then next Friday's first cut of June's CPI. The ECB Forum in Sintra Portugal (Mon-Wed) will likely produce many quotes and views, starting with opening speeches from Draghi and Bernanke.

UK

Outgoing BoE MPC member Forbes speaks tonight. BoE Governor Carney is scheduled to be at the ECB Forum and at a press conference to present the BoE's Financial Stability Report out Tuesday. Quiet data-wise.

Canada

BoC Governor Poloz speaks at the ECB Forum on Wednesday, with a speech in Calgary that day from Deputy Governor Patterson. Tonight's CPI the data focus.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

As expected, the RBNZ's OCR review came and went with little market reaction, with no change to the Bank's final paragraph on its neutral policy stance. Thus, the short end of the curve remains pretty flat, with expectations of the RBNZ remaining on hold for an extended period. The OIS market prices in little chance of any move by the Bank this year. From February next year, the probability of a rate hike begins to meaningfully increase, but the first full rate hike isn't priced until August 2018. Certainly, no prospect of further easing is considered by the market.

The RBNZ's "nothing has changed" message stands in contrast to other central banks, with some considering future rate hikes (US Fed, Bank of Canada, Bank of England) and others removing their easing bias (ECB, Norges Bank). However, with the NZD moving up over the past six weeks against the RBNZ's expectations of a weaker currency and oil prices moving lower against expectations of higher oil prices, the RBNZ's inflation forecasts are likely to currently be significantly lower than the already-low forecasts published last month. The hurdle rate for the Bank to tilt towards a hawkish bias seems pretty high at this juncture and we'd expect the neutral tone to stick around for awhile.

With little signal about future tightening in sight, it leaves us believing that 2-year swap will continue to trade in a tight 2.15-2.25% range over the foreseeable future. And any yield curve movement will likely be largely driven by the long end of the curve.

Looking at the week ahead, the low volatility environment is likely to continue. The key NZ release is the ANZ business outlook survey, and we wouldn't expect continuation of robust activity indicators and a further nudge up in inflation expectations to rattle the market.

US data and more Fed speakers on the circuit are also expected to pass with little market reaction. There will be some focus on Yellen's mid-week speech, but we doubt she'll deviate from the message she gave at her recent press conference. The key US releases are on Friday night. Weaker CPI that has already been released should feed into weaker PCE deflators.

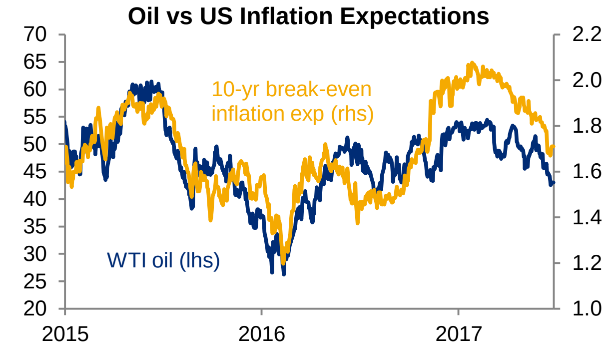
For rates traders, the oil market might prove to be a more influential indicator to watch. The 17% fall in oil prices over the last month has reduced global inflation expectations and complicates the outlook for monetary policy. Lower oil prices reduce the chance of US inflation picking up over the near term and plays to the hand of the Fed delaying the next possible rate hike until perhaps at least December.

In decomposing the US 10-year rate, over the past few months the key driver down to around 2.15% has been the lower inflation expectations component rather than the real rate component. A recovery in oil prices would help reverse that trend.

Lower US rates have been instrumental in driving down NZ 5 and 10-year swap rates and causing a flattening of the yield curve. With RBNZ monetary policy clearly out of the picture at the moment, the NZ dataflow is less important than usual for the NZ curve, and global drivers will be in the box seat.

This week we expect tight ranges to prevail for NZ swap rates. Our expectation remains for higher yields later in the year, but there is nothing in the immediate future to push them higher.

Watch Oil Prices as a Guide to US Rates/Inflation Exp.



Source: BNZ, Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.96	1.93 - 1.96
NZ 2yr swap (%)	2.21	2.16 - 2.24
NZ 5yr swap (%)	2.68	2.64 - 2.72
NZ 10yr swap (%)	3.14	3.10 - 3.21
2s10s swap curve (bps)	93	93 - 97
NZ 10yr swap-govt (bps)	42	38 - 45
NZ 10yr govt (%)	2.72	2.68 - 2.79
US 10yr govt (%)	2.14	2.10 - 2.23
NZ-US 10yr (bps)	57	53 - 62
NZ-AU 2yr swap (bps)	38	34 - 46
NZ-AU 10yr govt (bps)	36	32 - 39

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

Last week was as uneventful as expected, given the sparse economic calendar. In the end, the NZD managed to nudge higher on all the major cross rates in the order of 0.5-1.0%.

The RBNZ OCR Review came and went without much reaction. Certainly, there was no reaction in the rates market, while the NZD showed a modest gain after the announcement. This possibly reflected some fast-money accounts taking a short position ahead of the release in anticipation of some dovish overtones in light of the stronger NZD and lower oil prices. In the end, the Bank played an even hand, with only minor tweaks to the policy assessment and sticking to the facts with regards the NZD – noting the recent rise in the TWI was partly explained by higher export prices and that a lower NZD would help rebalance growth towards the tradeables sector.

The RBNZ (and RBA) stand out for their neutral policy tones at a time when the language of other central banks has moved towards indicating a removal of policy accommodation. In that camp we can add the US Fed, Bank of Canada, Bank of England and Norway's central bank. The ECB recently removed its easing bias.

If the RBNZ holds the neutral policy line – something we expect to remain for awhile – against the shifting tide of other central banks, then the NZ-global rates differential plays to a softer NZD.

While fundamental forces for the NZD – such as high risk appetite and higher NZ commodity prices – have been supportive recently, the latest CFTC data suggest a surge in the number of net long speculative contracts in the NZD. Positioning has been mainly short NZD over recent months, but there has been sign of capitulation and the data now suggest the highest number of net long positions in over four years. This now makes the NZD more vulnerable to the downside than usual to any negative surprises.

A new factor to consider for the fundamental outlook is the recent fall in oil prices, taking them down 17% over the past month. If this fall is sustained, then it adds to global deflationary pressure and it wouldn't take much for global central banks to revert back towards more dovish overtones.

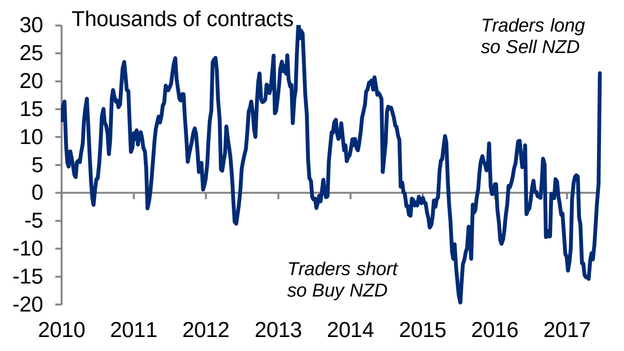
The lack of an inflationary impulse in the US is likely to delay the next Fed rate hike until December. This could potentially delay the expected recovery in the USD we have been counting on to drive the NZD lower. Our forecast for a weaker NZD back into the high 60s depends on a USD recovery that drives weaker risk appetite and lower commodity prices.

The week ahead looks a little more interesting than last week's offering, but not by much. We would expect another low volatility week in currency markets, with the NZD consolidating around current levels. The key release in NZ is Thursday's ANZ business outlook survey.

In the US, a number of Fed speakers join the circuit, including a mid-week appearance by Fed Chair Yellen. We doubt she'll add much colour to her recent press conference and wouldn't expect it to be market moving. Friday's personal income and spending data along with the PCE deflators hold the most interest on the US calendar. The soft CPI has already pointed to weak PCE deflators, so we're going to have to wait longer to see any possible uptick in inflation.

The Australian economic calendar is light, while the only other possible point of interest is China PMI data.

Net Long Speculative Positioning in NZD



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7283	0.7130 - 0.7320
NZD/AUD	0.9630	0.9480 - 0.9640
NZD/GBP	0.5717	0.5520 - 0.5750
NZD/EUR	0.6503	0.6330 - 0.6530
NZD/JPY	80.99	78.40 - 81.20

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7540	-3%
NZD/AUD	0.9460	2%

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Technicals

NZD/USD

Outlook:	Downward channel
ST Resistance:	0.7320 (ahead of 0.7400)
ST Support:	0.7170 (ahead of 0.7100)

The NZD has edged up further and is trading close to technical resistance around the top of the downward channel that has been in place for the past nine months. The recent intra-day high of 0.7320 is the first area of resistance, with stronger resistance developing around 0.74. The first area of support is 0.7170, ahead of the 200-day moving average around 0.7100.

NZD/AUD

Outlook:	Trading range
ST Resistance:	0.9650 (ahead of 0.9750)
ST Support:	0.9500 (ahead of 0.9400)

The cross is approaching important levels of technical resistance. The currency has rarely traded above 0.9650 over the past 18 months. A break of that opens up 0.9750 and above that level there is little resistance towards parity. Given the recent strong run, support levels are fairly weak well south of current spot.

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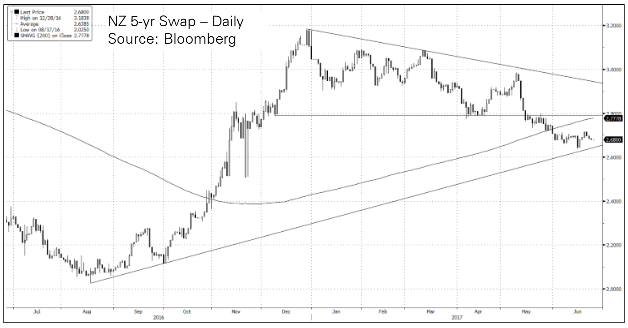


NZ 5-year Swap Rate

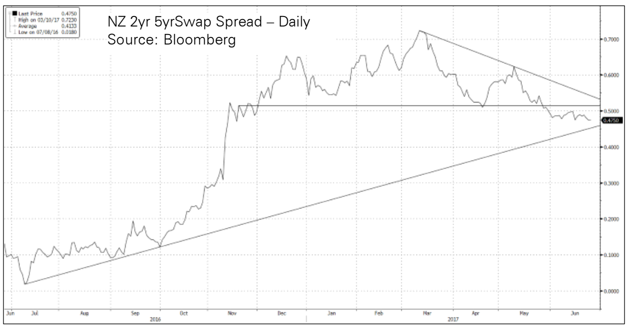
Outlook:	Lower
ST Resistance:	2.795
ST Support:	2.6425

Break through 200 day moving average signals a move to trendline support coming in at 2.6425 now.

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

Outlook:	Flatter
ST Resistance:	+56.5
ST Support:	+45.5

Still expect to move to trendline support that comes in now at +45.5.



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Key Upcoming Events

	Forecast	Median	Last
Monday 26 June			
Jpn, BOJ Summary of Latest Meeting, 15/16 June Meeting			
Germ, IFO Index, June		114.5	114.6
US, Durables Orders, May 1st est		-0.6%	-0.8%
US, Chicago Fed Nat Activity Index, May		+0.20	+0.49
Tuesday 27 June			
NZ, Residential Lending, May y/y			-29.9%
NZ, RBNZ's Hannah Speaks			
NZ, Merchandise Trade, May	+$721m	+$419m	+$578m
China, Industrial Profits, May y/y			+14%
UK, CBI Retailing Reported Sales, June			+2
US, Shiller Home Price Index, April y/y			+5.8%
US, Consumer Confidence, June		116.0	117.9
Wednesday 28 June			
Euro, M3, May y/y		+5.0%	+4.9%
US, Pending Home Sales, May		+0.8%	-1.3%
US, International Goods Trade, May advance		-$66.0b	-$67.6b
US, Wholesale Inventories, May 1st est		+0.2%	-0.5%
Thursday 29 June			
NZ, ANZ Business Survey, June			+14.9
Jpn, Retail Sales, May y/y		+2.8%	+3.2%

	Forecast	Median	Last
Thursday 29 June cont'd...			
Euro, Economic Confidence, June		109.5	109.2
Euro, Consumer Confidence, June 1st est		-1.3	-1.3P
Germ, CPI, June y/y 1st est		+1.4%	+1.5%
US, Jobless Claims, week ended 24/06		240k	241k
US, GDP, Q1 3rd est		+1.2%	+1.2%P
Friday 30 June			
NZ, Building Consents, May (res, #)			-7.6%
Aus, Private Sector Credit, May			+0.4%
China, PMI (NBS), June		51.0	51.2
China, Non-manufacturing PMI, June			54.5
Jpn, CPI, May y/y		+0.5%	+0.4%
Jpn, Unemployment Rate, May		2.8%	2.8%
Jpn, Household Spending, May y/y (real)		-0.5%	-1.4%
Jpn, Industrial Production, May 1st est		-3.0%	+4.0%
Euro, CPI, Jun y/y 1st est		+1.2%	+1.4%
Germ, Retail Sales, May		+0.3%	-0.2%
Germ, Unemployment Rate, June s.a.		5.7%	5.7%
UK, GDP, Q1 3rd est		+0.2%	+0.2%P
US, Personal Spending, May		+0.1%	+0.4%
US, Mich Cons Confidence, June 2nd est		94.5	94.5P
US, Chicago PMI, June		58.0	59.4

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.84	1.84	1.86	2.31
2mth	1.90	1.89	1.91	2.32
3mth	1.96	1.93	1.97	2.33
6mth	1.99	1.98	2.01	2.35
GOVERNMENT STOCK				
12/17	1.80	1.81	1.81	2.11
03/19	1.94	1.94	1.95	2.11
04/20	2.10	2.10	2.13	2.13
05/21	2.19	2.19	2.27	2.14
04/23	2.45	2.46	2.54	2.18
04/25	2.63	2.67	2.76	2.35
04/27	2.72	2.77	2.86	2.48
04/33	3.05	3.08	3.14	2.79
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	83.94	83	84	130
N. AMERICA 5Y	60.41	62	64	83
EUROPE 5Y	53.47	57	63	87

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.21	2.20	2.25	2.30
3 years	2.39	2.38	2.45	2.33
5 years	2.68	2.68	2.77	2.44
10 years	3.14	3.15	3.25	2.79
FOREIGN EXCHANGE				
NZD/USD	0.7284	0.7255	0.6923	0.7082
NZD/AUD	0.9625	0.9518	0.9306	0.9538
NZD/JPY	81.02	80.45	77.24	74.11
NZD/EUR	0.6505	0.6476	0.6190	0.6248
NZD/GBP	0.5716	0.5680	0.5332	0.4890
NZD/CAD	0.9662	0.9585	0.9373	0.9102
TWI	78.72	78.19	75.16	75.53

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