RESEARCH

Markets Outlook

27 November 2017

The Good (Old) Days

- **Business/consumer confidence diverging**
- **Political poll largely unchanged**
- **Q3 terms of trade to surpass peak of 1973**
- **NZ GDP history revised up 2.2%**
- **RBNZ FSR to simply outline criteria for LVR exit**
- **And…it's dry before summer even begins**

There is a fair amount to preview, and review, in today's Markets Outlook. This includes news on how the economy has been, and is, going; checking on confidence post the election, Wednesday's LVR-focussed Financial Stability Report from the RBNZ, and a wary eye on the (suddenly dry) weather.

But let's start with economic confidence, post the election. What we're starting to notice is a divergence in business and consumer confidence, with the former sagging and the latter proving robust. This is probably no great surprise. Some of the policies being proposed by the new government will be a direct impost on the business sector for the sake of benefitting employees. Labour market policies are integral to this.

Thursday's ANZ business survey will have an opportunity to voice any initial concerns. Conducted in November it will be the first 'clean' read post the government formation, although will also capture more of the recent dip in the currency. Its net confidence reading – in spite of tending to get some seasonal support in November – seems prone to abate further, from the -10 it sagged to in October. Brace yourself.

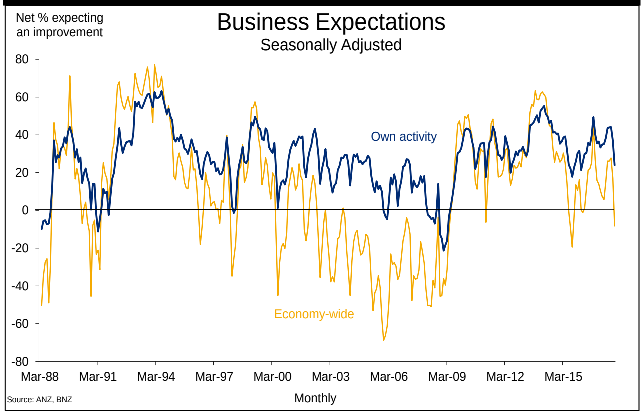
But given that this ANZ survey can tend to over-react, in a negative way, to Labour-led governments, we'll put more store in its direct messages around activity, employment, investment and profits (which had all lost steam over September/October too, we might add), and inflation.

As some pointer, we note the Auckland Chamber of Commerce survey, as reported last week, registered a slump in its net confidence index to -15, from +18 three months ago.

In contrast, consumer sentiment appears to be holding up relatively well. Indeed, the UMR poll of last week showed a much increased, and outright sizable, 48-point gap between optimists (65%) and pessimists (17%) on the direction the economy is heading in.

Consumer confidence in the new government looks to

Vulnerable



have increased too. But not in the way some in the media interpreted the Roy Morgan political poll of last week. Actually, it was very similar to its previous result, taken about a week before the 23 September election; Labour 39.5% (unchanged); NZ First 5.0% (down 1); Greens 10.0% (down 1); National 40.5% (up 0.5); TOP 2.0% (unchanged); Maori 1.5 (down 0.5); ACT 0.5% (unchanged).

Some reports compared these latest Roy Morgan survey results with the election percentage results, which is not a very scientific way of doing things. This is not to say voter support has not shifted toward the government parties since the election. But the latest Roy Morgan poll was not any proof of it. Note that the last Roy Morgan poll before the election over-estimated the outcome for the new government parties, as it turned out.

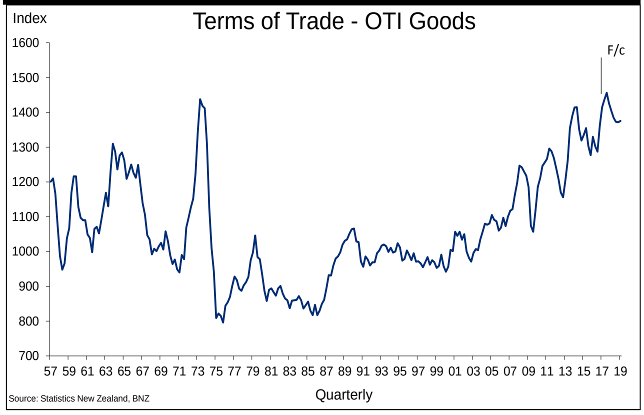
Having said this, there was valid news in the concurrently published Roy Morgan Government Confidence Index. This jumped 15.5 points to 146.5 – "the highest since early in the John Key era in January 2010 (NZ Herald)". As part of this, 66.5% of respondents (up 8%) said NZ is heading in the right direction.

But turning to NZ economic history, of the very recent variety, there is a fair bit of local data on offer this week.

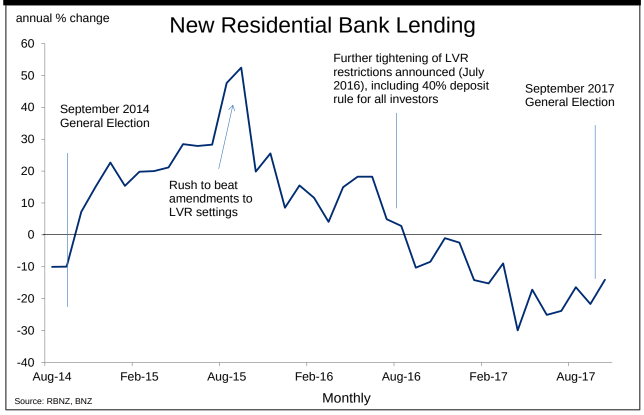
We expect Friday's Overseas Trade Indexes to show the merchandise terms of trade finally nudging above its record high level of 1973, with a 1.3% increase in the September quarter. But also watch for a correction in the OTI export volume measure (after its spike in Q2). Along with ongoing steady growth in core imports, this is all in keeping with our 0.7% expectation on Q3 GDP growth.

October's building consents are due Thursday. We look for these to solidify their rebound story of late – giving us confidence that construction activity will expand

A Broken Record



Worst Passing



reasonably well over the second half of 2017, after struggling to hold up over the first half of the year.

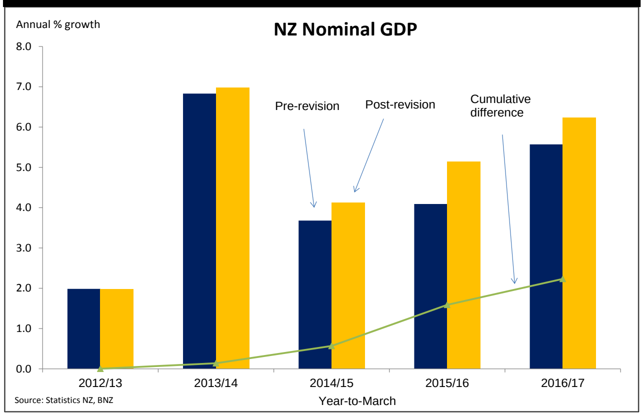
Thursday afternoon the RBNZ publishes October's money and credit aggregates. Annual growth in household credit will probably slow further in October, but the month to month progression has been stabilising, even picking up a bit, which is interesting. Last Friday's new residential lending figures for October supported this notion, with their annual rate of decline abating to just 14%, having been 22% in September.

In terms of how the housing market is doing, directly, October's Quotable Value NZ report is set down for Friday's dawn. It still seems too early to get a good fix on the market, so soon after the election, although initial signs are that it's holding together.

For a much broader read on New Zealand's recent economic history we thought last Friday's annual GDP accounts were quite something. They showed the nation's nominal GDP revised up all of 2.2% as a year-to-March 2017 level. So $270.6b compared to $264.7b pre-revisions. This is as Statistics NZ builds in new survey information available as part of its annual cycle.

This 2.2% gap has built up over the four years to March 2017, in fact, leaving a trail of higher nominal GDP growth

That's More Like It



in each of 2013/14 (7.0%, from 6.8%), 2014/15 (4.1%, from 3.7%), 2015/16 (5.1%, from 4.1%) and 2016/17 (6.2% from 5.6%).

Of course, these are dollar value results. So it's not clear how much of it represents stronger activity versus stronger prices. But these annual revisions have a habit of proving more volume than price. So there seems a good chance that much of this extra growth will be "real", when the full splits are revealed in the next (quarterly) GDP release, of 21 December.

Accordingly, there's a good chance NZ productivity measures will be upgraded by a similar degree (given no cause to change labour input variables in the calculation). This should help tone down criticism about New Zealand's supposedly poor (negative?) productivity of late – by bloggers and politicians alike. Could the biggest problem with productivity be the way macro-economic data (initially) interprets it?

What are the implications of all of this for the RBNZ? At a headline level, it's tempting to think that materially stronger GDP series will add pressure on the Bank. But the upgrades will also tend to boost the GDP speed limits that the Bank judges, in order to reconcile back to the moderate inflation we've seen in the CPI. Still, it will be interesting to see how the RBNZ absorbs these annual GDP revisions into its thinking and models. It often talks this through in the next available MPS.

It's something to think about especially as the upward revisions to (nominal) GDP have come principally via stronger investment spending and household consumption. There has been little to no revision to the exports, imports and government lines.

This suggests, by the way, that exports to GDP ratios will have to be re-estimated lower.

Indeed, any dollar amount compared to the new nominal GDP estimates will have its ratio trimmed. This is relevant to the discussion around government debt to GDP tracking, as well as keeping tabs on the proportionate size of the current account deficit. But also bear in mind that, even with nominal GDP revised up 2.2%, it tends to knock fractions, not big-figures, off such ratios. It's the numerator that matters more.

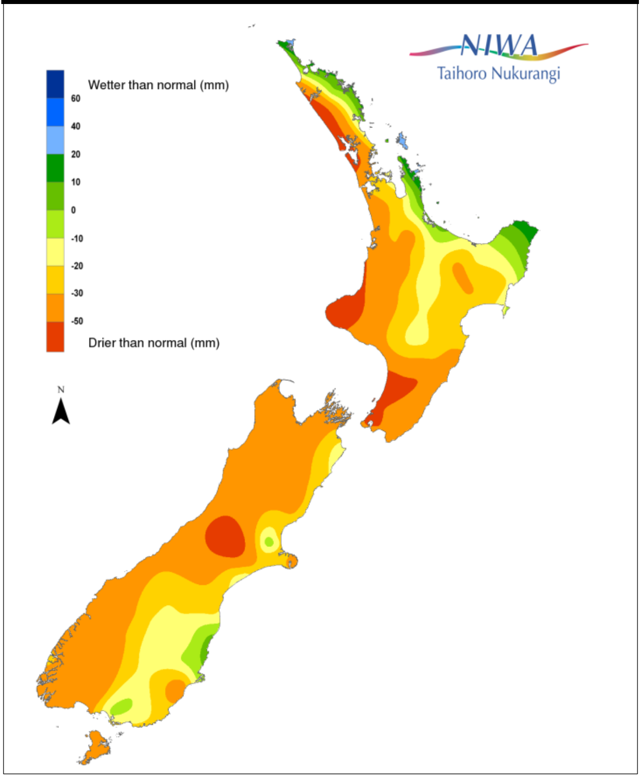
Regarding this week's RBNZ Financial Stability Report (FSR), while the dairy and commercial property sectors will no doubt get their usual mention it will be housing that people will remain most interested in. In particular, we're hoping to see an assessment of the impact of the tighter LVR restrictions brought in last year. While there is again chatter about the Bank signalling an imminent relaxation in the LVR policy we still believe it's too early for it to be acting so. We do hope, however, that this FSR outlines the criteria by which the RBNZ will start unwinding the LVR policies. We'll also be interested in any update on work on potential debt-to-income tools.

The FSR is scheduled for Wednesday (9:00am) and the Bank officials are due to give testimony on it to Parliament's new Finance and Expenditure Committee, starting 1:00pm that day.

Also note that there will be some NZ CPI news in the coming week. On Thursday Statistics NZ will publish a back series of the CPI as part of the re-weighting and re-basing process. This should preserve historical inflation rates, but reset the index levels to the new base (June 2017 = 1000). The new CPI weights are expected on 12 January, ahead of the Q4 CPI data release on 25 January 2018. We don't expect this to have a significant bearing on the CPI track, but the market might still be interested, in these days of decimal places being important for many.

Meanwhile, the risk of drought in New Zealand is rising. That might seem like a strange thing to say when right through winter and early spring there was far too much rain. Back then grass growth was restricted by saturated

Soil moisture anomaly (mm) at 9am on 26/11/2017



soils. But conditions have been changing over recent weeks. It has been drying out – rapidly. It has got to the point that many parts of the country now have soil moisture deficits compared to what is normal for this time of year. It is a growing risk to pastoral agriculture (and something for the hydro electricity generation sector to watch too) given it is getting dry ahead of summer and near-term forecasts show more dry weather ahead.

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Global Watch

- **Any inflation in the US, EU, or Japan?**
- **Powell and Yellen to speak**
- **China PMIs due**
- **AU cap ex upgrade expected**

Australia: A week out from the RBA meeting and ahead of September quarter GDP, the highlight for this week will be the Private New Capital Expenditure report for Q3, out Thursday. The report also comes with updated expectations for 2017-18, surveyed amid signs of improving business activity. In this context, we look for a further upgrade in investment expectations, which will also be supported by the usual through the year firming of plans.

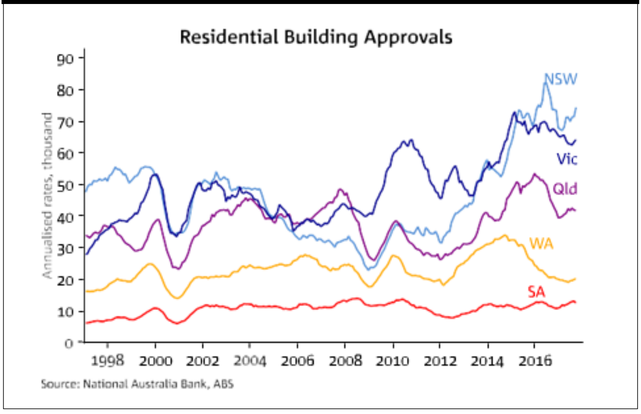
NAB looks for an upgrade from $101.8bn to $105bn. We would not be surprised to see some modest upgrade even for the Mining industry reflecting the combination of better industry conditions and maintenance capex spending now "catching up" to sustain production and physical assets. For Q3 spending, we look for growth of 1% after similar 0.8% growth in Q2.

The other notable releases for the week come on Thursday too with the release of RBA Credit and Building Approvals for October. For RBA Credit, we look for a modest rebound in growth from 0.3% m/m in September to 0.4%.

The residential building cycle is at an interesting juncture. It had seemed that apartment approval numbers had peaked, but the trend has turned modestly positive in recent months. Whether this reflects stronger underlying demand to which developers are responding to, remains to be seen, but it opens that possibility. (We also caution that approvals are one thing whereas sales and construction is another.) Without strong conviction, NAB is looking for a 1% rise in residential building approvals for October. While there is a lot of attention on the apartment space, it's becoming clearer that the detached housing cycle is building a little momentum.

China: Thursday's official Manufacturing and Non-manufacturing PMIs will be the main focus points, a very

Chart 2: Life yet in the housing cycle



small pull-back to 51.5 in November from 51.6 expected as government heavy industry cutbacks only gradually seep through. The Caixin Manufacturing PMI is out Friday; it's expected to be steady.

US: Q3 GDP is expected to be revised up to 3.2% from 3.0% (Wednesday), with interest then in whether Thursday's Core PCE deflator in the month ticks higher to 0.2% m/m in October from 0.1% m/m in September, and in the growth of US Manufacturing, the ISM index expected to be at a still punchy 58.3. Along with the appearances before Congress of Powell (Tuesday) and Chair Yellen's testimony on Wednesday there are several other Fed speakers scheduled.

Japan: Most market interest will be in Friday's CPI. Again static and low? There are three BoJ speakers, one on Wednesday, two on Thursday.

Eurozone: The main interest is likely to revolve around Thursday's preliminary November CPI.

UK: It's a very light week for UK data. BoE Deputy Ramsden speaks on Monday.

Canada: The BoC releases its Financial System Review Thursday, followed by a press conference from the BoC Governor Poloz and Deputy Governor Wilkins.

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Chart 1: Business capital expenditure at a turning point

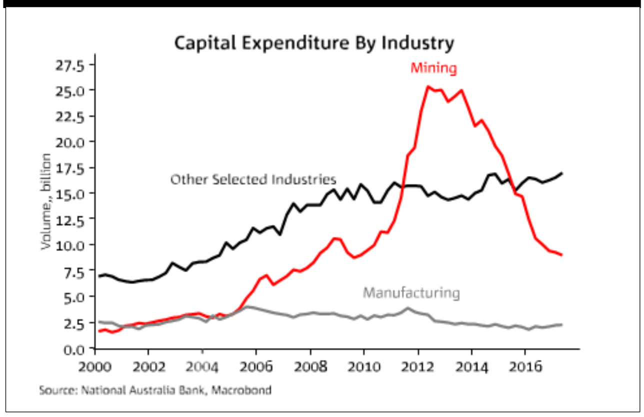
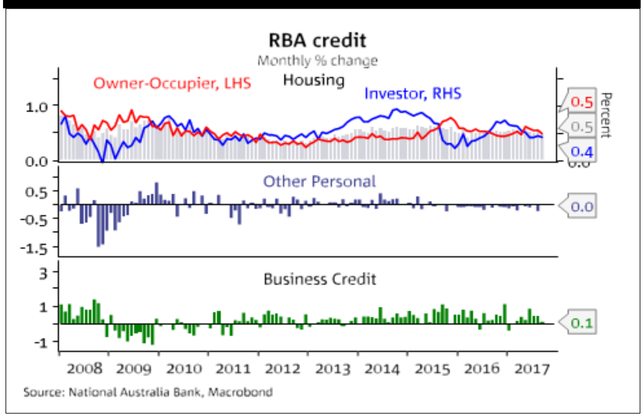


Chart 3: The evolving credit story



Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

Not a lot of action has been going on, with the RBNZ firmly on hold and global bond markets range-bound. The key theme at the short end of the curve remains a well-funded banking system that is keeping a lid on the 90-day bank bills-cash spread around 16bps, with no immediate threat of things changing.

This in turn is keeping a lid on the 2-year swap rate, which continues to hover around the bottom end of its range this year, currently at 2.16% and threatening the year-to-date low of 2.13%. The next MPS isn't scheduled until early February, which seems a long time away. Expect a tightly range-bound short end until then.

This week sees the release of the RBNZ's Financial Stability Report. The Statement is expected to outline a roadmap for the removal of LVR restrictions. The six-monthly report isn't usually market-moving. An eventual loosening up on macro-prudential policy paves the way for monetary policy to do some work, but this isn't a story until the second half of 2018.

The ANZ business outlook survey on Thursday is expected to show business confidence slumping further, being the first clean read since the new government was formed. We'd ignore the grumpiness of business. It's worth noting that Labour governments typically result in a step down in business confidence for the duration of the government, without any adverse impact on the economy.

On the global scene, the US Treasury curve continues to flatten, with the 2s10s spread falling as low as 58bps last week. The key driver behind this is a 2-year rate trending higher as further Fed tightening comes into focus, while the 10-year rate has stuck to a mostly 2.30-2.40% range for much of the past couple of months.

We're not interpreting the flattening curve as a sign of pending economic weakness. We see the long end of the curve distorted by the size of central bank balance sheets, with the ECB still buying bonds every week serving to keep rates suppressed.

It's certainly not helping that global inflation has yet to take off despite some of the best global growth conditions since the GFC. We had the FOMC minutes last week suggesting that "…many officials observed that low inflation might reflect not only transitory factors, but also the influence of developments that could prove more persistent". Until we get a significant inflation surprise, it seems that long rates will remain well contained.

At the end of the week the US PCE deflators are released, which should show core inflation nudging up a little, as indicated by previously released CPI data. Ahead of that both Yellen and Powell are both speaking, which could come across as dovish if they both lament the lack of inflationary pressure at present.

Like the short end, longer-dated NZ swap rates remain near the bottom end of this year's ranges. Risks feel skewed to the upside for 5 and 10-year rates, but with no immediate threat of that in the near term.

Rising US short term rates and softer NZ rates continue to put downward pressure on the NZ-US 2-year swap rate, now down to a fresh low for the cycle of 24bps. This is keeping downward pressure on the NZ-US 10-year bond spread, which is down to 44bps. Further Fed rate hikes while the RBNZ remains on hold suggest further downward pressure for the short-term spread. It's therefore hard to see the NZ-US 10-year bond spread blowing out in a hurry and we await more visibility on the RBNZ tightening cycle for a reversal of trend, still some time away.

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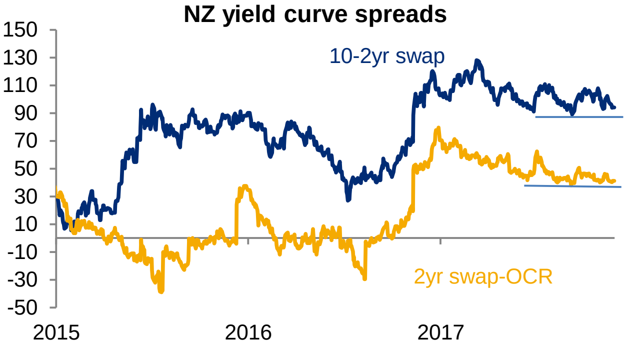
Flatter Curves



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.91	1.91 - 1.94
NZ 2yr swap (%)	2.16	2.14 - 2.22
NZ 5yr swap (%)	2.61	2.59 - 2.73
NZ 10yr swap (%)	3.11	3.08 - 3.26
2s10s swap curve (bps)	94	94 - 103
NZ 10yr swap-govt (bps)	32	27 - 34
NZ 10yr govt (%)	2.79	2.75 - 2.97
US 10yr govt (%)	2.34	2.30 - 2.41
NZ-US 10yr (bps)	44	43 - 59
NZ-AU 2yr swap (bps)	28	25 - 30
NZ-AU 10yr govt (bps)	28	23 - 32

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The key theme last week was a softer USD as we saw some doubt from the Fed about the nature of the recent weakness in US inflation. Fed Chair Yellen noted "…my colleagues and I are not certain that it is transitory, and we are monitoring inflation very closely". This was followed by minutes of the last FOMC meeting that revealed "…many officials observed that low inflation might reflect not only transitory factors, but also the influence of developments that could prove more persistent".

This saw the NZD up 1% for the week to 0.6880, removing the immediate threat of breaking down further, with the previous week's low around 0.6780 a key support level. Despite another surprisingly weak GDT dairy auction – the fourth consecutive fall in pricing – the NZD managed to hold its ground or show modest gains on most of the other crosses. This might suggest that the selling pressure we've seen in the NZD over recent months might now be over.

The ANZ business outlook survey on Thursday is expected to show business confidence slumping further, being the first clean read since the new government was formed. We'd ignore the grumpiness of business – the impact on economic activity is not expected to be significant. Any possible short-term negative NZD reaction to this release is expected to be transitory.

Ahead of that, the RBNZ's Financial Stability Report is expected to outline a roadmap for the removal of LVR restrictions. The six-monthly report isn't usually market-moving but at the margin a loosening up on macro-prudential policy is slightly NZD-positive at the margin.

The only major currency we follow that the NZD fell against last week was against EUR, with NZD/EUR down slightly and threatening to continue to trend lower. Data showed the euro-area economy booming with fresh highs in the PMIs and business confidence in Germany.

Meanwhile, it boggles the mind why the ECB will still be buying bonds right through to at least September 2018 to keep interest rates suppressed. It feels a safe bet to conclude that the EUR will be forced to do the heavy lifting while the ECB sits on its hands. The next support level for NZD/EUR is around 0.5550. A weaker NZD/EUR has been our strongest conviction call and we see no reason to back away from that view. CPI data late in the week is expected to show euro-area core inflation remaining soft at 1.0%.

Other news to watch on the international calendar are comments from Fed Chair Yellen at her semi-annual testimony to lawmakers and her replacement Powell, speaking at his Senate confirmation hearing. The risk is that they come across as dovish as they note the soft inflation backdrop. Focus will shift back to US tax policy as the Senate votes on the tax reform bill. Even if the Senate does vote for the tax reform bill there are further hurdles to cross, namely a reconciliation between the House and Senate versions. Key US data are at the end of the week, including the PCE deflators and ISM manufacturing index.

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Cross Rates and Model Estimates

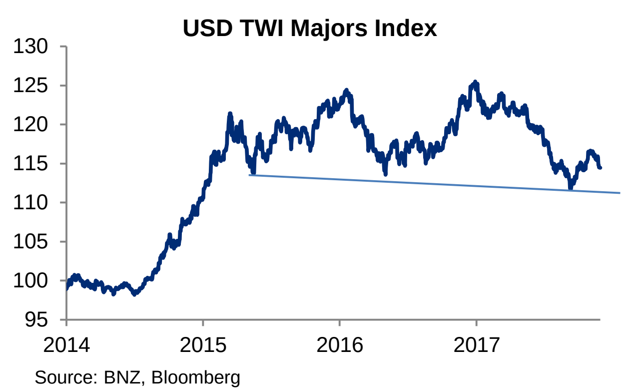
	Current	Last 3-weeks range*
NZD/USD	0.6886	0.6780 - 0.6980
NZD/AUD	0.9033	0.8980 - 0.9100
NZD/GBP	0.5161	0.5120 - 0.5320
NZD/EUR	0.5770	0.5740 - 0.6010
NZD/JPY	76.72	76.10 - 79.50

*Indicative range over last 3 weeks, rounded figures

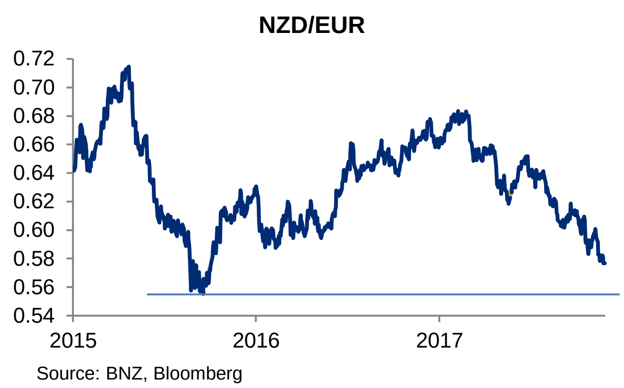
BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7180	-4%
NZD/AUD	0.8900	1%

USD Heading Lower Again



NZD/EUR Downturn Not Over Yet



Technicals

NZD/USD

Outlook:	Downside risk
ST Resistance:	0.7050 (ahead of 0.7200)
ST Support:	0.6780 (ahead of 0.6675)

The NZD performed better last week but is still vulnerable to the downside, with the recent low of 0.6780 the key support level, ahead of the June 2016 low of 0.6676. Resistance is well north of current spot, likely just over the 0.70 mark.

NZD/AUD

Outlook:	Downside risk
ST Resistance:	0.9170 (ahead of 0.9230)
ST Support:	0.8975 (ahead of 0.8875)

The 0.8975 level remains a weak level of support ahead of 0.8875. Resistance is well north of spot, around 0.9170.

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NZ 5-year Swap Rate

Outlook:	Neutral
ST Resistance:	2.79
ST Support:	2.545

Ranges holding at present so initiate a paid position around 2.58 and put a stop through 2.545.

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

Outlook:	Neutral
ST Resistance:	+54
ST Support:	+41

Ranges holding. Trade +54/+41 range with tight stops.

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Key Upcoming Events

	Forecast	Median	Last
Monday 27 November			
China, Industrial Profits, October y/y			+27.7%
US, Fed's Dudley Speaks			
US, New Home Sales, October		625k	667k
Tuesday 28 November			
Euro, M3, October y/y		+5.1%	+5.1%
Euro, Consumer Confidence, Nov 2nd est		+0.1	+0.1P
UK, Carney Speaks, FSR			
US, Wholesale Inventories, Oct 1st est		+0.4%	+0.3%
US, Consumer Confidence, November		124.0	125.9
US, Shiller Home Price Index, September y/y		+6.1%	
US, Fed's Powell Testifies			
US, International Goods Trade, Oct advance		-$65.0b	-64.1b
Wednesday 29 November			
NZ, RBNZ Fin. Stability Report			
Jpn, Retail Sales, October y/y		flat	+2.2%
Euro, Economic Confidence, November		114.6	114.0
Germ, CPI, Nov y/y 1st est		+1.7%	+1.6%
UK, Carney Speaks, FMSB Event			
US, GDP, Q3 2nd est		+3.2%	+3.0%P
US, Fed's Dudley Speaks, US Economy			
US, Pending Home Sales, October		+1.1%	flat
US, Yellen Testifies, Before Congress' JEC			
US, Beige Book			

	Forecast	Median	Last
Thursday 30 November			
NZ, ANZ Business Survey, November			-10.1
NZ, Credit Aggregates, Oct (household y/y)			+6.5%
NZ, Building Consents, October (res, #)			-2.3%
Aus, Private Sector Credit, October	+0.4%	+0.4%	+0.3%
Aus, Private New Capex, Q3	+1.0%	+1.0%	+0.8%
Aus, Building Approvals, October	+1.0%	-1.0%	+1.5%
China, Non-manufacturing PMI, November			54.3
China, PMI (NBS), November		51.5	51.6
Jpn, Industrial Production, Oct. 1st est		+1.8%	-1.0%
Euro, CPI, Nov y/y 1st est		+1.6%	+1.4%
Euro, Unemployment Rate, October		8.9%	8.9%
US, Personal Spending, October		+0.3%	+1.0%
US, Chicago PMI, November		62.5	66.2
Friday 1 December			
NZ, Terms of Trade, Q3	+1.3%	+1.3%	+1.5%
NZ, QVNZ House Prices, November y/y			+3.9%
China, PMI (Caixin), November		51.0	51.0
Jpn, CPI, October y/y		+0.2%	+0.7%
Jpn, Capital Spending, Q3 y/y		+3.2%	+1.5%
UK, Markit/CIPS Manuf Survey, November		56.5	56.3
US, Construction Spending, October		+0.5%	+0.3%
US, Fed's Kaplan/Harker Speak			
US, ISM Manufacturing, November		58.3	58.7

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	1.75
1mth	1.77	1.77	1.79	1.90
2mth	1.84	1.84	1.86	1.98
3mth	1.91	1.92	1.95	2.03
6mth	1.94	1.95	1.98	2.07
GOVERNMENT STOCK				
03/19	1.83	1.84	1.87	2.11
04/20	1.95	1.98	2.02	2.29
05/21	2.09	2.12	2.17	2.45
04/23	2.37	2.40	2.48	2.73
04/25	2.63	2.65	2.77	2.97
04/27	2.78	2.80	2.98	3.10
04/33	3.15	3.16	3.33	3.46
04/37	3.37	3.37	3.52	3.72
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	67	68	65	110
Nth America 5Y	52	55	53	74
Europe 5Y	49	51	51	82

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.16	2.16	2.16	2.25
3 years	2.32	2.33	2.33	2.43
4 years	2.47	2.49	2.50	2.60
5 years	2.61	2.63	2.66	2.75
10 years	3.11	3.12	3.20	3.25
FOREIGN EXCHANGE				
NZD/USD	0.6878	0.6809	0.6876	0.7073
NZD/AUD	0.9030	0.9019	0.8944	0.9454
NZD/JPY	76.70	76.69	77.83	79.17
NZD/EUR	0.5767	0.5803	0.5902	0.6664
NZD/GBP	0.5163	0.5145	0.5207	0.5696
NZD/CAD	0.8741	0.8729	0.8824	0.9486
TWI	72.6	72.6	73.0	78.0

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