28 August 2017

Record Terms

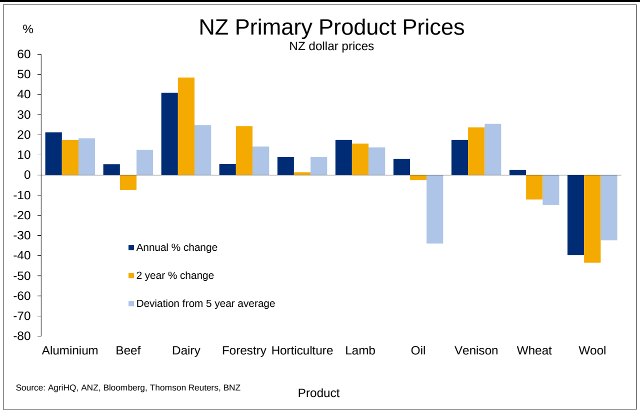
- Terms of trade to hit record
- Higher export prices the latest plus
- But subdued import prices important too
- Q2 trade volumes to support our robust GDP view
- How are businesses feeling pre-election?
- Building consents, house prices, credit data due

A strong support to the NZ economy over recent years has been a high terms of trade. That is, the ratio of export prices to import prices. The terms of trade ultimately determine how many imports can be bought for a given amount of exports; an increase represents a lift in purchasing power. The terms of trade have been trending higher over recent years boosting national income in the process and supporting all manner of things like saving, demand, growth and the external and fiscal accounts.

A recent lurch higher in primary product export prices is the latest development expected to take the terms of trade to new heights (that is some feat with data extending all the way back to the 1860s). We have long forecast the merchandise terms of trade to hit a record level in 2017, which we think Friday's figures for Q2 will confirm. Specifically, we expect a 2.4% gain in the quarter taking the annual gain to 12.6%. This would see the quarterly terms of trade not only exceed its 1973 peak but also pass the annual levels during the Korean War induced (wool) boom of the early 1950s.

The implications of the current terms of trade boom are many and varied and shouldn't be underestimated. The influence of strong terms of trade pervades many areas of the economy. It is not just a strong dairy payout, although a $6.75 milk price forecast (that we lifted to last week) is certainly part of it. It is also strong export pricing elsewhere with most primary prices above their 5 year averages. Overall, we expect export prices in Q2 to be 2.8% higher in the quarter (with strong gains in dairy and meat prices), and up 13.3% on a year ago.

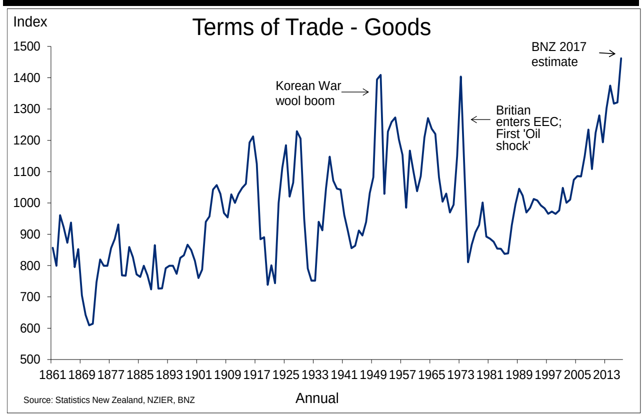
Many Export Prices Above 5-Year Average



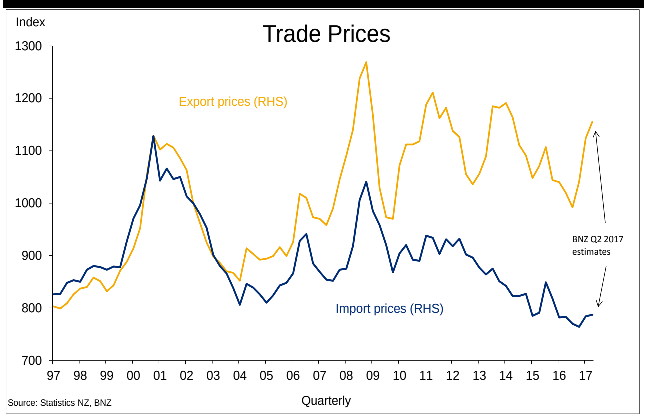
Importantly, currently strong export prices are not a function of a weaker currency. This is market driven strength. Indeed, buoyant offshore export pricing supports the NZD that, in turn, keeps a lid on import prices. We think import prices rose 0.4% in Q2, taking annual inflation to 0.5%.

But low import price inflation has been driven by many components, including lower prices for oil and technological goods. Such things have seen import prices actually trending lower over the past five years or so. It has been another critical factor pushing the terms of trade higher. Low import prices have also been an important part of the generally low inflation environment in New Zealand over that period. It raises the question whether domestic policy can or should try to offset such forces on domestic prices, at least in the first instance.

Terms of Trade To Hit Record



Import Prices Subdued



National Australia Bank

It all adds up to stronger purchasing power that supports demand and economic growth. That purchasing power was evident in strong retail sales growth in the first half of 2017 (over and above the influence of strong population growth and additional boost from sporting events, and despite a general slowing in the housing market). This helps support our view of robust economic growth in Q2. Friday's trade figures will also provide some direct input into this and could influence our thinking via its trade volume measures. We expect OTI merchandise export volumes to record a sizeable rebound in Q2, while import volumes are expected to post solid expansion indicative of the state of domestic demand.

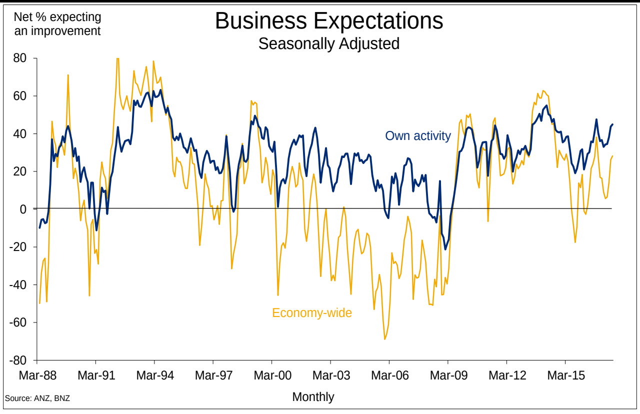
Business (and consumer) confidence has been buoyed by elevated terms of trade. But how are NZ firms feeling going into next month's election? We'll get insight into this with August's ANZ business survey released on Thursday. So far at least, it has not conveyed election jitters, as confidence and activity expectations have stayed strong. But with recent gyrations in the political polls, and more policy ideas revealed, any assumptions of business-as-usual might be starting to be questioned with respect the government policy. It wouldn't surprise us if confidence peeled back a bit from July's 19.4. We will also be interested in the latest inflation pointers within this survey, after they eased marginally in July.

For the other data out this week, it kicks off on Wednesday with July's building consents. Indicators from the industry have been running into some turbulence this year, albeit at very high altitude. So it will be interesting to see if these consents can help give a sense of direction, having regained poise over recent months, after swooning a bit late last year.

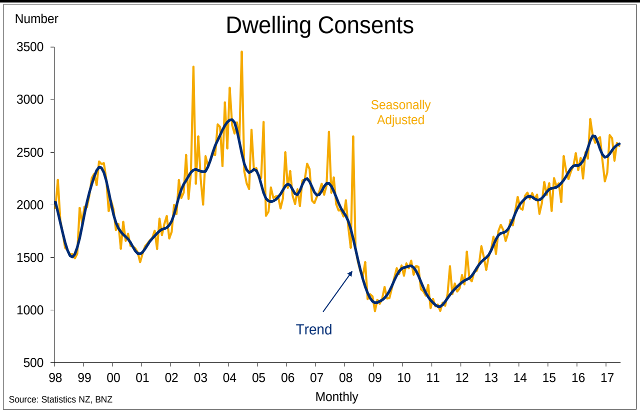
For Thursday's credit aggregates we can imagine that annual growth in the stock of housing credit continued to slow in July, from 7.7% in June. This is given the reduction in new residential lending, and housing market turnover, we've seen for the month. But has consumer credit continued to accelerate, after picking up to 6.5% y/y in June? Business credit, for reference, was running at 6.2% y/y in June while agriculture credit growth arrested its recent slide, edging up to 2.6% in June from 2.2% in May.

Further insight into the housing side of things will be provided by Friday's QVNZ housing report. A further slowing in its measure of annual house price inflation, from +6.4% in July, seems inevitable. The only question is by how much. But the real value will be in the anecdotal reports, to detect whether the clear fall in activity is 'just' election nerves or the start of a more fundamental correction in home prices. In any case, it will likely take a few months post-election and into the more liquid spring trading period to make an informed judgment.

Any Election Jitters?



Looking For Direction



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Global Watch

- US data to watch: payrolls, ISM, PCE deflator
- Trump's tax announcement due Wednesday
- Chinese PMIs to ease a touch?
- AU Q2 Construction and Capex guides to GDP

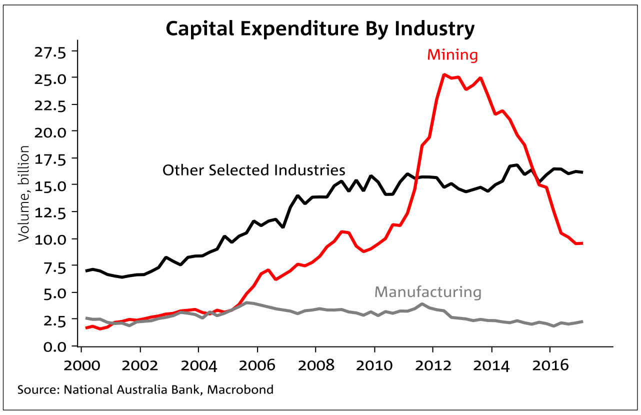
Australia: The major data releases don't start until Wednesday when Q2 Construction Work Done and July Building Approvals are released. That's followed Thursday by Q2 Capex and RBA Credit ahead of a host of second-tier data that includes the AiG and CBA Manufacturing PMIs for August, the full month August CoreLogic Home Values report and the RBA's August Commodity Price Index.

There is also Panel Participation from the RBA's Sarah Harris, Deputy Head of Financial Market Infrastructures, Payments Policy Department, at the Risk Australia 2017 Conference. We do not expect this to be market sensitive by nature of the conference and the closeness of the RBA Board meeting next Tuesday.

After falling back from a resource-driven peak in 2012-13, Construction Work Done has been broadly steady for the past two quarters as Engineering Construction has levelled out. Last quarter's Building Activity decline (-4.7%) was likely heavily affected by very wet weather in Queensland, with some of those effects possibly carrying over into the June Quarter in the aftermath of Cyclone Debbie. There will very likely be catch up, though those full effects might not be fully apparent until the September report is available in late November.

For the equally volatile Engineering Work Done component, a pull-back in Mining investment from the further (near to) completion of major LNG projects could weigh on this element. Other reports point to a degree of catch up in operating and maintenance capital spending to restore mines and infrastructure to capacity after the large cut to costs and spending that in hindsight might have

Mining Near to the Bottom



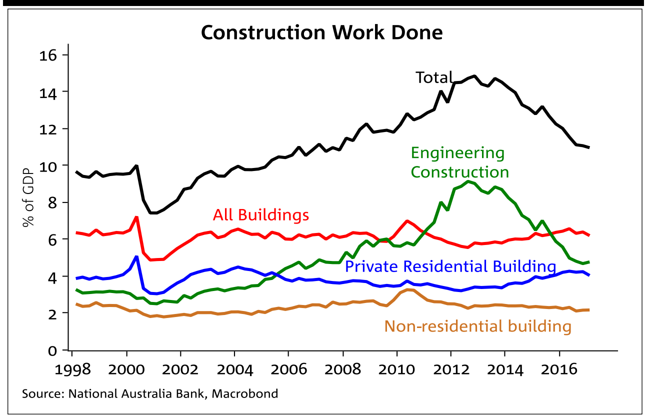
gone too far. Infrastructure spending, led by state governments, has also been rising in trend terms.

All up, NAB looks for a 1% net gain in Construction Work Done, recognizing the several diverging elements to this aggregate measure affected by mining, residential building, non-residential building, and domestic infrastructure spending.

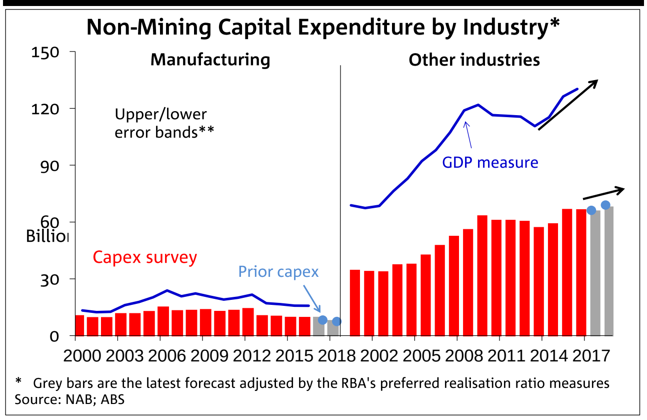
Also being released on Wednesday is the July Building Approvals report. After last month's surprise rise of 10.9% from a 4.0% increase in house approvals and a 20.1% increase in "other dwelling" (apartments) approvals, NAB looks for partial payback this month.

NAB's forecast is for a decline of 4.0%. Unit development activity looks to have been capped for now in the wake of further APRA constraints on lending announced at the end of March. On the other side of the coin, additional stamp duty concessions and additional grants for first home buyers from the start of the new financial year from state governments could might well bring forward an element of housing demand in an environment of improving employment prospects, supporting residential building approvals in coming months. Thursday's HIA New Home Sales report for July will be viewed in that light, sales in June down 6.9% and

The Construction Evolution



Non-Mining Intentions Are Lifting



likely crimped as first home buyers delayed purchase to take advantage of the additional incentives.

Thursday sees release of Q2 Capex and July RBA credit. NAB looks for a small decline of 1.0% after last quarter's 0.3% gain. As a measure of private capital expenditure, this measure is less impacted by state government infrastructure spending only to a limited extent. The March quarter Capex report expectations for 2016-17 pointed to a hefty 20% decline in Mining investment in Q2, weighing on likely spending in Q2. Against that, signs of rising non-mining investment and hints of some "catch up" in resource-sector spending to maintain equipment and production would be some offset. NAB also looks for a modest upgrade to Capex expectations for 2017-18 on the back of improving business confidence and signs of higher levels of business activity, including from profitability. For 2017-18, NAB looks for expected capital spending of $95bn, up from $84.4bn reported in March, partly from a genuine upgrade and partly from the usual uplift that occurs closer to the start of the new financial year.

As for RBA credit growth, we look for another month of 0.5% growth, likely reflecting some possible slowing in investor credit but steady to higher owner-occupied mortgage credit. Business credit growth was elevated in June and might ease in July.

US: Market interest centres on Friday's ISM Manufacturing/Payrolls double header, both expected to be solid. Thursday's PCE deflators will be trawled for any emerging inflation, as will payrolls. The second estimate of Q2 GDP is expected to be revised marginally higher. Also watch for any tax announcement from President Trump on Wednesday.

China: The official Manufacturing PMI (Thursday) is expected to reveal a further slight moderation. The accompanying Non-manufacturing PMI is also released then, followed Friday by the Caixin Manufacturing PMI, expected to reveal a slight slowing.

Japan: Retail Sales (Tuesday) and Industrial production (Thursday) of market interest.

Eurozone: Wednesday's Confidence surveys to improve further, followed by higher headline/ steady core CPI (Thursday).

UK: House prices, consumer-mortgage finance and the Manufacturing PMI out.

Canada: Thursday's June/Q2 GDP reports expected to reveal slower growth.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The short end of the NZ rates curve remains without a pulse. With policy rate hikes off the agenda for an extended period and no clarity on the next government, the next permanent Governor or the next Policy Targets Agreement it is not surprising that the market has no appetite to trade.

So the 2-year swap rate barely budged last week, remaining in a tight 2.15-2.20% range and the first full rate hike isn't priced until November 2018. Any movement over coming weeks is likely to reflect flow and global rate gyrations. Local data due this week isn't expected to change market expectations. A pre-election fall in business confidence in the ANZ monthly survey, potentially quite large, wouldn't come as a surprise.

The longer end of the curve is more interesting, with yields close to year-to-date lows and leaves us wondering whether the next move is another lurch down or some reversal of yields back up to mid-range levels.

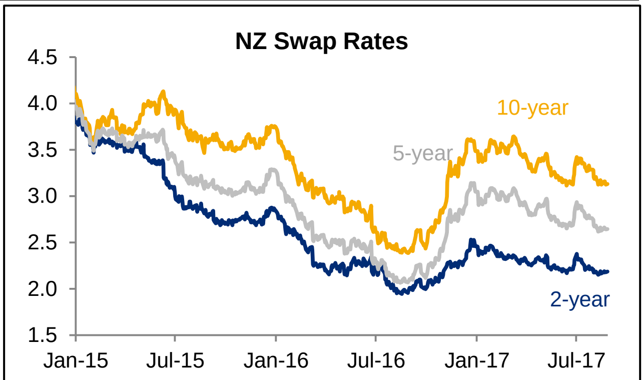
Speeches by Yellen and Draghi at Jackson Hole last week purposefully steered away from the monetary policy outlook. But there is plenty of global data this week to ponder what the next move will be. Euro area CPI inflation data mid-week are expected to be fairly flat relative to prior readings. The bond market is vulnerable to any positive inflation surprise. Germany's 10-year rate at a nominal 0.38% and real rate of lower than minus 1% still look far too low ahead of the ECB's likely tapering of bond purchases from early next year. US data are not expected to provide a smoking gun for rate hikes. PCE deflator inflation data are likely to remain soft, as indicated by previously released CPI data, while the risk is that wages and non-farm payrolls data at the end of the week are soft relative to expectations. We don't expect Trump's mid-week launch of his tax reform policy to elicit much market reaction. Actions speak louder than words, and with a dysfunctional government there is little confidence that Trump can get his pro-growth agenda back of track.

The US 10-year Treasury yield has drifted down to 2.17% over the past couple of months, approaching the year-to-date intra-day low of 2.10%. This backdrop has helped drive NZ 5 and 10-year swap rates down close to year-to-date lows.

We don't see domestic drivers, including the election, having much impact on the NZ rates curve, so global factors remain in the driving seat. Our working assumption remains that the market underprices the chance of further Fed tightening over the next year or two. And upside to global yields from ECB policy normalisation and the Fed's balance sheet reduction cannot be ignored, although admittedly these are not of immediate concern.

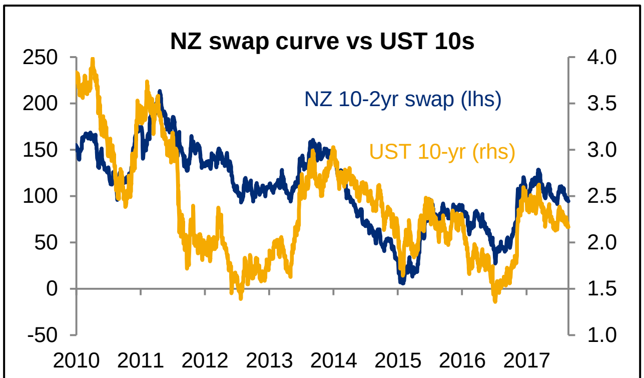
Over coming weeks we see yields consolidating around current levels, but see the next big move, when it comes, more likely to be to the upside than downside for yields.

Swap Rates Close to Year-to-Date Lows



Source: BNZ., Bloomberg

NZ Curve at the Mercy of Long-Term Rates



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.96	1.94 - 1.96
NZ 2yr swap (%)	2.19	2.15 - 2.20
NZ 5yr swap (%)	2.65	2.61 - 2.69
NZ 10yr swap (%)	3.13	3.12 - 3.21
2s10s swap curve (bps)	95	95 - 101
NZ 10yr swap-govt (bps)	25	23 - 36
NZ 10yr govt (%)	2.89	2.78 - 2.92
US 10yr govt (%)	2.17	2.16 - 2.29
NZ-US 10yr (bps)	72	55 - 74
NZ-AU 2yr swap (bps)	25	24 - 29
NZ-AU 10yr govt (bps)	23	17 - 27

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

After stabilising the previous week, selling pressure returned to the NZD last week. We can't help continue to believe that (poor) positioning goes a long way in explaining NZD underperformance this month to date.

Through to the end of July, the NZ TWI had surged by over 5% in the space of a couple of months and net speculative positioning reached a record long level. This made the NZD highly vulnerable to the downside. As it has turned out, not much has been required to provide the knock-out blow. There is a laundry list of slightly negative NZD factors that cumulatively have provided a good reason for traders to trim positions by selling the NZD.

These include the more uncertain general election outcome after three political leaders have recently fallen on their swords, slightly lower NZ commodity prices, some volatility in risk appetite with a move to the downside, and the RBNZ confirming that any rate hikes are a very distant prospect.

Despite the improvement in risk appetite last week as US-North Korean political tensions were removed from the spotlight, the NZD still weakened on all the crosses, including 1% falls against the USD and AUD and NZD/EUR falling 2½% to its lowest level in over a year. The recovery in our risk appetite index to 77% sees our short term fair value estimate rise back up to over the USD 0.75 mark. Our short term view is that NZD/USD consolidates in a roughly 0.72-0.73 zone over coming weeks, before downward pressure resumes.

A weaker NZD/EUR has been our highest conviction view but the steepness of the fall has still been greater than expected. We still see a fairly low hurdle to reach the mid-0.50s as the ECB signals a path towards policy normalisation. But surely the rate of decline will moderate, after the 7% fall in the cross over the past couple of months and 11½ fall in the past six months.

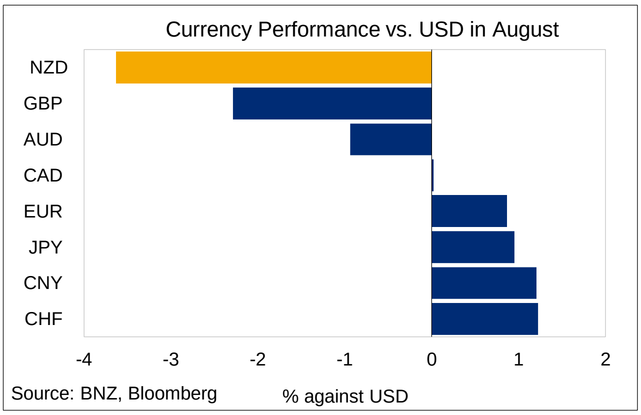
As we noted in a research report last week, the fall in NZD/AUD to below 0.92 has been deserved, and the current spot rate is close to our short term fair value estimate. The cross is at the lower end of the range we'd expect it to trade over the next six months, but that doesn't deny the possibility of slightly further possible downside over the short term. Some of the strong rally in metal prices we've seen over recent weeks that has been supportive of the AUD has a speculative feel to it. An eventual reversal of that trend in metals offers the best chance of NZD/AUD to return to favour.

The week ahead is laden with a number of key US economic releases, with the more important releases at the end of the week. These include the PCE deflators on Thursday night, although soft CPI data suggest that it is too early to see a turnaround in these. Friday night sees the release of the ISM report and the non-farm payrolls report that includes wages. For technical, rather than fundamental, reasons the risk is for US employment and wages to come in on the soft side, providing no fuel for a recovery in the USD.

Trump will be launching a major push on tax reform mid-week with a speech in Missouri. Normally we'd see this as a USD-positive event, but the market has been constantly disappointed with any progress on Trump's pro-growth policy agenda. The market now needs to see action rather than words to bid up the USD for fiscal reasons.

We don't see any potential market-moving events for the local economic calendar this week. Elsewhere, the only other thing on our radar is euro area inflation data for August.

NZD Underperforms in August



Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7243	0.7190 - 0.7370
NZD/AUD	0.9136	0.9110 - 0.9340
NZD/GBP	0.5605	0.5590 - 0.5710
NZD/EUR	0.6064	0.6050 - 0.6270
NZD/JPY	79.09	78.50 - 81.60

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7560	-4%
NZD/AUD	0.9170	0%

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Technicals

NZD/USD

Outlook: Down

ST Resistance: 0.7400 (ahead of 0.7490)

ST Support: 0.7190 (ahead of 0.7100)

The NZD tested key support just below the 0.72 mark last week and it managed to hold, despite the USD not performing particularly well. A break of that level opens up a lot of room to the downside.

NZD/AUD

Outlook: Downside risk

ST Resistance: 0.9400 (ahead of 0.9500)

ST Support: 0.9075 (ahead of 0.8900)

Various (weak) support levels have been broken one by one on the way down. The 0.9075 level is more significant. A break of that opens up a more decisive shift into the high 0.80s.

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NZ 5-year Swap Rate

Outlook: Neutral

ST Resistance: 2.68

ST Support: 2.61

Very close to a breakout here. Trade a break, below 2.61 opens up 2.51% above 2.68 opens up 2.85.

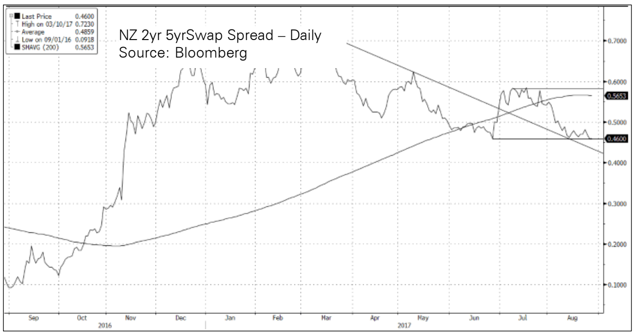
NZ 2-year - 5-year Swap Spread (yield curve)

Outlook: Steeper

ST Resistance: +58

ST Support: +45

Still expect move steeper stop on break of +45.



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Key Upcoming Events

	Forecast	Median	Last
Monday 28 August			
US, International Goods Trade, July advance		-$64.6b	-$64.0b
US, Wholesale Inventories, July 1st est		+0.3%	+0.7%
Tuesday 29 August			
Jpn, Unemployment Rate, July			2.8%
Jpn, Household Spending, July y/y (real)			+2.3%
US, Consumer Confidence, August		120.0	121.1
US, Shiller Home Price Index, June y/y			+5.6%
Wednesday 30 August			
NZ, Building Consents, July (res, #)			-1.0%
Aus, Construction Work Done, Q2		+1.0%	-0.7%
Aus, Building Approvals, July		-5.0%	+10.9%
Jpn, Retail Sales, July y/y			+2.1%
Euro, Economic Confidence, August			111.2
Germ, CPI, Aug y/y 1st est			+1.7%
US, GDP, Q2 2nd est		+2.7%	+2.6%P
US, ADP Employment, August		+185k	+178k
Thursday 31 August			
NZ, Credit Aggregates, July (housing y/y)			+7.7%
NZ, ANZ Business Survey, August			+19.4
Aus, Private New Capex, Q2		+0.2%	+0.3%
Aus, Private Sector Credit, July		+0.5%	+0.6%

	Forecast	Median	Last
Thursday 31 August cont'd...			
China, PMI (NBS), August		51.2	51.4
China, Non-manufacturing PMI, August			54.5
Jpn, Industrial Production, July 1st est			+2.2%
Euro, CPI, August y/y 1st est			+1.3%
Euro, Unemployment Rate, July			9.1%
Germ, Unemployment Rate, August s.a.			5.7%
US, Pending Home Sales, July			+1.5%
US, Chicago PMI, August		58.3	58.9
US, Personal Spending, July		+0.4%	+0.1%
Friday 1 September			
NZ, Terms of Trade, Q2	+2.4%	+2.7%	+5.1%
NZ, QVNZ House Prices, August			+6.4%
Aus, CoreLogic HPI, August			+1.5%
China, PMI (Caixin), August		50.9	51.1
Jpn, Capital Spending, Q2 y/y			+4.5%
Euro, PMI Manufacturing, August 2nd est			57.4P
UK, Markit/CIPS Manuf Survey, August			55.1
US, ISM Manufacturing, August		56.4	56.3
US, Unemployment Rate, August		4.3%	4.3%
US, Non-Farm Payrolls, August		+180k	+209k
US, Construction Spending, July		+0.6%	-1.3%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.82	1.81	1.81	2.08
2mth	1.89	1.88	1.87	2.15
3mth	1.96	1.94	1.93	2.23
6mth	1.98	1.99	1.98	2.21
GOVERNMENT STOCK				
12/17	1.79	1.79	1.79	1.80
03/19	1.89	1.87	1.92	1.78
04/20	2.03	2.01	2.11	1.78
05/21	2.17	2.14	2.26	1.79
04/23	2.47	2.43	2.56	1.93
04/25	2.73	2.70	2.77	2.11
04/27	2.89	2.84	2.91	2.25
04/33	3.27	3.22	3.25	2.56
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	72.67	77	78	101
N. AMERICA 5Y	59.72	62	57	71
EUROPE 5Y	55.89	59	52	68
SWAP RATES				
2 years	2.19	2.18	2.22	1.99
3 years	2.36	2.34	2.42	2.01
5 years	2.65	2.65	2.76	2.12
10 years	3.13	3.14	3.26	2.46

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7252	0.7309	0.7441	0.7257
NZD/AUD	0.9129	0.9221	0.9407	0.9528
NZD/JPY	79.28	79.89	82.52	72.90
NZD/EUR	0.6068	0.6218	0.6376	0.6422
NZD/GBP	0.5620	0.5678	0.5720	0.5557
NZD/CAD	0.9047	0.9202	0.9335	0.9357
TWI	76.24	77.20	78.87	77.00Date

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