29 May 2017

Eyeing A Record

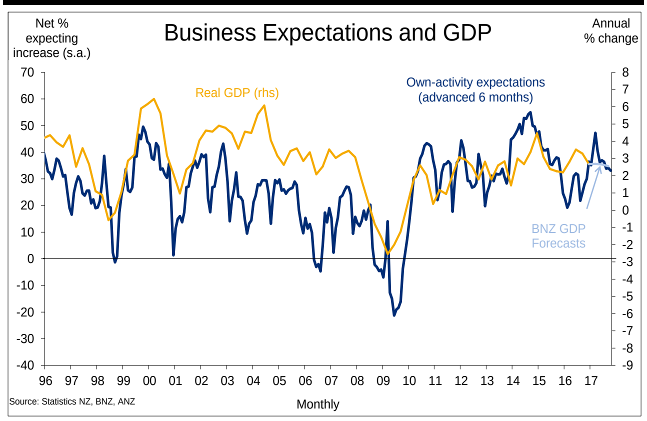
- Businesses to remain optimistic?
- Terms of trade eyes record, as commodity prices swing higher
- Fiscal expansion has us mulling growth forecast upgrade
- RBNZ FSR expected to focus more on housing, less on dairy

The NZ economy continues to perform well. The latest broad indicator will come via Wednesday's ANZ business survey. While its confidence index moderated to about average in April, respondents maintained a strong outlook regarding their own activity, employment, investment and profitability. With this there have been signs of stretched capacity and a firming intent to raise prices. We haven't seen anything in the past month or so to change this narrative, so we expect May's edition of the business survey to reiterate these broad themes.

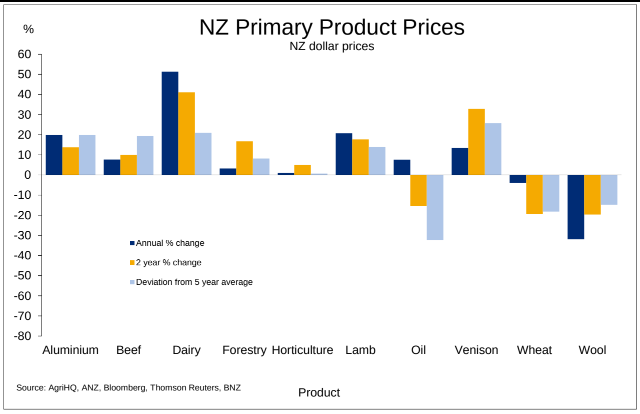
A budding tailwind to the economic momentum is a burgeoning upswing in primary product prices. This was highlighted last week as Fonterra revised up its forecast milk price for the current dairy season to $6.15 per kilogram of milksolids, from $6.00 previously forecast and the woeful $3.90 achieved in the previous season. Moreover, Fonterra opened with a firm $6.50 forecast for the upcoming 2017/18 season. While the latter will depend on how market conditions evolve from here, overall the announcement is positive news for a sector that has been doing it tough over recent seasons.

Importantly, many primary product prices are looking better. In NZD terms, not only are they higher than a year ago but also currently sit above their respective 5-year averages. This includes dairy, beef, forestry, horticulture, lamb and venison. In short, current price strength is broad-based driven by price gains in offshore markets.

Positive



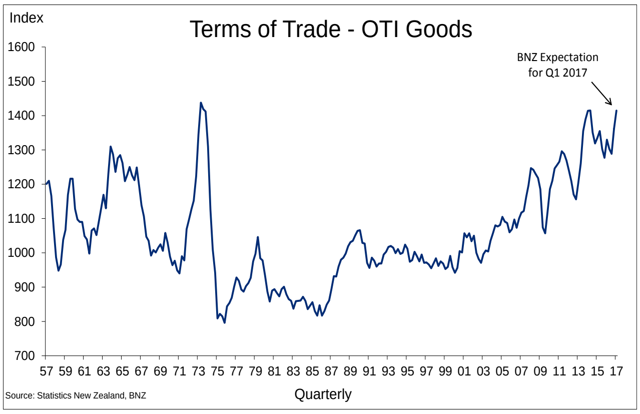
Broad-Based Strength



We expect the commodity price upswing to start showing up in this Thursday's Overseas Trade Indexes. We anticipate the OTI terms-of-trade measure for the March quarter to go close to its highest level since the early 1970s, with a quarterly increase of 3.9% (to be up 6.4% on a year earlier). The quarterly lift is the result of an anticipated primary-product-inspired 4.5% increase in export prices and an expected 0.6% increase in import prices. Moreover, we expect a further lift in the terms of trade in the second quarter to threaten the early 1970's high and maybe even the early 1950's all-time high. On the volume side in Thursday's figures, we expect a mildly positive net export story with regards for Q1 GDP calculations (compared to the horribly net negative result in the previous quarter).

Don't underestimate the importance of gains in the terms of trade to elevated levels. After all, it represents a substantial boost to nominal income that will ultimately support activity. A higher terms of trade is also helpful for the external accounts and, as we saw in last week's

Toward Record Levels

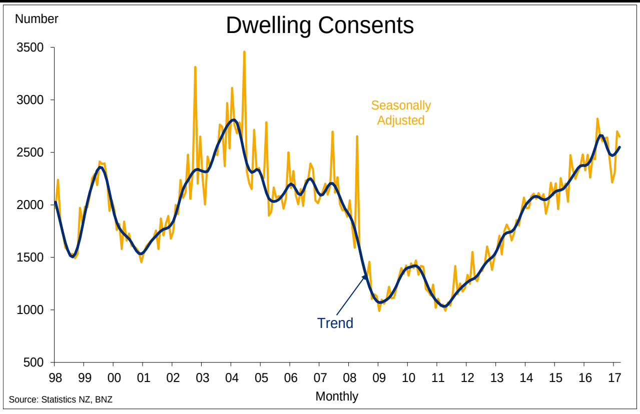


Government Budget, it is one factor supporting a higher tax base providing options for policy. Speaking of which, we are still working through the detail of the net economic stimulus measures announced in the Budget as we mull a potentially significant upward adjustment to our economic growth forecasts.

As primary prices have improved, some question marks have arisen around momentum in parts of the housing market and related activity. On the latter note that April's building consents are due tomorrow (10:45am), although are unlikely to provide much clarity. Their residential component in March essentially consolidated the massive jump logged for February. Still, we prefer to see some more in the way of monthly increase, to make sure the swoon that consents went through late last year was, in fact, mostly a timing issue. But, being April, watch again for trading-day dents (as looks to be the case in some other April data we've already witnessed).

This could even be an issue for Friday's (3:00pm) money and credit aggregates although, as stock measures, they tend to be less volatile than the flow measures, such as new-lending (which did look very weak in last week's data for the month). This is an area to watch in case there is more to it that holiday timing (and severe weather during April). May's Quotable Value NZ housing report is due out first thing on Thursday morning (5am). We expect some further mild slowing in the annual rate of house price inflation, from April's 11.1%.

Beware April Holidays / Severe Weather



The Reserve Bank is scheduled to publish its 6-monthly Financial Stability Report on Wednesday (9.00am). This should recognise that the dairy industry is coming out of its hole. However, in terms of the other main sore point over recent reports, the housing market, there has been scant sign that its threat to financial stability is fading into the background. Indeed, the RBNZ has increasing amounts to talk about in this space. The FSR will no doubt include impact analysis of the latest loan-to-value ratio (LVR) restrictions introduced last year and now with some time passed. We would also expect the NZ central bank to keep making the case for a debt-to-income lending cap tool (even though the government is still sounding unconvinced about granting such a lever to the RBNZ).

doug_steel@bnz.co.nz

Global Watch

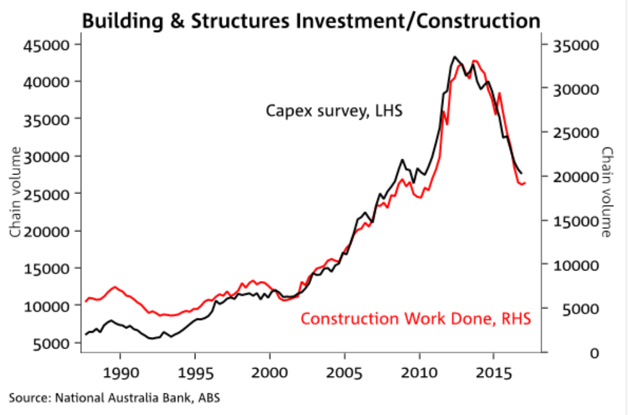
- US payrolls, wages, inflation data due
- Chinese PMIs expected to ease
- Draghi at Committee on Monday
- Capex and retail sales the data focus in Australia

Australia

For Capex on Thursday the Work Done report released last week points to a steadier level of Building and Structures spending in the quarter. Nevertheless, we are mindful the two reports are not directly comparable with the Capex survey excluding sectors such as health, education and agriculture. NAB's expectation therefore is that overall capital spending in the March quarter declined in the order of 1.5% q/q, which is weaker than the market consensus of +0.5% q/q.

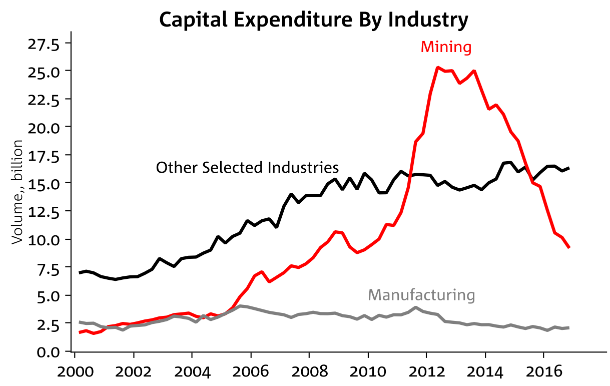
Along with the estimate of spending in the March quarter, Capex also contains an estimate of likely expenditure for 2017-18, polled in April-May when business Confidence was showing signs of rising. For the 2017 financial year, NAB's forecast is $87.1 billion, marginally higher than in the previous survey, when expectations were for spending of $80.6 billion. Most of this upward revision reflects the usual seasonal firming of plans, rather than a material uplift.

Chart 1: Buildings and Structures steadier



Source: National Australia Bank, ABS

Chart 2: Looking for the next investment spending spur



Source: National Australia Bank, Macrobond

The Retail Sales report for April will be closely watched as a sign of consumer health and income pressures. Last month again saw a disappointment, with spending in Queensland down and likely affected by the earlier effects from Cyclone Debbie. NAB expects to see only a minor uptick in sales growth this month, a rise of 0.3% forecast. Should sales again underperform, the market will be interested in whether any weakness was concentrated in Queensland and NSW where weather could well have curtailed spending further.

Also on the slate for release are Building Approvals and RBA Credit, also for April, NAB is expecting Approvals to rebound slightly (+3.0% after -13.4% in March), while RBA Credit is expected to be subdued at 0.4% m/m, up only marginally from March's 0.3% increase. AIG Manufacturing PMI and Core Logic house price data are due Thursday.

China

After Monday and Tuesday's Dragon Boat Festival holidays, the main focus will be Wednesday's Official PMIs for May, the Manufacturing PMI expected to ease further to 51.0 from 51.2. Caixin's Manufacturing PMI is out Thursday and is also expected to ease, to 50.2 from 50.3.

US

After Durable goods orders tonight and Monday's holiday, the week kicks off with the April PCE deflators, Personal Income, and Spending and Conference Board Consumer Confidence on Tuesday, ahead of Thursday's Manufacturing ISM report that's expected to be a still solid 54.6 (L:54.8). Then there's the all-important payrolls report on Friday, expected to show a still strong 174k jobs gain and annual growth in average hourly earnings ticking back up to 2.7% from 2.5%, closer to a recent 2.9% peak and again within sight of 3% regarded, more consistent with the Fed's 2% inflation goal. There are yet more Fed speeches and the Fed's Beige Book.

Japan

Tuesday's labour market and Retail Sales reports will draw some attention, but Wednesday's Industrial production report is likely to be of more interest. BoJ Policy Board member Harada speaks on Thursday.

Eurozone

With interest building ahead of the June 8 ECB meeting, President Draghi's appearance before the European Parliament Economic Committee on Monday will be closely watched. There are several other ECB speakers on the schedule. The May CPI report on Wednesday will take most of the data interest.

UK

As the election campaign continues, it's a lighter week for data watchers – note Monday is the Spring Bank Holiday, Thursday's PMI Manufacturing report the highlight, expected to ease to 56.1 (L:57.3)

david.degaris@nab.com.au / tapas.strickland@nab.com.au

Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The short end of the NZ curve remains underpinned by expectations of no change to RBNZ monetary policy for some time. The OIS curve shows about a 50/50 chance of a tightening by March next year and almost a full rate hike by June 2018. That's still over a year away. The RBNZ's message on the inflation outlook has been crystal clear, and we don't see economic data over coming months triggering any change in sentiment.

So this week's ANZ business outlook survey and its reading of inflation expectations should pass with little reaction, even if we see confidence holding up and inflation expectations rising further. Nothing else on the local calendar looks to be potentially market moving. NZ's terms of trade, out this week, are heading towards a record high level. But this factor got no attention in the RBNZ's recent Monetary Policy Statement, so clearly the Bank doesn't see that as relevant to its policy stance.

NZ's 2-year swap rate has traded in a very tight range since the MPS, around 2.20-2.25% and we expect that to continue over coming months.

US long term rates are trading near the bottom of their range this year. The likely delay to any progress on US fiscal stimulus while Trump's administration is under investigation is one factor. More importantly though, US economic data are tending to surprise to the downside. Citigroup's US economic surprise index has plunged from a multi-year high in mid-March to currently its lowest level in a year. Last week's FOMC minutes showed a softened message – members thought "it would be prudent" to await additional evidence confirming the transitory nature of the Q1 slowdown before tightening policy further.

Recent US data suggest a more moderate Q2 GDP recovery, with trade data, inventories and retail sales all coming in softer than expected recently. Soft April CPI data sets the scene for this week's April core PCE deflator reading to dip to around 1.5% y/y. That shouldn't be treated as "news" and this week we'll be paying more attention to the personal spending data and the employment report at the end of the week, particularly wage inflation. Soft readings for these could see further downside pressure on rates.

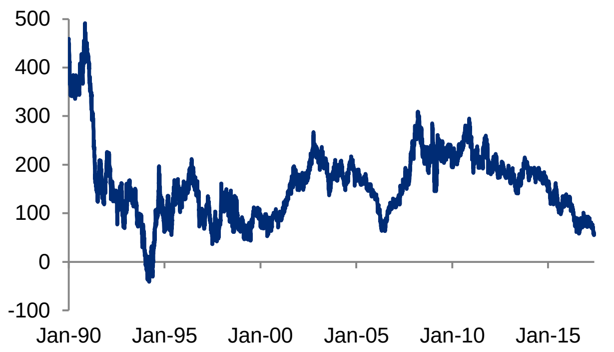
That said, bear in mind the possible asymmetric risks around the rates outlook from here based on market positioning. CFTC data showed further building of speculative long positions in US 10-year futures, with the highest net long positioning in nearly 10 years. This suggests an element of comfort amongst traders that long bond yields are unlikely to rise much from here and might even fall, despite being at the lower end of the current year's trading range.

So it seems that the market is well positioned for some soft economic data continuing and not well positioned for much stronger outturns. Strong data such as a rebound in CPI and wage inflation over coming months could easily see a reversal of fortunes and a quick-fire 20bps sell-off in long rates.

NZ long term rates reached fresh lows for the year last week, helped by the US backdrop and expectations of a fairly muted tightening cycle in NZ, which still looks some distance away. Given the asymmetric risk around US rates, we think that NZ 5-10 year rates might struggle to fall much further from here, and borrowers might like to take opportunities to hedge around current levels. The 5-year rate is getting towards the bottom of the 2.70-2.90% range we see over coming months.

Last week's NZ Budget highlighted NZ's strong fiscal accounts. NZ government bonds on issue are set to decline over coming years, adding to their scarcity attraction, in a world flooded with debt. The NZ-US 10-year government spread has fallen to levels not seen in 18 years, and we don't see much of a hurdle for squeezing down even further.

NZ-US 10-year Govt Spread…Back to the 1990s



Source: BNZ, Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.97	1.97 - 2.00
NZ 2yr swap (%)	2.23	2.20 - 2.37
NZ 5yr swap (%)	2.73	2.72 - 2.99
NZ 10yr swap (%)	3.21	3.20 - 3.48
2s10s swap curve (bps)	99	99 - 112
NZ 10yr swap-govt (bps)	40	36 - 43
NZ 10yr govt (%)	2.81	2.79 - 3.10
US 10yr govt (%)	2.25	2.18 - 2.42
NZ-US 10yr (bps)	56	55 - 71
NZ-AU 2yr swap (bps)	46	40 - 49
NZ-AU 10yr govt (bps)	40	33 - 41

*Indicative range over last 3 weeks

jason.wong@bnz.co.nz

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The NZD showed a solid performance last week, rising by about 2% against the USD, AUD, EUR, JPY and nearly 4% against GBP. There was no good reason for the NZD's significant outperformance over the week other than we have been somewhat puzzled by its underperformance over recent months, so a recovery of sorts has been well overdue.

Last week's recovery saw some of the valuation gap against our short-term fair value estimate (around USD 0.75) close up. That model estimate has been nudged up recently by high levels of risk appetite (near a 3-year high) and the NZ commodity price index that feeds into it rising to a 2½-year high. It seems like the NZD played some catch up last week to these positive fundamental forces.

Given the track record this year of the actual NZD undershooting our fair value model estimate we still harbour some doubt over whether the valuation gap will close anytime soon. If it does close, it might be more likely as a result of eventually lower risk appetite or lower commodity prices which lower the model estimate towards the spot rate. For followers of technical analysis, the 0.71 mark represents an area of resistance.

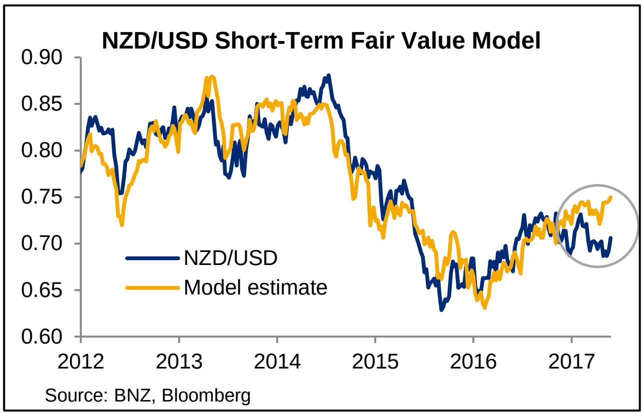
The USD remains generally out of favour, a reflection of a weaker run of economic data – as evidenced by the plunge in the US economic surprise index – and a political risk premium that was built in after investigations began into President Trump's link to Russia interference in last year's election.

We think that the US political risk premium will eventually fade, and help the USD recover. But a near term hurdle is former FBI director Comey's testimony to the Senate Intelligence Committee, which should be soon but a date has yet to be set.

FOMC minutes last week put a June rate hike by the Fed in the spotlight, but the messaging was softened to the extent members thought "it would be prudent" to ensure that evidence confirms the transitory nature of the Q1 slowdown. The clear message is that further rate hikes are data dependent.

This week, the US core PCE deflator for April is expected to show a dip to 1.5% y/y, which would be the weakest inflation in 18 months, hardly supportive of any further Fed tightening. But there's no incremental news there, given that (soft) April CPI data have already been released. More important will be Friday night's US employment report and, in particular, average hourly earnings. Further weakness in wage inflation would be clearly USD-negative, while a recovery in wage inflation would support Fed hikes in June and beyond, supporting the USD.

NZD Still Lagging Positive Fundamentals



They are the key possible market-moving economic releases in the week ahead. It's a fairly full US economic calendar, with other releases of note being consumer confidence and the ISM manufacturing indicator.

The significance of NZ economic data over coming months as a possible currency driver is diminished by the RBNZ's clear policy guidance. We can't see this week's ANZ business outlook survey, the generally most market-sensitive release of those on offer this week, likely to sway the RBNZ from its current stance.

NZD/AUD closed last week at its highest level since early February. We think the current spot rate is now at a fairer level, after the inexplicable weakness over recent months. After a strong recovery from AUD 0.91-0.92, the 0.95 level is expected to mark an area of short term resistance and we expect a consolidation phase to develop over the months ahead.

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7058	0.6820 - 0.7080
NZD/AUD	0.9484	0.9240 - 0.9500
NZD/GBP	0.5511	0.5270 - 0.5520
NZD/EUR	0.6317	0.6160 - 0.6400
NZD/JPY	78.53	76.30 - 79.40

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7500	-6%
NZD/AUD	0.9310	2%

jason.k.wong@bnz.co.nz

Technicals

NZD/USD

Outlook: Downward channel
ST Resistance: 0.7090 (ahead of 0.7250)
ST Support: 0.6970 (ahead of 0.6850)

The NZD has moved up decisively away from recent lows and is nearing the first area of resistance just under the 0.71 mark. There is a big gap to the following level of resistance at 0.7250. The 0.6850 area remains a key level of support, but ahead of that we might see some support emerge just under 0.70.

NZD/AUD

Outlook: Trading range
ST Resistance: 0.9550 (ahead of 0.9650)
ST Support: 0.9270 (ahead of 0.9150)

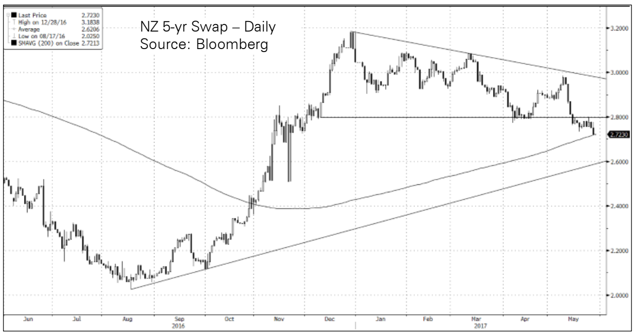
The jumpy recovery from mid-March has been strong and the currency could see some resistance set in around the 0.95-0.9550 mark. The technical picture is fairly messy and we'd put initial support around just under the 0.93 mark.

jason.k.wong@bnz.co.nz

NZ 5-year Swap Rate

Outlook: Neutral
ST Resistance: 2.795
ST Support: 2.59

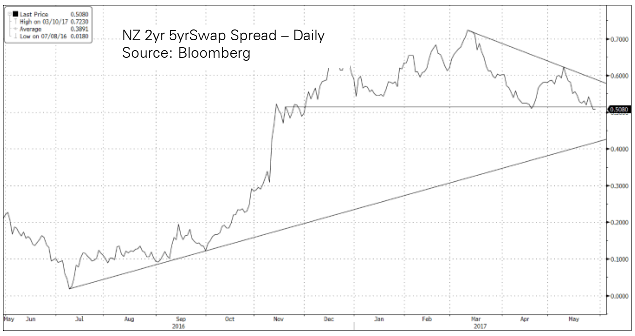
Sitting right on 200 day moving average. A close below here will signal a move to 2.59.



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

Outlook: Flatter
ST Resistance: +59
ST Support: +42

Move through +52 signals a move to trendline support at +42.



pete_mason@bnz.co.nz

Key Upcoming Events

	Forecast	Median	Last
Monday 29 May			
Euro, M3, April y/y			+5.3%
Germ, (circa) Retail Sales, April			+0.1%
US, Fed's Williams Speaks			
US, Holiday, Memorial Day			
Tuesday 30 May			
NZ, Building Consents, April (res, #)			-1.8%
Aus, Building Approvals, April			-13.4%
Jpn, Retail Sales, April y/y		+2.2%	+2.1%
Jpn, Household Spending, April y/y (real)		-0.7%	-1.3%
Jpn, Unemployment Rate, April		2.8%	2.8%
Euro, Consumer Confidence, May 2nd es		t	-3.3P
Euro, Economic Confidence, May			109.6
Germ, CPI, May y/y 1st est			+2.0%
US, Consumer Confidence, May		119.9	120.3
US, Shiller Home Price Index, March y/y			+5.8%
US, Personal Spending, April		+0.4%	flat
US, Fed's Brainard Speaks, Monetary Policy			
Wednesday 31 May			
NZ, ANZ Business Survey, May			+11.0
NZ, RBNZ Fin. Stability Report			
Aus, Private Sector Credit, April			+0.3%
China, PMI (NBS), May		51.0	51.2
China, Non-manufacturing PMI, May			54.0
Jpn, Industrial Production, April 1st est		+4.3%	-1.9%
Euro, CPI, May y/y 1st est			+1.9%
Euro, Unemployment Rate, April			9.5%
Germ, Unemployment Rate, May s.a.			5.8%

	Forecast	Median	Last
Wednesday 31 May cont'd...			
US, Beige Book			
US, Chicago PMI, May		57.0	58.3
US, Pending Home Sales, April		+1.0%	-0.8%
Thursday 1 June			
NZ, Terms of Trade, Q1	+3.9%		+5.7%
NZ, QVNZ House Prices, May			+11.1%
Aus, Retail Trade, April			-0.1%
Aus, Private New Capex, Q1			-2.1%
Aus, Manufacturing PMI (AiG), April			59.2
Aus, CoreLogic HPI, May			+0.1%
China, PMI (Caixin), May		50.2	50.3
Jpn, Capital Spending, Q1 y/y		+3.8%	+3.8%
Euro, PMI Manufacturing, May 2nd est			57.0P
UK, Markit/CIPS Manuf Survey, May		56.1	57.3
US, Construction Spending, April		+0.5%	-0.2%
US, Jobless Claims, week ended 27/05			234k
US, Fed's Powell Speaks, Policy Normalisation			
US, Markit PMI, May 2nd est			52.5P
US, Productivity (non-farm), Q1 saar 2nd est			-0.6%P
US, ADP Employment, May		+180k	+177k
US, ISM Manufacturing, May		54.6	54.8
Friday 2 June			
NZ, Credit Aggregates, April			
Euro, PPI, April y/y			+3.9%
US, Unemployment Rate, May		4.4%	4.4%
US, Non-Farm Payrolls, May		+176k	+211k
US, International Trade, April		-$44.0b	-$43.7b

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.86	1.86	1.84	2.26
2mth	1.91	1.91	1.90	2.32
3mth	1.97	1.97	1.97	2.39
6mth	2.00	2.01	2.02	2.40
GOVERNMENT STOCK				
12/17	1.80	1.81	1.80	2.15
03/19	1.93	1.95	2.13	2.17
04/20	2.10	2.13	2.30	2.20
05/21	2.21	2.27	2.44	2.23
04/23	2.49	2.54	2.72	2.32
04/25	2.69	2.76	2.96	2.57
04/27	2.81	2.86	3.02	2.72
04/33	3.10	3.14	3.30	3.04
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	85.25	84	86	131

	Today	Week Ago	Month Ago	Year Ago
GLOBAL CREDIT INDICES (ITRXX) cont'd...				
N. AMERICA 5Y	62.18	64	67	84
EUROPE 5Y	61.35	63	75	78
SWAP RATES				
2 years	2.23	2.25	2.36	2.30
3 years	2.42	2.45	2.58	2.35
5 years	2.73	2.77	2.92	2.52
10 years	3.22	3.25	3.40	2.91
FOREIGN EXCHANGE				
NZD/USD	0.7050	0.6923	0.7038	0.6773
NZD/AUD	0.9470	0.9306	0.9312	0.9371
NZD/JPY	78.45	77.24	77.45	74.64
NZD/EUR	0.6309	0.6190	0.6471	0.6038
NZD/GBP	0.5503	0.5332	0.5490	0.4672
NZD/CAD	0.9484	0.9373	0.9489	0.8884
TWI	76.45	75.16	76.46	73.11

Contact Details

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Jason Wong
Currency Strategist
+(64 4) 924 7652

Main Offices

Wellington
60 Waterloo Quay
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Global Co-Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891