30 October 2017

Change Brings Costs and Opportunities

- **December's EFU crunch time for policy costing**
- **November MPS will surely forecast higher inflation**
- **Should the RB Act embed financial stability as well?**
- **Q3 pay-equity deal to start LCI on inflationary course**
- **Current NZ data hard to read around the election**

There is so much going on this week – in terms of data and policy issues – it is hard to know where to start. There are a fair few economic reports, for sure. However, they will all be subject to uncertainties related to the recent election cycle, and will thus be hard to read. So we might as well begin with the various policy issues on the table, which are, in turn, entirely relevant to the 9 November RBNZ Monetary Policy Statement (MPS).

As details on the new government's policies continue to emerge, there are questions about not only their impacts on the economy (we're still in a state of flux on this) but also the bottom line of the fiscal accounts. There has been speculation of some sort of a mini-Budget. But absent more clarity on that, we take December's Half-year Economic and Fiscal Update (HYEFU) as being the crunch time for costing the new government's policies. For folk wondering what the inclusion rules are around this, they are set out in the Public Finance Act (which has come to subsume the old Fiscal Responsibility Act of 1994), as follows;

26U Disclosure of policy decisions and other circumstances that may influence future fiscal situation

(1) An economic and fiscal update prepared under section 26O or section 26S or section 26T must incorporate, to the fullest extent possible that is consistent with section 26V, all Government decisions and all other circumstances that may have a material effect on the fiscal and economic outlook.

(2) If the fiscal implications of Government decisions and other circumstances referred to in subsection (1) can be quantified for particular years with reasonable certainty by the day on which the forecast financial statements are finalised, the quantified fiscal implications of those Government decisions and other circumstances must be included in the forecast financial statements.

(3) If the fiscal implications of Government decisions and other circumstances referred to in subsection (1) cannot be quantified for or assigned to particular years with reasonable certainty by the day on which the forecast financial statements are finalised, those Government decisions and other circumstances must be disclosed in the statement of specific fiscal risks of the Government required by section 26Q(3)(b).

Speaking from experience, the EFUs normally take a long time to produce at the best of times. And so it might be touch and go as to what government decisions are formalised in time for the various cut-off dates. However, we can imagine the government will want to make clear its main, and big-ticket, items in good time for the HYEFU, and that Treasury will be keen to incorporate as much of the new or amended policy as possible. Deferring to the Budget of next May seems too far away, for a government seemingly in a hurry to change things, while proving its fiscal credentials.

We are certainly eager to see the full costing of the new coalition government's policies. Of course, the Labour party was up front about its policy platform meaning for $7b more net core Crown debt by 2020/21 (and more than $11b more by 2021/22), compared to the pre-election EFU. It will be interesting to see if the new government can hold close to that. But, as people are asking, we suggest there is upside, possibly quite a bit. This suggests potential for the bond programme to be revised that much higher as a consequence.

Of course, there is the broader debate about what sort of balance sheet this (or any?) government should run, especially amid a lot of purported capital investment. Nonetheless, for a Labour party that campaigned on delivering a sustainable operating surplus across an economic cycle certain lines in the sand have been drawn.

As for the publication date in December of the HYEFU, we haven't seen anything scheduled by Treasury as yet. But it will be a day to mark in the calendar when confirmed.

As much as this means Treasury staff will be under pump, we could say the same thing about the good folk down at the central bank. While we can debate the impact of the new government's policies on real growth and economic confidence, we believe there is little doubt they will add to the upside around inflation. This is added to by the fact the TWI currency has abated quite a bit over the last few months, to now be around 6% below RBNZ assumptions as per its last forecast round.

The Reserve Bank is not stupid. It will be fully aware of these things too. In our opinion, it is almost certain it will revise up its inflation track when it produces its 9 November MPS. What is less certain is what it will do with its interest rate track as this will depend on the Bank's judgment as to the permanence of these inflationary impacts. Whatever the case, we believe that there is very little chance that the Bank will be more dovish than it was in August and it may well be noticeably more hawkish. This would rail against recent market movements.

The other thing on the Reserve Bank's plate is, of course, proposed changes to its framework. On this, we welcomed new Finance Minister, Grant Robertson's interview with TV One's Q&A programme over the weekend. It clarified to us that, in the first instance, the current Policy Targets Agreement will likely be in place until the new RBNZ Governor is appointed in March. Also, Robertson alluded to the review of the Reserve Bank Act itself as taking some time. We agree. Indeed, it could be well into next year (even 2019) before changes are passed into new law.

This is because it should be taken as the chance for a full review, not just to insert some words about maximising employment, or the like. So we have to wonder what else a new Reserve Bank Act might end up incorporating. Could it be a grand opportunity, for example, to embed regard the Bank should have to financial stability, not just inflation (and employment). While this isn't something the new government has talked about, it might be a dimension raised by others, including the Reserve Bank – as all voices are heard during the full review.

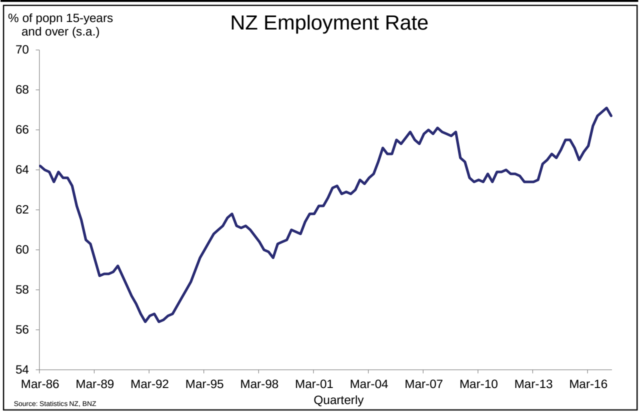
But even confining our attention to employment as a new consideration for the RB Act, we might be careful what we wish for. Imagine if we had it already? It could be used to argue for normalised, even tight, interest rate policy. After all, New Zealand has one of the very highest employment rates in the world. With this, businesses are reporting a very tight labour market, in effect (albeit one not producing strong wage inflation, for the meantime).

This is different from confining labour market assessments to a specific level of the unemployment rate, which Robertson has distanced himself from with regard to RBNZ mandates. This is even though the Prime Minister has talked about the unemployment rate needing to get below 4% (from its recent 9-year low of 4.8%). There could be a tension between these concepts.

Further insight into New Zealand's labour market will be given in Wednesday's suite of employment and wage reports. Being for the September quarter they might be compromised by the proximity of the election that occurred late in the quarter. But even running into a very tight-looking election, we note that local businesses were conveying a robust view around hiring.

How this (ever) translates into the quarterly estimates of the Household Labour Force Survey (HLFS), however, is always a bit of a lottery. We say this with the Q2 HLFS having registered a 0.2% fall in employment, yet a further moderation in the jobless rate, to 4.8%, as the

Maximum Employment



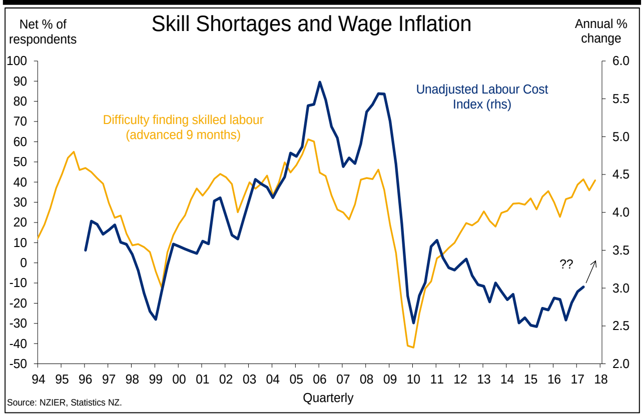
participation rate came down from its all-time high of 70.6% in Q1, to 70.0%.

For Q3 we propose a 0.7% rebound in the HLFS's employment and a 0.1 fall in its unemployment rate, to 4.7%, lowest in 9 years. The market also expects the jobless rate to decrease to 4.7%, albeit based on a 0.8% gain in jobs. For the record, the RBNZ, in its August Monetary Policy Statement, anticipated a Q3 unemployment rate of 4.7% (on its way to 4.5% right through calendar 2018).

Regards wages and salaries, we anticipate the Q3 Labour Cost Index to rise 0.7%. This is in line with the market's median expectation. However, it's worth pointing out that for the locally-based respondents it's averaging higher than 0.7%. This probably attests to better recognition that the Q3 LCI will likely be boosted by the care-workers' pay-equity settlement with the government, which meant for some hefty pay increases in many cases.

A 0.7% increase in the Q3 LCI would lift its annual inflation to 1.9%, from 1.6%. This, in turn, would suggest the unadjusted LCI measure will be running noticeably above 3% per annum, as a truer sense of where nominal wage inflation is at.

Turning



Turning to the other economic reports for the coming week, tomorrow sees October's ANZ Business Survey. Sure, its headline results tend to get a seasonal boost this month. But the key thing to note for this one is that the survey would have been canvassed largely in the murk of the post-election negotiations. So we'll have to wait for November's edition to get the first real judgement on the new government.

Tuesday morning's building consents for September will help show whether last month's big jump was part of a bona fide rebound, or not. September's credit aggregates are also scheduled for Tuesday (3:00pm). The election during the month is even more reason to expect household credit growth to have slowed further, but with probably less impact on business and agriculture credit.

For more insight into how the housing market is holding up (or not?), the Quotable Value NZ results for October are due Thursday (5:00am). Its home price index, even without the prolonged government formation process, looked set to confirm slower inflation, so it seems just a matter of confirming the degree. The real interest is in what this QVNZ report says about sentiment, given the politics.

Thursday's ANZ Job Ads for October will be a timely adjunct to the Q3 labour data – particularly as a test to how the drawn-out government formation process has affected sentiment in the market.

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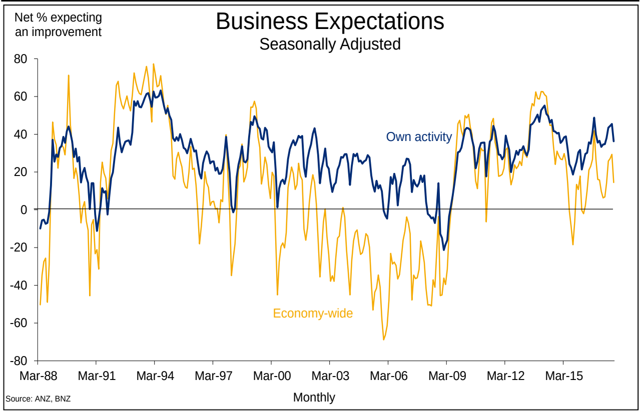
Pre-election



Global Watch

- **FOMC on hold Wednesday**
- **US PCE deflator, ISM, payrolls due**
- **BoJ on hold Tuesday, BoE to hike Thursday**
- **EU GDP and CPI out on Tuesday**
- **AU retail, trade, building data of interest**

Australia

The three main events this week are the Trade Balance and Building Approvals on Thursday, and Retail Sales on Friday. Retails Sales is the one to watch given expectations for a strong rebound after a sharp 0.6% fall in August.

NAB's own Cashless Index predicted last month's read and this month it is predicting a 0.6% m/m rise. We have moderated this to a 0.5% increase in our forecasts given the potential for last quarter's number to be revised higher. As for the quarterly volumes measure that feeds into GDP, this past quarter has overall been a flatter quarter for retailers and combined with the retail-related CPI prices, estimates point to a marginal 0.1% rise in volumes for the quarter.

For Thursday's Trade Balance, NAB's forecast is that the surplus rose to \$A1.6bn, up from \$A1.0bn in August. As far as the bulk commodities are concerned, use of port shipments and price data and mapping these to ABS estimates points to a flattish read for iron ore exports, higher volumes offset by the pull-back in iron ore prices. Coal in contrast is expected to rise a large 12.9% (+0.6bn). Reporting also suggests that the ramp up in production from the new Gladstone LNG plants continued in September.

Building Approvals is a notoriously volatile monthly series and we have no strong predisposition for September's reading, out Thursday. Solid underlying population demand points to activity remaining high; we look for a 1.1% gain in September, some modest growth also hinted at by the AiG PCI Construction Index.

Chart 1: A weak quarter for retailers

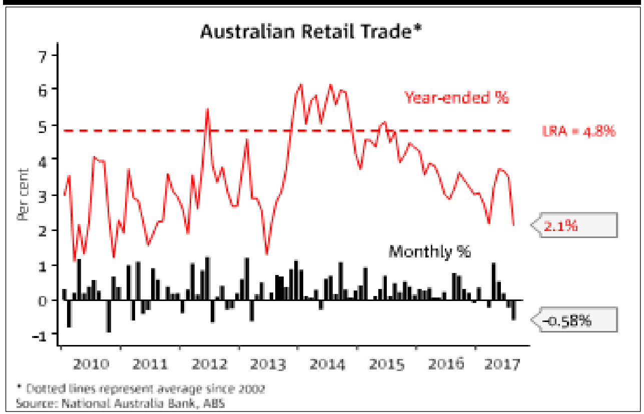
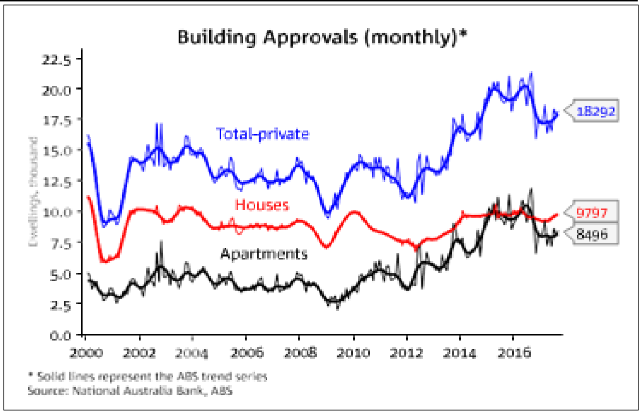


Chart 2: Approvals holding up



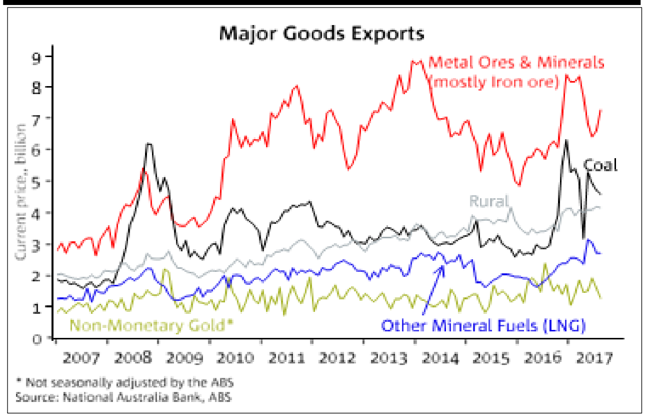
Finally, among the more sensitive data points, NAB looks for another month of 0.5% growth in RBA Credit for September. There'll be continued interest in both housing and business credit growth.

Around the above major releases, there's a smattering of second-tier releases, including Tuesday's ANZ Roy Morgan Consumer Confidence Survey and the September HIA New Home Sales report. The AiG Manufacturing PMI is out Wednesday along with the CoreLogic House Price report for October (another month of near-flat prices is in the offing) and the RBA Commodity Price Index. The AiG PSI Services index is out Friday while the Manufacturing and Services new CBA PMIs are out Wednesday and Friday.

US

The main economy focus will be Monday's PCE deflators, another tepid 0.1% Core PCE deflator in prospect. Then it's a triple dose from Wednesday's ISM Manufacturing (expected to be a still solid 59.1), the statement coming with an on-hold FOMC (the current Chair's 3rd last?) and a post-hurricane bounce in payrolls of 310K, out Friday. Average hourly earnings are expected to have risen a slower 0.2% in October after September's outsized 0.5% jump.

Chart 3: Bulk commodities heavy lifting



Japan

Tuesday's September Industrial Production is the most sensitive of the releases. The BoJ meets Tuesday; will they revise down inflation forecasts?

Eurozone

It's a big day Tuesday with Q3 GDP and the October CPI (Core L: 1.1%).

UK

The market is priced for a rate hike from the BoE on Thursday. The Manufacturing PMI is due Wednesday (F: 55.9) and the Services PMI on Friday.

Canada

Wednesday's August monthly GDP on Tuesday will get some interest ahead of Friday's October labour market report, expected to be solid.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

According to the market the first RBNZ hike isn't fully priced until February 2019. Despite clear evidence that inflation is running higher than the RBNZ expected, the NZD is weaker, oil prices are higher and the new government's policies will add to inflationary risk, the market seems to think that the RBNZ will hike rates later than previously expected. The market seems to think that potential changes to the RBNZ Act will make the RBNZ more tolerant of higher inflation.

To be fair, when we say "market", receiving pressure on short-dated swaps has been largely driven by offshore accounts. They see the new government as a game-changer. We disagree. In our view the change of government shouldn't materially affect the direction of the economy. For all the talk of a major change in government direction, the reality is more likely one of tweaks in policy that shouldn't really concern the market. If anything, the government's policies point to higher, not lower, interest rates. Any changes to the RBNZ Act are likely to be a long way off as it will involve a lot of work to incorporate all the changes that are desired, including reducing the Governor's sole decision-making powers, incorporating macro-prudential policy and financial stability into the mix, and upping the focus on employment in pursuing the price stability objective. At the moment, much of this is recorded within the confines of the Policy Targets Agreement. Mooted changes will result in an improved legal framework but won't change, in practice, the RBNZ's policy reaction function.

We'll discuss more on the RBNZ's 11 November MPS next week, but the overwhelming weight of evidence since the August Statement points to higher inflationary pressure and a more hawkish tone from the Bank. The key local focus this week will be on the employment and wages data, which are expected to show a slightly tighter labour market, with the unemployment rate down to a 9-year low of 4.7% and rising wage inflation.

The Government will be spending the coming weeks costing its policies, and we are likely to see a mini-Budget of sorts alongside the December Fiscal Update. The Public Finance Act means that the Treasury must "incorporate, to the fullest extent possible, all Government decisions and all other circumstances that may have a material effect on the fiscal and economic outlook." Under Labour's previous costings, the bond tender programme was projected to be an average $2bn per annum higher over the next three years, taking annual bond issuance up from $7bn to $9bn. Since then, we have seen more spending promises and incorporating NZ First and Green party policies into the mix can only add to upward pressure on the bond programme.

While the NZ 10-year government bond yield is up 10bps to 3.10% over the past couple of weeks, that move has been driven by higher US Treasury yields. The NZ-US 10-year spread remains at the lower end of recent ranges at around 60bps. Short-end spreads have narrowed on increased confidence of Fed tightening ahead and the pushing out of rate hike expectations in NZ. Higher US rates make sense to us, lower NZ rates don't. With that in mind the RBNZ's 11 November MPS will be a critical document. If the RBNZ simply repeats its message that rate hikes remain a distant prospect and the inflation outlook is little changed, then that would justify the recent rally in NZ short-dated rates and narrow NZ-global spreads at the long end. However, a more hawkish stance would jolt the market and see it more in tune to the risks we see developing on inflation and rates.

Of the US, UK, and Japan policy meetings this week, we have most interest in the Bank of England's message, wondering whether the Bank will guide to further rate hikes after the well-anticipated hike to 0.50%. US data this week and the FOMC meeting aren't expected to get in the way of a widely anticipated December rate hike. The US 10-year rate blasted up through technical resistance of 2.40% last week, but the fact it closed the week some 7bps off its peak, back down to 2.405% at the end of the week, signals some resistance for rates to shift up to a higher plane.

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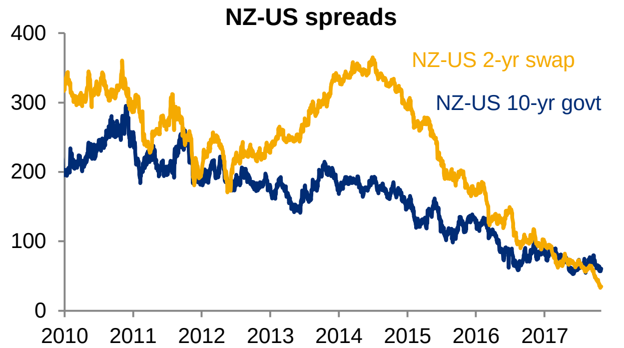
NZ-US 10Yr Spread Dragged Lower by 2-Yr Spread



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.95	1.92 - 1.95
NZ 2yr swap (%)	2.17	2.16 - 2.22
NZ 5yr swap (%)	2.68	2.67 - 2.76
NZ 10yr swap (%)	3.24	3.17 - 3.28
2s10s swap curve (bps)	107	98 - 108
NZ 10yr swap-govt (bps)	23	20 - 28
NZ 10yr govt (%)	3.01	2.89 - 3.04
US 10yr govt (%)	2.41	2.27 - 2.48
NZ-US 10yr (bps)	60	57 - 66
NZ-AU 2yr swap (bps)	24	15 - 24
NZ-AU 10yr govt (bps)	24	16 - 26

*Indicative range over last 3 weeks

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

In last week's price action, the USD's nascent recovery continued, supported by stronger economic data and higher Treasury yields. EUR was hit last week as the ECB's tapering of asset purchases announcement created an impression that QE was open-ended and any rate hike wouldn't come until 2019. The AUD was weaker after softer-than expected CPI data.

The NZD was largely a bystander amongst all this, seeing it fall against a resurgent USD and equalling its year-to-date low of 0.6818 set in May before closing the week on a stronger note. Meanwhile, the NZD made modest gains against the softer EUR and AUD currencies.

The more mixed performance of the NZD rather than broadly based depreciation might suggest that selling pressure seen post-election is drawing to a close. Our working assumption remains that the NZD over-reacted to domestic political change. While the new government likes to claim that there will be a significant change in economic direction, the reality is more likely one of tweaks in policy that shouldn't really concern the market.

Our short-term fair value model estimate sits just under the USD0.73 mark, nudged ever so slightly lower by weaker NZ commodity prices against a backdrop of very high risk appetite. A fading of the NZ political risk premium supports a stronger NZD, but if the resurgent USD gets further legs then that would limit the recovery.

With portfolio flows driving recent NZD weakness, the RBNZ will be obliged to see the weaker currency as an inflationary force when it releases its new set of forecasts on 9 November. We'll discuss more on that next week, but the overwhelming weight of evidence since the RBNZ's August MPS points to higher inflationary pressure and a more hawkish tone from the Bank. This is potentially a positive NZD development over the next couple of weeks as the market looks forward to this announcement.

The week ahead is a bumper one on the economic calendar. Locally, the ANZ business outlook survey predates the announcement of the formation of government. Next month's reading will be more interesting and will likely show a big fall in many activity indicators. So the local focus this week will be on the employment and wages data, which should be friendly to the NZD as they potentially show a tight(er) labour market and rising wage pressure.

The US FOMC announcement Thursday morning should be less interesting than usual, with the Fed expected to repeat its key policy message that keeps alive the prospect of a December rate hike (and is 85% priced). There will not be any new forecasts issued or a press conference. More interest will be on the employment and wages data at the end of the week and ahead of that ADP employment and the ISM manufacturing survey. These data aren't expected to get in the way of a December rate hike by the Fed. Watch out for Trump's new Fed Chair appointment before the end of the week, which is widely expected to be Powell, who currently sits on the FOMC.

The Bank of England has guided the market towards a rate hike this week, the first one for the cycle. Rather than the likely rate hike itself, the market will be interested in the Bank's appetite for further hikes. While inflation is running above target, the economic outlook under Brexit uncertainty doesn't look very flash to us.

The BoJ's policy meeting should pass without reaction. The Bank remains far from achieving its inflation target and the ability to ease policy any further is pretty much exhausted, seeing it sit on its hands and continue to buy bonds and keep the yield curve 10-years out close to zero.

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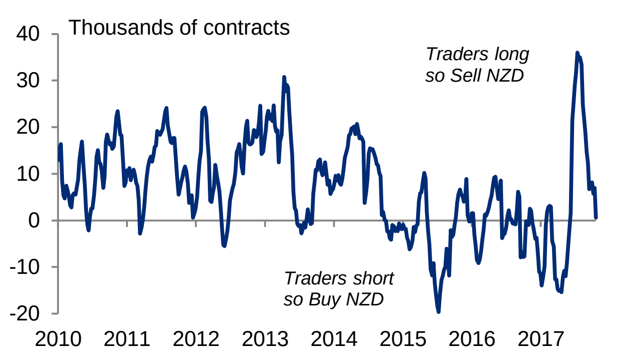
Speculative Net-Long NZD Positions Now Closed



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6876	0.6820 - 0.7200
NZD/AUD	0.8960	0.8860 - 0.9170
NZD/GBP	0.5238	0.5170 - 0.5450
NZD/EUR	0.5923	0.5810 - 0.6110
NZD/JPY	78.21	77.80 - 81.00

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7280	-6%
NZD/AUD	0.9110	-2%

Technicals

NZD/USD

Outlook: Down
ST Resistance: 0.7050 (ahead of 0.7200)
ST Support: 0.6820 (ahead of 0.6670)

The NZD has broken through long-term trend support which opens up further downside potential. Last week the currency failed to break May's low of 0.6818, making this the first area of support. Initial resistance now around 0.7050.

NZD/AUD

Outlook: Down
ST Resistance: 0.8975 (ahead of 0.9170)
ST Support: 0.8875 (ahead of 0.8825)

The currency failed to break downside support at 0.8875, a positive sign for now but too early to suggest a turning point. Initial resistance around 0.8975 ahead of 0.9170.

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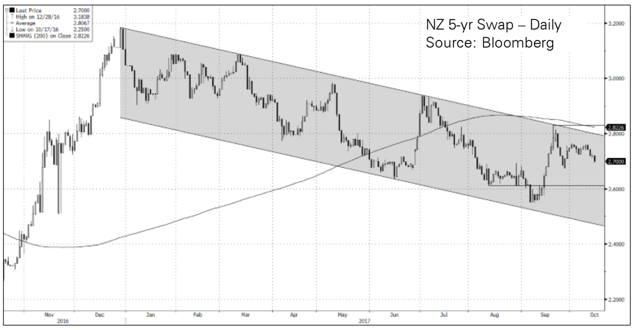
NZ 5-year Swap Rate

Outlook: Neutral
ST Resistance: 2.83
ST Support: 2.61

Range remains intact. We continue to await a break to initiate a new position.



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

Outlook: Steeper
ST Resistance: +62
ST Support: +48.5

Trendline breached, so expect a move to +62.

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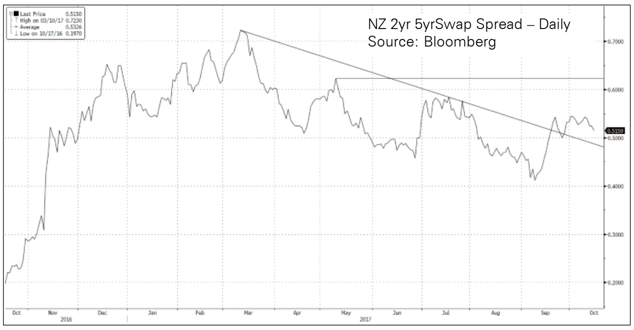

Key Upcoming Events

	Forecast	Median	Last
Monday 30 October			
Jpn, Retail Sales, September y/y		+2.3%	+1.7%
Euro, Economic Confidence, October		113.3	113.0
Germ, CPI, Oct y/y1st est		+1.7%	+1.8%
US, Personal Spending, September		+0.9%	+0.1%
Tuesday 31 October			
NZ, ANZ Business Survey, October			flat
NZ, Building Consents, September (res, #)			+10.2%
NZ, Credit Aggregates, Sept. (housing y/y)			+6.7%
Aus, Private Sector Credit, September	+0.5%	+0.5%	+0.5%
China, PMI (NBS), October		52.1	52.4
China, Non-manufacturing PMI, October			55.4
Jpn, BOJ Policy Announcement, Policy Rate		-0.1%	-0.1%
Jpn, Industrial Production, Sept. 1st est		-1.6%	+2.0%
Euro, CPI, Oct y/y 1st est		+1.5%	+1.5%
Euro, Unemployment Rate, September		9.0%	9.1%
Euro, GDP, Q3 1st estimate		+0.5%	+0.6%
US, Chicago PMI, September		60.0	65.2
US, Employment Cost Index, Q3		+0.7%	+0.5%
US, Consumer Confidence, October		121.0	119.8
Wednesday 1 November			
NZ, LCI Priv Ord Wages, Q3 y/y	+1.9%	+1.9%	+1.6%
NZ, HLFS Unemployment Rate, Q3	4.7%	4.7%	4.8%
Wednesday 1 November cont'd			
China, PMI (Caixin), October		51.0	51.0
UK, Markit/CIPS Manuf Survey, October		55.9	55.9
US, Construction Spending, September		-0.2%	+0.5%
US, ISM Manufacturing, October		59.4	60.8
US, FOMC Policy Announcement, Upper	1.25%	1.25%	1.25%
US, ADP Employment, October		+200k	+135k
Thursday 2 November			
NZ, QVNZ House Prices, October y/y			+4.3%
NZ, ANZ Job Ads, October			+0.4%
Aus, International Trade, September	+$1.60b	+$1.20b	+$0.99b
Aus, Building Approvals, September	+1.1%	-1.0%	+0.4%
UK, BOE Policy Announcement/Inflation Report		0.50%	0.25%
US, Fed's Powell Speaks			
Friday 3 November			
Aus, Retail Trade, September	+0.5%	+0.4%	-0.6%
China, Services PMI (Caixin), October			50.6
UK, Markit/CIPS Services, October		53.4	53.6
US, ISM Non-Manuf, October		58.5	59.8
US, Factory Orders, September		+1.2%	+1.2%
US, International Trade, September		-$43.3b	-$42.4b
US, Non-Farm Payrolls, October		+310k	-33k

Historical Data

	Today	Week ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.00
1mth	1.79	1.80	1.84	2.09
2mth	1.87	1.87	1.89	2.12
3mth	1.94	1.96	1.96	2.14
6mth	1.98	1.98	1.98	2.13
GOVERNMENT STOCK				
03/19	1.89	1.89	1.92	2.00
04/20	2.05	2.04	2.10	2.11
05/21	2.21	2.19	2.25	2.19
04/23	2.53	2.49	2.56	2.39
04/25	2.82	2.78	2.83	2.58
04/27	3.03	2.96	2.99	2.71
04/33	3.39	3.30	3.33	3.03
04/37	3.57	3.50	3.54	3.30
GLOBAL CREDIT INDICES (ITRXX)				
Australia 5Y	65	65	73	104
Nth America 5Y	53	53	55	79
Europe 5Y	51	54	56	73

	Today	Week ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.17	2.17	2.22	2.14
3 years	2.35	2.35	2.42	2.23
4 years	2.52	2.53	2.60	2.32
5 years	2.68	2.68	2.76	2.42
10 years	3.24	3.21	3.29	2.83
FOREIGN EXCHANGE				
NZD/USD	0.6870	0.6967	0.7196	0.7151
NZD/AUD	0.8952	0.8925	0.9194	0.9397
NZD/JPY	78.13	79.03	81.14	74.94
NZD/EUR	0.5920	0.5929	0.6132	0.6510
NZD/GBP	0.5233	0.5278	0.5419	0.5840
NZD/CAD	0.8808	0.8811	0.9001	0.9588
TWI	73.2	73.8	76.3	77.3

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