1 June 2017

Contents

Economic Outlook

There is a strong income pulse brewing in the New Zealand economy, courtesy of rising export prices and relatively subdued import prices. This was manifest in today's Q1 merchandise terms of trade hitting their highest level since 1973. But this, being price driven, will not show up directly in quarterly real GDP. Indeed, Q1 GDP (due 15 June) remains at risk of being slow. Currently we anticipate an increase of 0.7%. But this relies on strong lifts in Wholesale Trade (6 June) and Manufacturing (7 June), and a steady result for Building Work Put in Place (6 June). More broadly, business surveys remain upbeat, consistent with above-trend economic growth. Last week's Budget has added to this, in confirming policies of a sizable net stimulus, albeit scheduled to start 6 months after September's general election. We are in the process of upgrading our macro-economic forecasts on this basis, but with key parts of it not yet finalised. Please bear this in mind when reading our tables.

Interest Rate Outlook and Strategy

Since our last Strategist, a global bond rally has taken NZ yields to new year-to-date lows. NZ rates have outperformed as relatively high yields and a dovish RBNZ outlook attracts inflows. The NZGB-UST 10yr spread is at its tightest level since the 1990s. NZGB yields are now trading at historically low levels against swap. We see value in receiving NZ long end swap against NZGBs. Our view for higher long end US yields and a steeper NZ curve has clearly been challenged by recent price action, with NZ 2/10yr swap curve moving firmly under 100bps. Upcoming US payrolls and wages data ahead of the 14 June FOMC meeting will provide key tests to recent price action and positioning in UST 10yr yields which have moved to very long. A June Fed hike is 85% priced, with considerable focus on the Fed's forward guidance.

Currency Outlook

NZD/AUD began the year just over 0.96, fell steeply from the end of January to mid-March to around 0.91 and has since trended higher in a jumpy fashion to the current rate just over 0.95. In our opinion the anomaly in pricing was the steep fall and we view the recent recovery as taking the pair back towards a fairer level. Our forecasts haven't changed and we continue to have a positive medium-term bias towards the NZD/AUD cross rate. Officially, a move to parity is projected by early 2019, but given the typical error bands around forecasts, this could easily occur much earlier. The key driver of this view is a better economic outlook in NZ versus Australia.

High Terms of Trade Data Not Without Hooks

- Terms of trade highest since 1973
- A big support to nominal incomes
- So don't fret too much if Q1 GDP looks soft
- As seems the risk given the quarter's trade volumes

There is a strong positive income pulse brewing in the NZ economy, courtesy of rising export prices and relatively subdued import prices. But this, being price driven, will not show up directly in quarterly real GDP figures that might well look a bit softer in the near term. We expect the terms of trade to remain elevated compared to history, while we judge the near-term volume weakness to be transitory.

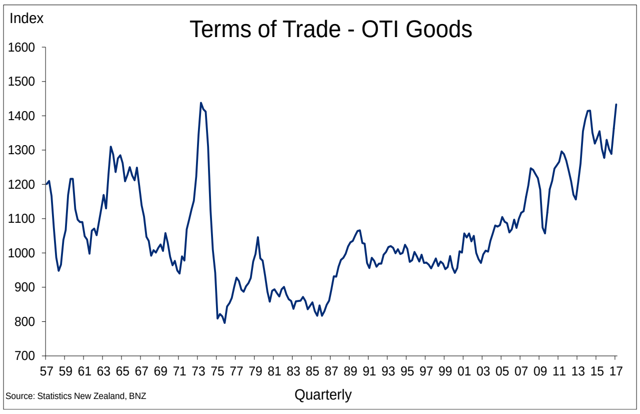
Let's start with the positive. We have been talking about the prospect of higher terms of trade for quite some time, but it is now starting to show up in the official statistics. The merchandise terms of trade rose 5.1% in the first quarter, to be up 7.8% on a year ago, and to its highest level since 1973. The quarterly result reflects export prices (+8% q/q) rising faster than import prices (+2.7%). Increases in both export and import prices fits with the general inflation lift that we have seen in 2017. Services terms of trade rose 0.1% q/q, to be up 2.6% on a year ago.

On the goods side, the export price gain reflects a firm and broad export price upswing for a range of primary products. This was well telegraphed by higher commodity prices. There might yet be a bit more to come through the official statistics in this regard such that the terms of trade could test its early-1950s all-time high. Some surprise today, to us at least, came via a 6.1% quarterly rise in non-food manufactured export prices.

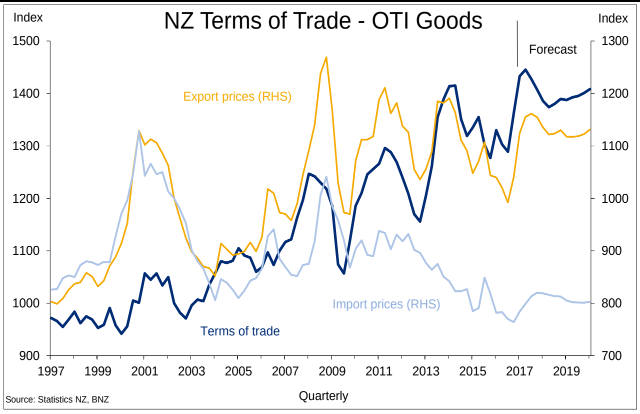
Even though we expect some pullback in the terms of trade over the coming year as primary product prices ease back, it is expected to remain at an elevated level relative to history. A higher terms of trade is a lift in purchasing power of the nation's exports; an income boost.

It is always difficult to know exactly how these terms of trade data line up against RBNZ expectations because the

High



Supportive Outlook



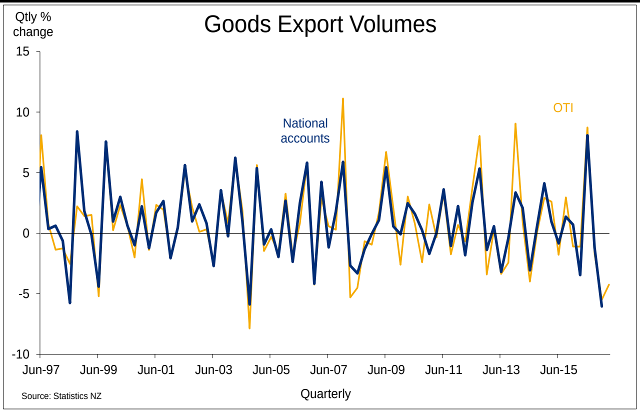
Bank prefers to analyse the terms of trade for goods and services on a national accounts basis (that data is due out with GDP on 15 June). But, prima facie, today's outcome suggests the terms of trade are tracking a touch stronger than the RBNZ anticipated in its May Monetary Policy Statement. If so, this would help offset the fact that the NZD is pushing above what the Bank projected. It might also add comfort to the Bank if its 0.9% pick for Q1 GDP proves too high, as increasingly looks like being the case.

Speaking of the currency, the NZD's strength is fundamentally supported by a high terms of trade. That is it shouldn't be a surprise to see a firm currency when prices for the products a country sells to the world are high relative to prices of the products a country buys from overseas. A firmer currency essentially distributes terms of trade gains around the economy.

It is important to note that this price-driven income effect from the terms of trade is not directly captured in real GDP, even though it can be just as powerful for lifting living standards (higher terms of trade directly lifts real gross national disposable income – a broader measure of real income growth than real GDP).

That is worth bearing in mind when interpreting upcoming real GDP data, which could yet look a bit slow. We say this as we look at the direct GDP indicators in today's figures, like the 4.2% quarterly decline in export volumes and 1.2% rise in import volumes. At least some of this looks temporary. A big drop in dairy volumes in the quarter was no surprise and should bounce back in time, with signs milk production finished the season strong. The second consecutive quarterly drop in forestry product export volumes is in contrast to generally very positive indicators across that sector. The decline in non-food manufactured export volumes did surprise us, although is the flipside of the strange looking strong price lift noted above.

Still Low



These suggest net goods trade will be a substantial drag on Q1 real GDP growth, counter to our prior expectations of real trade being at least neutral. This puts our current Q1 GDP estimate on notice for possible downward revision. But we haven't seen enough on the production side to change our 0.7% view just yet. We will finalise our view following next week's indicators for wholesale trade, building work and manufacturing. But it is worth noting that our expenditure based measure of GDP growth is now looking quite slim for the first quarter.

Today's trade indexes essentially split the already known trade values for the quarter into their price and volume components. In effect, the results generally show higher prices and lower volumes than we expected for the quarter itself but do fit with our general thinking that 2017 is shaping up to be a year of slower GDP growth with higher inflation compared to 2016.

Real GDP growth might well be a bit slower near term, but nominal incomes are being boosted by higher terms of trade. The balance might well prove positive. That certainly seems to be the assessment of local businesses judging by yesterday's upbeat survey.

In the bigger picture, the indirect effects of the income boost from higher terms of trade on the economy are worth thinking about. It ultimately provides options:

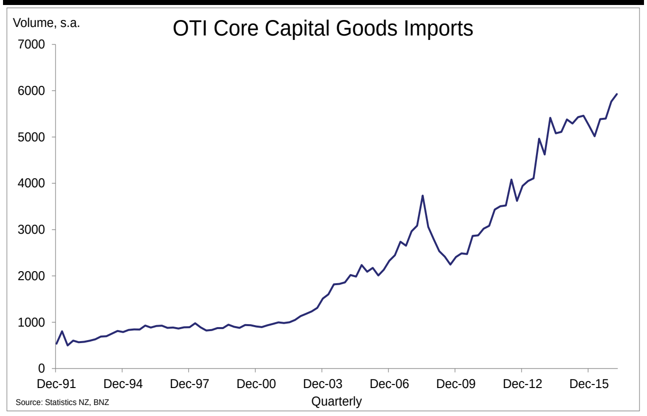
• Spend it – we've already seen some signs of this with very strong retail sales in Q1, including a strong pickup in sales outside the main centres of Auckland, Wellington and Canterbury as higher primary product prices support incomes. Some farm spending indicators have turned positive, although not aggressively so to date.

• Invest it – the pre-conditions are certainly there for more investment judging by yesterday's business confidence survey showing high capacity utilisation, rising profit expectations and stronger intentions to invest. Today's figures are encouraging with core capital import volumes up 2.8% in Q1, to be up 18.1% on a year ago.

• Save it – it is always difficult to isolate one factor's influence on saving, across all its possible forms. But the sharp slowing in agricultural debt expansion over recent times is noticeable as dairy farmer cash flows improve and some debt repayment comes onto the agenda.

Of course, it is very difficult to precisely isolate the influence of higher terms of trade across the various facets of the economy. But, overall, we think the boost to nominal incomes will support spending, saving and investment ahead. Our forecast suggests the mix of those will see reasonable growth as well as some further narrowing in the current account deficit in 2017. Higher terms of trade also helps lift the tax base, a plus for the fiscal accounts.

Investment Rising



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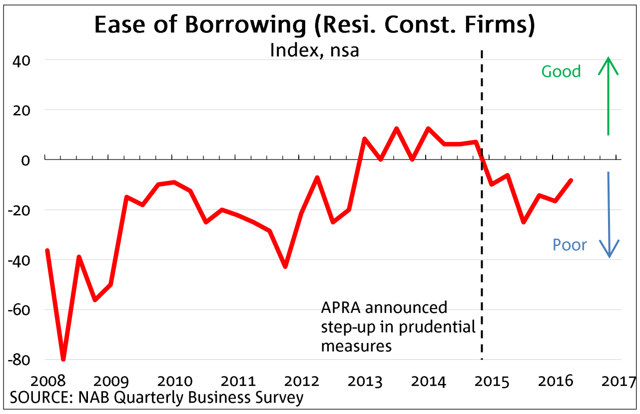
Australia's Housing Construction Cycle

- The peak in Australia's housing construction boom is approaching
- 'Oversupply' of apartments warrants close monitoring
- However, various industry constraints will provide an offset

This is an abridged version of A Look at Australia's housing construction cycle.

Dwelling investment in Australia has made a sizeable contribution to GDP growth in recent years. However, indications suggest that the construction cycle may soon reach its peak and could detract from economic growth as soon as 2018. Statistical modelling techniques that take advantage of available information on projects in the construction pipeline, suggest that new commencements could drop more than 13% in 2017, 7% in 2018 and a further 9% in 2019. If so, dwelling construction would fall 4% a year in 2017 and 2018 according to these models. Such an outcome conforms with our expectation for the construction industry to 'self-regulate' the amount of supply coming online. That said, our statistical models predict the (large) pipeline of existing projects to run down much slower than would seem likely in practice. Instead, NAB Economics is forecasting dwelling construction to rise another 2% in 2017, before falling around 1% in 2018 and 3½% in 2019.

Much has been made of emerging risks in the apartment market. The apartment construction pipeline is at least two times higher than historical norms (relative to population growth) in most states, and prices in some CBD apartment markets (including Melbourne) are already falling. That said, much commentary in the public domain is overly alarmist. Lower construction approvals, diminished spare construction capacity and tougher credit conditions are likely to slow the rate of completions, and the industry has previously shown capability to self-regulate supply. This is likely to elongate the construction cycle and reduce the risk of a destabilising market correction – although pockets of the market may still experience excess supply.

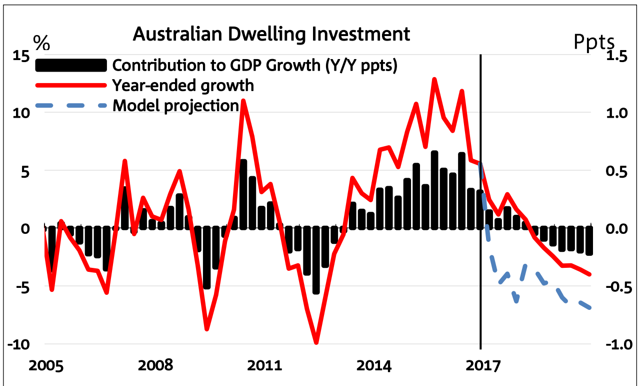


SOURCE: NAB Quarterly Business Survey

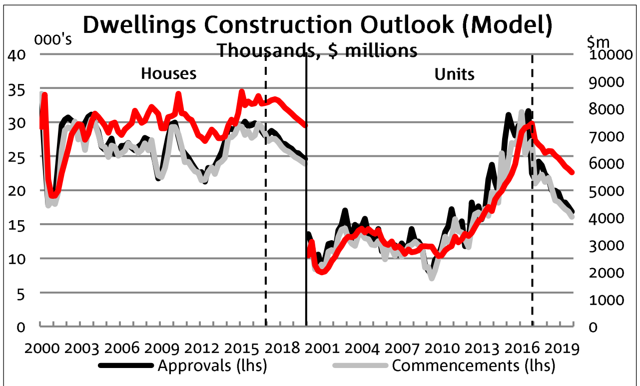
On the demand side, the fundamentals remain quite strong, supported by solid population growth, especially in Victoria, although measures are in place to slow investor and foreign demand. Indicators of foreign demand are limited, but the NAB Residential Property survey suggests that policies aimed at deterring foreign buyers (including tighter constraints in foreign jurisdictions) are having an impact. In addition, the longevity of the current resilience in investor demand is difficult to gauge. Recent macroprudential policies (mainly targeting interest-only mortgages) are yet to fully take effect, while changes to capital requirements have already been flagged by APRA. The longer-term effectiveness of such policies, however, is still up for debate.

On balance, there is a high degree of pent up demand in some markets, especially Sydney, which combined with expectations for solid population growth, should help to soak up much of the new housing stock. That said, NAB projections see the national housing market becoming (modestly) oversupplied by late 2018 (although the timing varies by state). Additionally, with much of the construction centred in apartments, it remains to be seen whether that aligns with buyer preference, while there are also concerns over the quality of some of the new apartment stock.

There was a raft of (mainly supply-side) policies in the 2017-18 Federal Budget. While these will add to construction activity in the out years, the net impact is expected to be somewhat marginal.



Sources: ABS; NAB Economics



Sources: ABS; NAB Economics

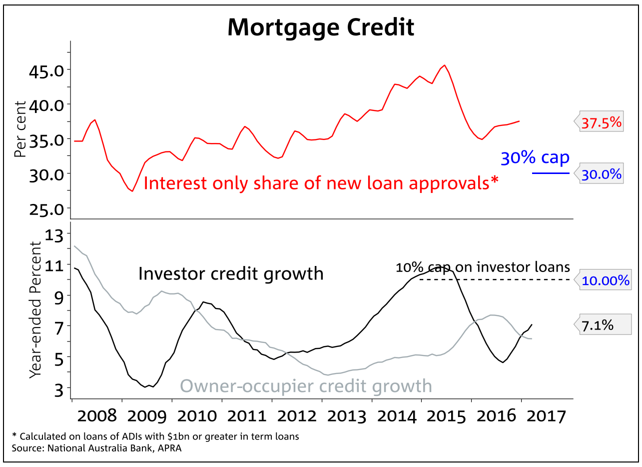
The strong supply response we are seeing in Australian residential property is a trend worth monitoring, but is certainly not completely without merit given the strength of demand fundamentals. Construction rates have failed to keep pace with strong population growth in recent years, contributing to very high levels of pent-up demand, especially in Sydney. Very low interest rates and the relative appeal of dwelling investment (as investors searched for higher returns in the low yield global investment climate of recent years) are only now allowing supply to finally meet that demand. That said, foreign and investor demand has played a larger than usual role in the current cycle, and it is not yet clear to what extent this has amplified the risks to the housing market. It also has an impact on housing affordability, although the current supply response should help in that regard.

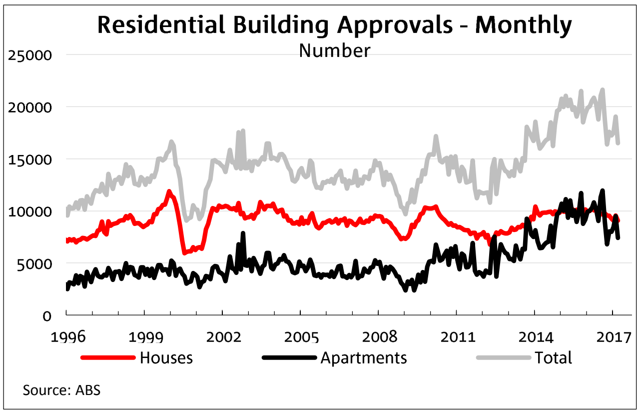
While rising supply should work to improve housing affordability, there remain legitimate questions about the suitability of the housing stock that is currently under construction. Some indicators tend to suggest that the 'quality' of the dwellings is not at the same level that Australian buyers are used to, although the evidence is mixed. Additionally, the heavy focus on apartment construction will require a sizeable shift in buyer preferences, with Australian buyers historically favouring detached dwellings. That said, strong population growth (primarily international migration), rising congestion, deteriorating affordability and an ongoing concentration of employment growth in metro areas suggests that a shift in buyer preferences may come by way of necessity. Continued divergence in price growth between detached houses and apartments will also assist in shaping preferences. (For NAB's latest housing price forecasts, please see pages 10-11 of the Q1 NAB Residential Property Survey)

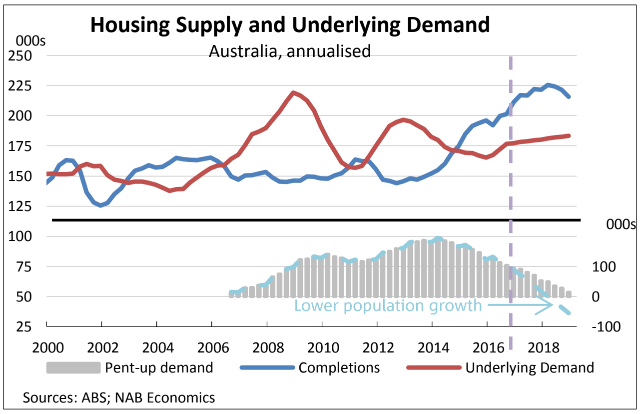
Nevertheless, with concerns rising around potential settlement risks for new developments, particularly as credit conditions are tightened, we are likely to see the construction industry begin to 'self-regulate' the volume of new supply. That would be consistent with past behaviour and can already be seen in the level of new building approvals – although they are yet to fall to the extent that we had expected (and have partially rebounded more recently). In combination with other constraints (diminished spare capacity and tighter financing), we could potentially see the construction cycle become more elongated than previously thought – peaking at a lower level, but holding at elevated levels for longer – which would also help to alleviate over-supply concerns.

Our statistical modelling suggests that residential commencements could fall more than 13% in 2017 and a further 7% in 2018 – although some analysts point to a much more significant decline this year. If so, dwelling construction would actually decline by 4% a year in 2017 and 2018 according to these models. That said, our statistical models predict the pipeline of existing projects to run down much slower than would seem likely in practice, so is taken to be more akin to a worst case scenario rather than the most likely path for construction activity. Instead, NAB Economics are forecasts dwelling construction to rise another 2% in 2017, before falling around 1% in 2018.

Should the construction cycle play out as expected, there needs to be an ongoing shift in household preferences toward apartments to soak up the new housing stock. According to NAB Economics projections, this trend will continue to be fairly gradual (thus likely manageable) in NSW, but could be more stark in Victoria and Queensland, again highlighting the risks involved.







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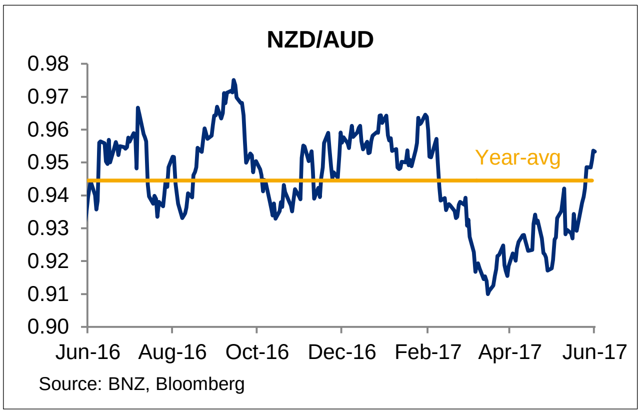
Currency Strategy

- NZD/AUD recovered strongly by 4% in May, correcting the pricing anomaly we saw develop through March-April. Signs of a pothole in Australian growth and much stronger relative NZ/Australia commodity pricing goes some way towards driving the cross back towards a fairer value.
- Our medium-term outlook of an eventual move towards parity remains, based on the macro outlook continuing to favour NZ over Australia.
- After the strong recovery, the near-term outlook is now cloudier, but our central forecast is that a period of consolidation around the mid-90s should play out.

Our view on the NZD/AUD cross rate hasn't changed, but given the big swing in that exchange rate this year, an update on drivers and thoughts seems appropriate. The cross began the year just over AUD 0.96, fell steeply from the end of January to mid-March to around AUD 0.91 and has since trended higher in a jumpy fashion to the current rate of just over AUD 0.95.

NZD/AUD Recovers Back to Annual Average



In our view the anomaly in pricing was the steep fall to AUD 0.91. That was never justified on fundamentals, in our view. AUD strength during February can be traced to a speculative rise in iron ore prices and RBA Governor Lowe dampening down market expectations for further rate cuts.

We view the recent recovery in NZD/AUD as taking the currency back towards a fairer level. Supporting the move has been a large, steady fall in iron ore prices back towards a more sustainable level. We could also point towards tighter liquidity conditions in China having a more justifiable negative impact on the AUD compared to the NZD and strength in NZ commodity prices at a time when Australia's harder commodities are coming under some pressure.

The list can go on. Next week sees the release of Q1 Australian GDP data which are expected to be barely positive, with some risk of a negative outturn. By contrast, NZ's stronger terms of trade are driving a surge in income growth. Recent Budgets in the two countries also show contrasting fortunes. The Australian Budget surprised the market with a poorly thought through tax impost on its banking system to cover a hole in the fiscal accounts, while NZ's fiscal position improved to allow tax cuts, increased benefits, higher capex and net debt reduction.

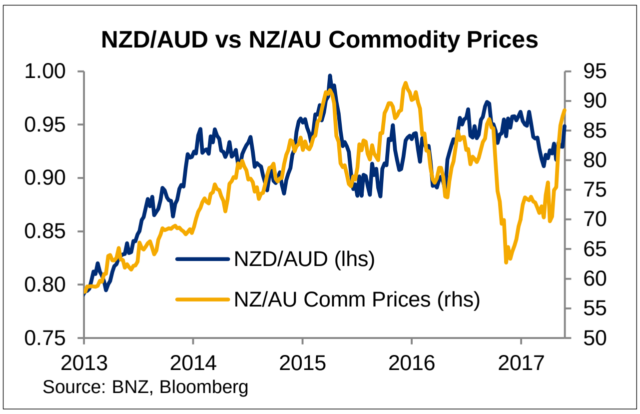
What do our models say?

Interpretation of our short term NZD/AUD models have required some careful judgement to make sense of the big swing in the cross rate.

Relative commodity prices between NZ and Australia have swung wildly, a reflection of the swings in iron ore and dairy prices. Relative pricing has moved in NZ's favour, with dairy and other "soft" commodity prices recovering at a time when the hard commodities have come under some pressure.

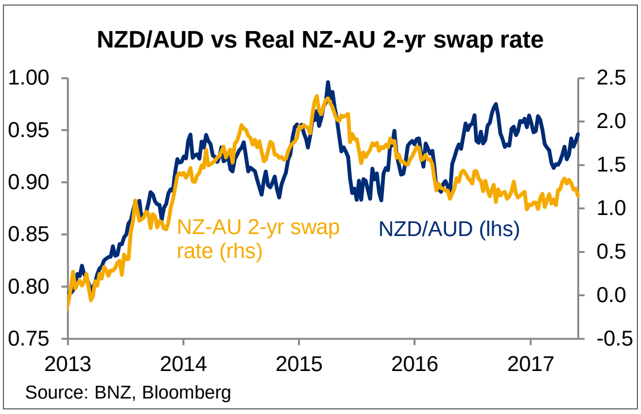
At face value, late last year and earlier this year one might have considered a cross of AUD 0.85 as a fairer price. But the market rightly "looked through" the overshoot of iron ore pricing to the upside and the overshoot of dairy prices to the downside. Neither was based on solid economic foundations. Current commodity price levels now seem more appropriate relative to fundamentals.

Big Swings in Relative Commodity Prices Recently



The link between NZ-Australian short term interest rates and the cross rate broke down early last year. Over longer time series, real rates matter more than nominal rates and NZ-AU rate differentials implied a lower NZD/AUD cross rate. At the time, we didn't give this much respect as we believed that NZ's economic fundamentals remained stronger than Australia's and ultimately we saw, and continue to see, more chance of the RBNZ tightening monetary policy ahead of the RBA.

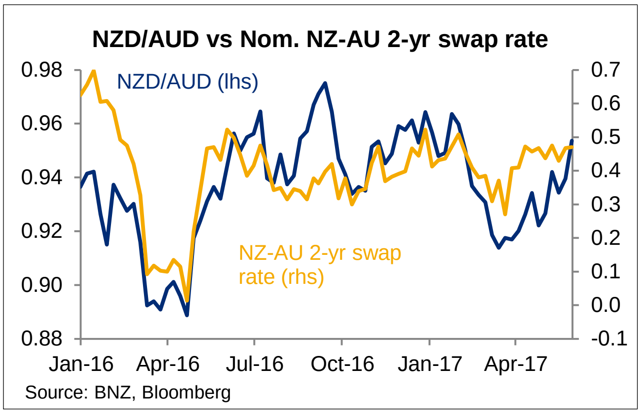
Reduced Correlation With Interest Rate Gap



Source: BNZ, Bloomberg

Focusing on a more recent period after the levels-break in the relationship, the link between rates and the cross rate might now be restored. The chart below uses the nominal 2-year swap gap over this shorter period.

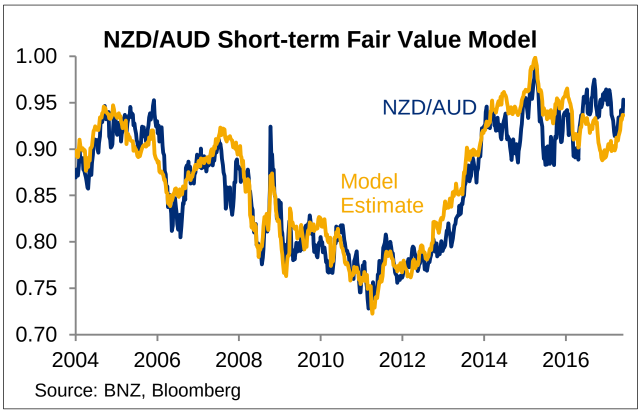
Rate Gap Link with NZD/AUD Might Be Restored



Source: BNZ, Bloomberg

Relative commodity prices and interest rates, along with relative business confidence form the basis of one of our short term fair value models. This fair value model estimate has recovered at a faster pace than the actual cross and now shows only a modest valuation gap. Current fair value on this measure is around AUD 0.9350.

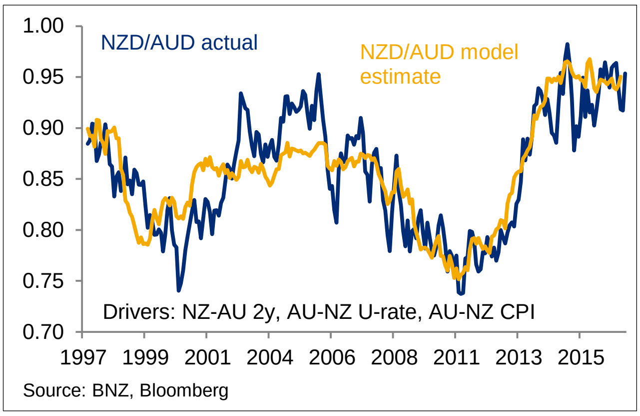
NZD/AUD Trading Near a Fair Level Now on This Model



Source: BNZ, Bloomberg

Our alternative short-term model which includes relative unemployment rates and doesn't contain relative commodity prices shows a much smoother fair value track – hovering between AUD 0.94-0.96 over the last couple of years.

NZD/AUD Fair Value on This Alternative Model



Source: BNZ, Bloomberg

Outlook

Our forecasts haven't changed and we continue to have a positive medium-term bias towards the NZD/AUD cross rate. Officially, a move to parity is projected by early 2019, but given the typical error bands around forecasts, this could easily occur much earlier.

The key driver of this view is a better economic outlook in NZ versus Australia. This sees increasing pressure on NZ capacity relative to Australia (eg. a widening unemployment rate gap in NZ's favour), leading the RBNZ to tighten monetary policy ahead of the RBA. Relative terms of trade and relative fiscal comparisons also favour NZ over Australia.

Recent weakness in the AUD reflects the market adopting a fairly negative disposition towards the Australian economic outlook. Some even argue that the economy will be close to technical recession over Q1/Q2 this year. Negative growth in next week's Australian GDP figures would be the first leg of that double. Overlay that with weaker terms of trade as the country's key export commodity prices tumble, and the picture is even weaker in nominal terms.

By contrast, NZ's GDP figures are expected to improve, particularly in nominal terms. NZ nominal GDP growth is likely to be in excess of 7% through calendar 2017. The 5.1% q/q boost to NZ's terms of trade highlights the income boost that will be sloshing around the economy over the period ahead.

We suspect that a lot of this good news story for NZ relative to Australia is already reflected in the exchange rate. A period of consolidation might well be upon us over the near-term, but the broad medium-term thrust remains towards the upside.

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FX Momentum Model

Generally Long NZD

- Strong, broad-based momentum in the NZD saw a cutting of pre-existing short positions, and the model has introduced long NZD positions versus the USD, AUD and GBP over the past week.

Mixed USD positions

- The model holds long EUR, CHF and CAD positions against the USD and is short GBP against the USD ahead of next week's UK election.

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BNZ Foreign Exchange Momentum Model

Our momentum model is used primarily as an indicator of speculative account activity, as opposed to a trading tool. The model provides some indication of the levels at which speculative accounts may be entering into long or short positions in the major currencies. It can also provide a steer on how basic trend following/momentum accounts are positioned.

The basic trading algorithm our model uses is as follows:

1. Buy if the price breaks above recent ranges, or sell if it breaks below recent ranges.
2. In exiting a position, the model uses a trailing stop. The stop is set at the previous10-day high or low, but with an additional adjustment factor that sets a wider stop when markets are more volatile.

Together, these two conditions constitute the core of any momentum model, whose central premise is that a break outside of a range indicates that the price will continue in the direction of the break. A couple of extra conditioning filters have been added to our momentum model to try to stop the model reacting to false breaks.

FX Momentum Model Positions

31-May-17 << NY Close

Currency pair	Position	Entry date	Entry level	Mkt	Return	Stop	Long trigger	Short trigger
NZD/USD	Long	24-May-17	0.7047	0.7085	0.5%	0.6915		
NZD/AUD	Long	25-May-17	0.9425	0.9536	1.2%	0.9285		
NZD/EUR	Neutral	29-May-17	0.6311	0.6300			0.6398	0.6158
NZD/GBP	Long	25-May-17	0.5445	0.5496	0.9%	0.5330		
NZD/JPY	Neutral	17-May-17	76.98	78.48			79.36	76.27
AUD/USD	Neutral	19-May-17	0.7446	0.7430			0.7546	0.7329
AUD/JPY	Neutral	05-May-17	82.90	82.31			84.52	81.77
DXY	Short	16-May-17	98.50	96.92	1.6%	98.13		
EUR/USD	Long	16-May-17	1.1023	1.1244	2.0%	1.1076		
GBP/USD	Short	26-May-17	1.2831	1.2890	-0.5%	1.3016		
USD/JPY	Neutral	17-May-17	111.78	110.78			114.37	110.24
USD/CHF	Short	16-May-17	0.9856	0.9678	1.8%	0.9862		
USD/CAD	Short	24-May-17	1.3456	1.3500	-0.3%	1.3625		

Notes: This portfolio represent hypothetical, not actual, investments. Reported returns do not include the cost-of-carry. All trades are entered and exited at triggered levels

The BNZ OIS-ter: Fed hike priced next month; not much else

- There hasn't been much change to monetary policy expectations over the past fortnight. In NZ, projected rate hikes remain in the distant future with the first full rate hike priced around June/August 2018. Australia's rate curve remains flat. Over the past fortnight the market has priced in a slightly higher chance of a rate cut sometime this year, as data increasingly suggest that the economy hit a pothole in the first half. Some 6bps of rate cuts are priced in the Australian curve by year-end.
- The Fed is expected to raise the Fed Funds rate later this month, with some 21bps priced in. Beyond then, the outlook is less clear, with the next rate hike not priced in until well into 2018.
- The ECB is expected to gradually harden up on its ultra-loose policy guidance beginning next week, but rate hikes are still in the distant future.

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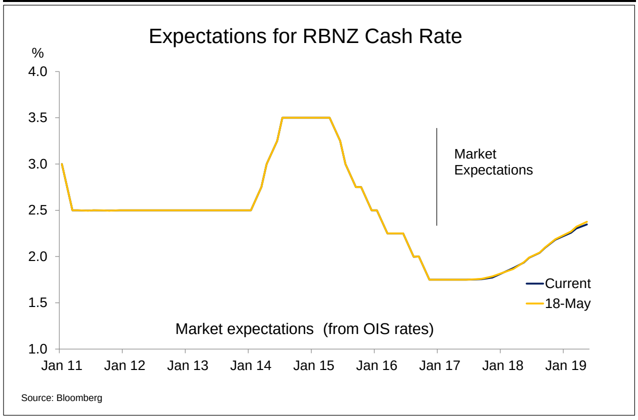
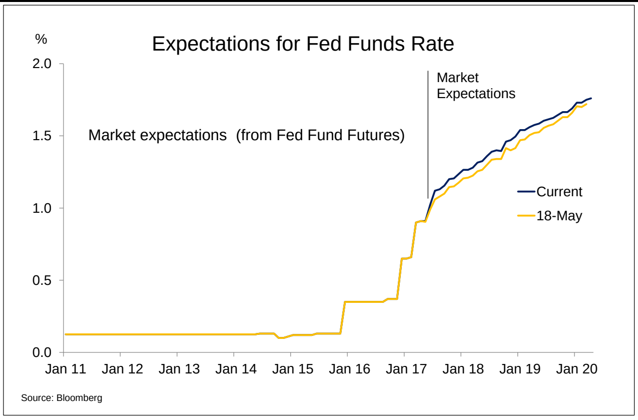
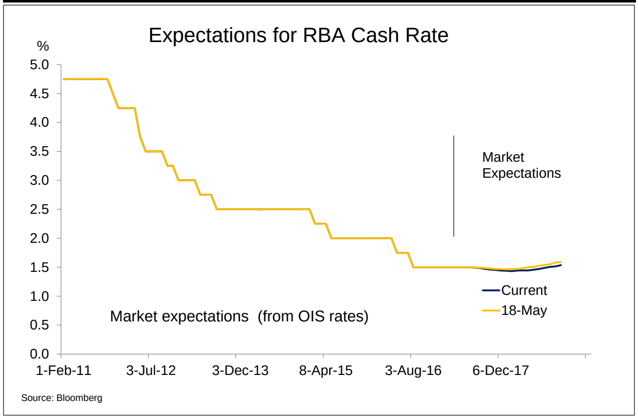
New Zealand



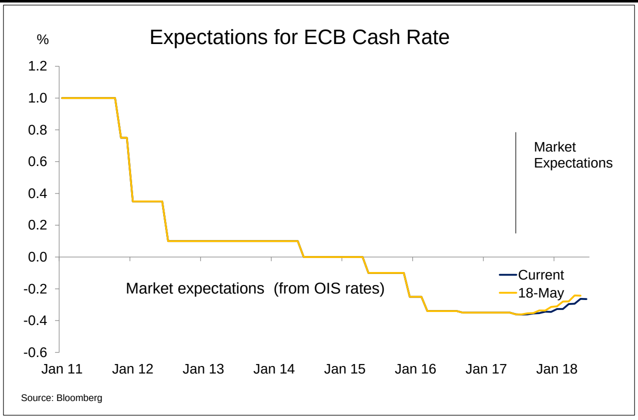
United States



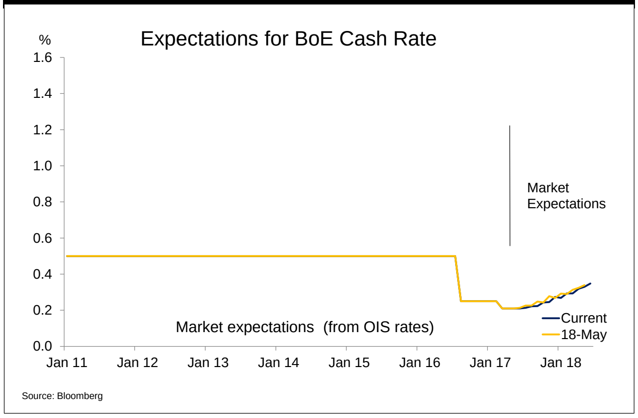
Australia



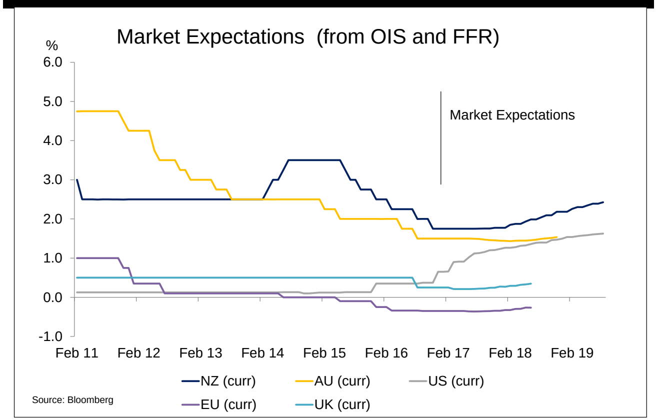
Eurozone



United Kingdom



Cross Country



Interest Rate Strategy: Carry Still The King

- Outperformance in NZ rates amid ongoing rally in global bonds.
- Relatively steep NZD and AUD 2/5y swap curves attractive to global investors amid flattening moves.
- We still look for a turn higher in US rates to steepen NZ 2/10y curve - payrolls and the June FOMC meeting could challenge a market that is now positioned very long in US 10yrs.
- Value in receiving swap against NZGB at the long end.

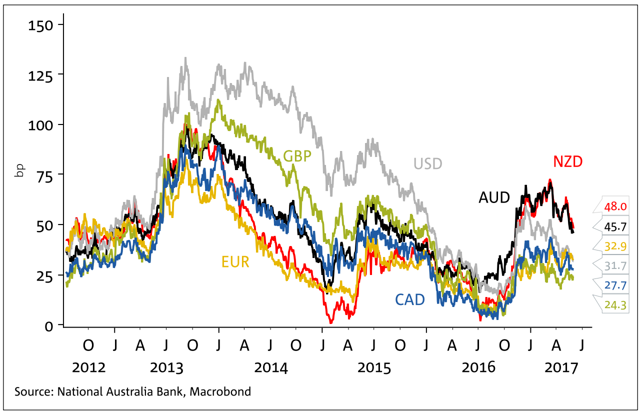
Global rally and relatively steep front end

Since our last BNZ Strategist, a global bond rally has taken NZ yields to new year-to-date lows. NZ rates have outperformed as relatively high yields and a dovish RBNZ outlook attracts inflows. The NZGB-UST 10yr spread is at the tightest level since the 1990s.

The themes driving NZ front end rates are little changed. A lack of pay side interest and the ongoing search for carry leaves front end rates near six month lows. As outlined in previous research, we see the 2y swap rate holding around 2.15-25% until global yields turn higher and even then, it's hard to see 2.35-40% tested without a change in direction from the RBNZ. A move to around 2.15% - a level last seen before the RBNZ's move away from an explicit easing bias in Nov-16 – could prompt some profit taking from funds receiving the NZ front end for carry.

The 2-5y part of the curve has seen stronger receiving interest. We see this as largely driven by the global rates rally in recent weeks. As Chart 1 shows, NZ and AU 2/5y curves are still steep relative to global peers. Forward receiver structures roll-down at comparatively better levels in NZ swaps than other G10 rates markets. Rates vol has been fairly low and without a firmer sign of the global reflation trade returning, carry-seeking in NZ 2-5y rates is attractive for many investors.

Chart 1: Global 2/5y swap curves

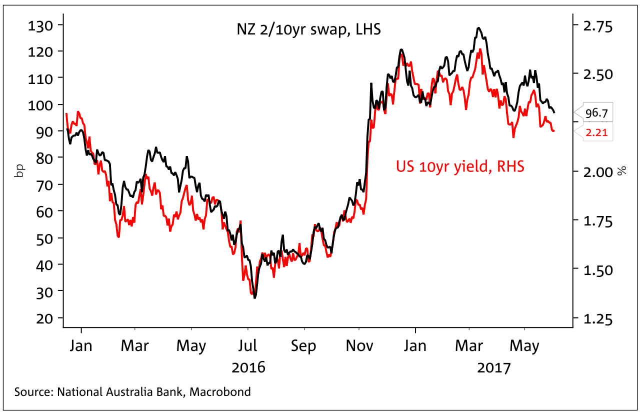


NZ 2/10y swap breaks through 100bp

The broader NZ 2/10y swap curve has broken firmly through 100bp. As Chart 2 shows, the outlook for the curve is pretty much a directional call on the US 10y yield – even more so since the RBNZ's May MPS showed an unwillingness for the Bank to consider lifting rates despite stronger inflation data.

Our view for higher US yields and a steeper NZ curve has clearly been challenged by price action over the last few weeks. Tomorrow's payrolls figures and the June FOMC meeting will provide key tests to recent price action and positioning in US 10yrs which have moved to very long (using CFTC data as a guide). A June Fed hike is 85% priced. However, the outlook for rates beyond that has been lowered amid limited signs of a firmer pickup in inflation pressures. Therefore, US wages data tomorrow is arguably more important than the headline payrolls or ISM results. We see much of the recent move as an over-reaction, but acknowledge that sentiment on reflation trades won't turn without a firmer catalyst in the form of data or Fed guidance.

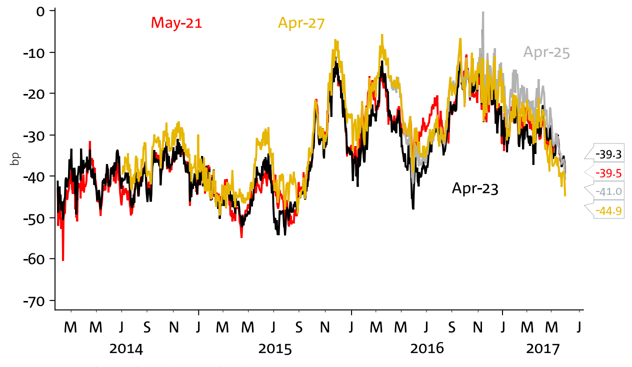
Chart 2: NZ 2/10y swap curve vs US 10y yield



NZGB long end too rich vs swap

Demand for long end NZGBs has been strong and despite limited paying flows, NZGB yields are now trading at historically low levels against swap. Supply expectations are also playing a part, after last week's Budget confirmed the strong fiscal outlook remains in place. The DMO's 2017-18 funding programme is unchanged at $7bn. The DMO intends to issue a new Apr-29 before 31-Dec-17. The injection of this supply could eventually see NZGBs underperform swap at the long end. But a more likely catalyst for a turnaround seems to be a slowing in bond buying flows. As the chart shows, the 2027 I-spread is now near the lowest levels since early 2015. At these levels we see value in receiving NZ long end swap against NZGBs. The Apr-27s and Apr-33s are the richest on the ASW curve.

Chart 3: NZGB spreads to swap (I-Spread)



Source: National Australia Bank, Macrobond

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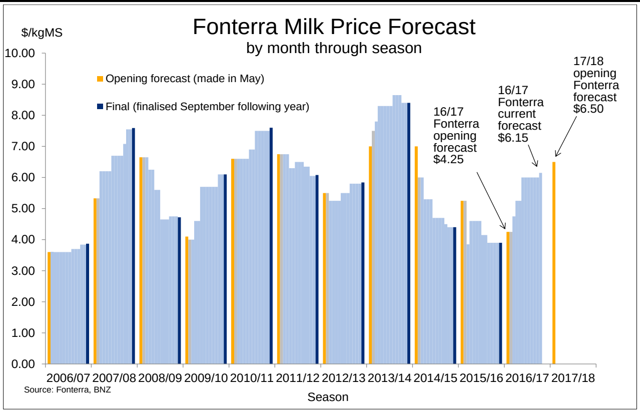
NZ Economic Review

Int'l Travel and Migration (Apr) – 19 May
It's hard to know if the slight moderation in net inward migration in April meant anything or not. But at a seasonally adjusted +5,780, from +6,130 in March, it was the lowest in 8 months. Looking at recent trends there does appear to be a top forming, at least. As for short-term arrivals, their 22% jump, y/y, was no surprise to us at all, given holiday timings, and the major event boost of the Masters Games.

Fonterra Milk Price Forecasts – 24 May
Fonterra's first milk price forecast for 2017/18 came in at $6.50. This was within the bounds of expectations and seemingly based on global dairy prices maintaining decent levels. Our forecast for the final 2017/18 milk price is $6.00, on the view there is some moderation in dairy prices later in the year. Also, Fonterra has lifted its forecast for the 2016/17 season, by 15c to $6.15. This is well above average breakeven estimates in the low $5s and a far cry from the prior season's $3.90 milk price. The lift from $3.90 to $6.15 represents a more than $4 billion lift in revenue to the dairy industry as a whole.

Back in the Black

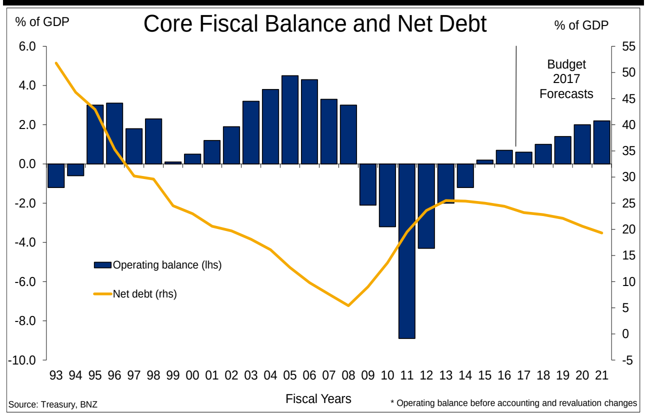


Merchandise Trade (Apr) – 24 May
After a rough December quarter, New Zealand's merchandise exports look to be rebounding this year, while imports are largely maintaining their good momentum. The value of goods exports was up 10% on a year ago (clearly surpassing market expectations). Imports were up 4% y/y. The monthly trade surplus of $578m should be enough to hold the current account deficit in at recent levels.

New Residential Mortgages (Apr) – 24 May
At face value, April's new residential lending looked awful; down 30% on the same month last year, having posted an annual fall of just 8.9% in March. While a moderating trend can't be denied, we wonder the extent to which April's annual change was compromised by holiday timings and the vicious weather during the month (as we've seen a very similar pattern in house sales over Feb/Mar/April, compared to year-ago levels).

Government Budget – 25 May
In this Budget the government announced a sizable net stimulus, centred on a Family Incomes Package. With this now made official, we have to boost our macro-economic forecasts, although haven't finalized the extent of it as yet. From the Crown's perspective, the stimulus has been fully funded by the stronger surplus track that had been emerging, on the back of a robustly expanding nominal economy. So the Budget projections look broadly similar to those of December's Economic and Fiscal Update, of increasing operating surpluses and declining net debt. It remains an enviable fiscal position, and leaves the government with more options still, should it come to that.

A Net Stimulus Announced, But Easily Afforded



Building Consents (Apr) – 30 May
We weren't expecting to see April's new dwelling consents dip the 7.6% that they did. But then we did wonder if they might be yet another monthly data out-turn for April that suffered from trading-day impacts. April's dwelling consents numbers were down 11% on a year ago, whereas in March they were up 20% y/y. There was a more marked deceleration in non-residential consents on this basis (-11%, from +82%). However, this seemed to be aggravated by lumpy items that featured large in March (entailing hotels, hospitals, shops and offices). All considered, however, there would seem to be some loss of momentum in consents.

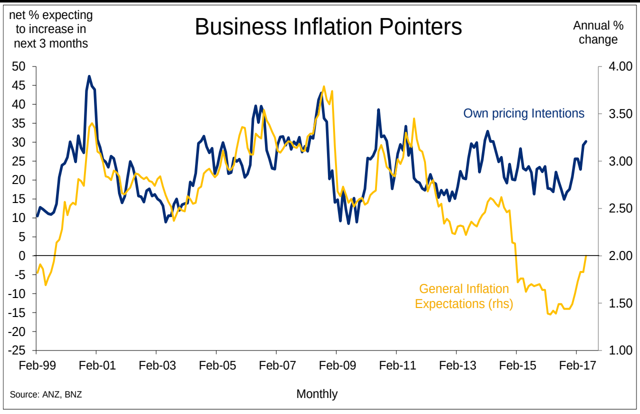
RBNZ Financial Stability Report – 31 May
As the Reserve Bank put it "New Zealand's financial system remains sound and the risks facing the system have reduced in the past six months." But also that it continues to face risks.

Even with the rebound in dairy incomes, the Bank was sounding a bit more concerned about the agriculture industry than we would have thought, as it referenced ongoing high debt levels. Yet on housing the Bank expressed a tad more comfort than we anticipated, as it cited the "significant" slowing in house price inflation. In this vein, the FSR presented some stress-testing of owner-occupiers (rather than its bugbear, investors, interestingly enough) while also delving into the dynamics around bank funding costs, along with a look at commercial property metrics.

But if there was an issue that featured prominently in this FSR (as with the last one) it was the RBNZ continuing to press for a debt-to-income (DTI) lending cap tool to be admitted to its macro-prudential toolkit. While the government doesn't seem eager to grant the Bank such a lever anytime soon, it's nonetheless a discourse to keep an eye on.

ANZ Business Survey (May) – 31 May
If New Zealand's business sector is getting nervous about September's general election, there was little sign of it in this ANZ business survey. Yes, net confidence – even with its 5 point increase in May, to +15 – is barely different to average, having been well above trend late last year. However, most every indicator regarding activity wriggled up, to a level further above trend. And the survey's inflation gauges were now pointing to annual CPI inflation of 2%, at least.

Mid Point, or Bust?



Overseas Trade Indexes (Q1) – 1 June
While the merchandise terms of trade hit its highest level since 1973, the negative results on Q1 net export volumes maintains our nervousness around that quarter's GDP outcome (due 15 June). For more on all of this, please see the lead article in today's Strategist.

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NZ Upcoming Data/Events

Credit Aggregates (Apr) – 2 June
While the money and credit aggregates are produced in different detail these days, the broad numbers have retained a full historical stretch. So we can still make sense of the trends via household, business and agriculture credit totals. We would expect the household component, at least, to have slowed further, given the housing indicators we've seen for April already.

Holiday, Queen's Birthday – 5 June

Crown Financial Statements (Apr) – 6 June
These government accounts will be judged against the newly minted baselines of the 25 May Budget. This will include the costs of the Kaikoura earthquake, attributed to the 2016/17 operating balance.

Wholesale Trade (Q1) – 6 June
To be consistent with our GDP thinking we hope to see nominal wholesale sales rise in the order of 1.5 to 2.0% for the March quarter, in seasonally adjusted terms.

Building Work Put in Place (Q1) – 6 June
GDP-wise there is a lot riding on this March quarter building result. We are worried that it might take a dive, if we are to take the late-2016 slump in building consents at face value. However, our formal view is that building activity holds about steady in the quarter.

ANZ Commodity Export Prices (May) – 6 June
Indicators suggest a decent lift in the overall world price index, of around 3%, with a somewhat larger gain in the NZ price index given the general dip in the currency's value in the month.

GDT Dairy Auction – 7 June
There remains much going on in individual dairy product markets, but, at the time of writing, we see the pluses and minuses netting to not much overall change at this auction.

Manufacturing Sales (Q1) – 7 June
By the time we get these quarterly manufacturing data we will have a better idea on how well (or not?) Q1 GDP growth is looking, based on other partials. Still, we are looking for them to imply a strong rebound in manufacturing production in Q1, after the fall they registered in Q4. Primary food processing looks supportive but we wonder about the rest of manufacturing (especially with today's surprisingly soggy numbers around non-food manufactured exports).

ANZ Job Ads (May) – 7 June
Having expanded so strongly, for so long, this job advertising series could be excused for pausing breath, at any stage.

Electronic Card Transactions (May) – 12 June
With Q1 retail trade having surged anew, we look for May's electronic card transactions to keep the Q2 story alive and well. To do so, we are picking a value increase of 0.5%, to match the increase it posted in April. May's result will also give us a clue as to how much April's outcome might have been affected by the atrocious weather in that month.

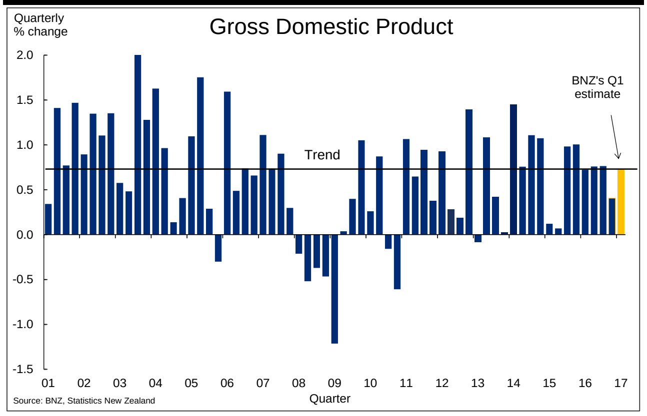
Food Price Index (May) – 14 June
We expect May's food prices to rebound 1.1%. This is after surprising on the low side for April, with a drop of 0.8%. This is implicit to the 0.1% increase we've already toned down to on the Q1 CPI, which would trim its annual inflation to 1.8%, from 2.2% in Q4.

Balance of Payments (Q1) – 14 June
We expect a year to March current account deficit equivalent to 2.8% of GDP, so hardly different to the 2.7% proportion reported for calendar 2016.

GDP (Q1) – 15 June
Our nervousness on Q1 GDP growth has, if anything, become more intense. This morning's negative results on net export volumes, as per the Overseas Trade Indexes, didn't help. Our view at this time of writing is for a 0.7% increase in Q1 GDP. But this relies on strong support from yet-to-be-published figures on Wholesale Trade and Manufacturing, and Building Work Put in Place holding up OK in the March quarter. Fingers crossed.

BNZ PMI (May) – 16 June
April's Performance of Manufacturing Index, at 56.8, did well to stay in touch with March's stellar result of 58.0, especially with April's holidays and awful weather. Anything close to these levels in May would be a great result.

Better and Better



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Quarterly Forecasts

As at 01 June 2017

Key Economic Forecasts

Quarterly % change unless otherwise specified

Forecasts

	Dec-15	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18
GDP (production s.a.)	1.0	0.7	0.8	0.8	0.4	0.7	0.7	0.6	0.6	0.6
Retail trade (real s.a.)	1.3	0.8	2.2	0.7	0.9	1.5	0.9	0.6	0.5	0.7
Current account (ytd, % GDP)	-3.4	-3.1	-2.9	-3.0	-2.7	-2.8	-2.7	-2.7	-2.6	-2.5
CPI (q/q)	-0.5	0.2	0.4	0.3	0.4	1.0	0.1	0.6	0.4	0.8
Employment	1.1	1.2	2.3	1.4	0.7	1.2	0.7	0.6	0.5	0.4
Unemployment rate %	4.9	5.2	5.0	4.9	5.2	4.9	4.9	5.0	5.0	5.2
Avg hourly earnings (ann %)	2.5	2.5	2.1	1.6	1.1	1.1	1.1	1.9	2.6	2.7
Trading partner GDP (ann %)	3.2	3.1	3.3	3.2	3.5	3.4	3.3	3.5	3.4	3.4
CPI (y/y)	0.1	0.4	0.4	0.4	1.3	2.2	1.8	2.1	2.1	1.9
GDP (production s.a., y/y))	2.2	2.8	3.5	3.3	2.7	2.7	2.7	2.4	2.7	2.5

Interest Rates

Historical data - qtr average Forecast data - end quarter	Cash	Government Stock 90 Day Bank Bills	5 Year	10 Year	Swaps 2 Year	5 Year	10 Year	US Rates Libor 3 month	US 10 yr	Spread NZ-US Ten year
2016 Mar	2.45	2.55	2.60	3.05	2.50	2.80	3.30	0.60	1.90	1.15
Jun	2.25	2.35	2.20	2.60	2.25	2.45	2.90	0.65	1.75	0.85
Sep	2.10	2.30	1.90	2.25	2.05	2.15	2.45	0.80	1.55	0.70
Dec	1.85	2.10	2.40	2.95	2.25	2.65	3.10	0.90	2.10	0.80
2017 Mar	1.75	2.00	2.70	3.25	2.40	3.00	3.50	1.15	2.50	0.80
Forecasts										
Jun	1.75	2.00	2.50	3.00	2.25	2.80	3.30	1.30	2.50	0.50
Sep	1.75	2.00	2.60	3.10	2.40	2.90	3.40	1.40	2.50	0.60
Dec	1.75	2.10	2.70	3.20	2.50	3.00	3.50	1.60	2.50	0.70
2018 Mar	2.00	2.35	2.85	3.30	2.80	3.15	3.60	1.60	2.50	0.80
Jun	2.25	2.65	3.15	3.60	3.10	3.45	3.90	1.90	2.75	0.85
Sep	2.50	2.90	3.20	3.65	3.20	3.50	3.95	2.10	2.75	0.90
Dec	2.75	3.15	3.30	3.65	3.40	3.60	3.95	2.40	2.75	0.90
2019 Mar	3.00	3.40	3.40	3.70	3.50	3.70	4.00	2.55	2.75	0.95
Jun	3.25	3.65	3.45	3.75	3.60	3.70	4.00	2.80	2.75	1.00

Exchange Rates (End Period)

USD Forecasts

	EUR/USD	USD/JPY	GBP/USD	NZD/USD	AUD/USD
Current	1.12	111	1.29	0.71	0.74
Jun-17	1.12	114	1.31	0.68	0.73
Sep-17	1.11	116	1.29	0.67	0.71
Dec-17	1.13	118	1.27	0.67	0.70
Mar-18	1.15	120	1.26	0.68	0.70
Jun-18	1.15	120	1.25	0.68	0.70
Sep-18	1.17	122	1.24	0.69	0.70
Dec-18	1.19	122	1.22	0.69	0.70
Mar-19	1.20	120	1.25	0.71	0.70
Jun-19	1.20	118	1.25	0.71	0.71
Sep-19	1.21	116	1.27	0.72	0.72

NZD Forecasts

	NZD/EUR	NZD/JPY	NZD/GBP	NZD/USD	NZD/AUD	TWI-17
Current	0.63	78.5	0.55	0.71	0.95	76.7
Jun-17	0.61	77.5	0.52	0.68	0.94	75.0
Sep-17	0.60	77.7	0.52	0.67	0.94	74.9
Dec-17	0.59	79.1	0.53	0.67	0.96	75.1
Mar-18	0.59	81.0	0.54	0.68	0.96	75.7
Jun-18	0.59	81.6	0.54	0.68	0.97	76.2
Sep-18	0.59	83.6	0.55	0.69	0.98	76.6
Dec-18	0.58	84.2	0.57	0.69	0.99	76.9
Mar-19	0.59	84.6	0.56	0.71	1.01	78.2
Jun-19	0.59	83.8	0.57	0.71	1.00	78.3
Sep-19	0.60	83.5	0.57	0.72	1.00	78.7
TWI Weights	0.1135	0.0635	0.0456	0.1398	0.2073	

Source for all tables: Statistics NZ, Bloomberg, Reuters, RBNZ, BNZ

Annual Forecasts

As at 01 June 2017

	March Years					December Years				
	Actuals		Forecasts			Actuals		Forecasts		
	2015	2016	2017	2018	2019	2015	2016	2017	2018	2019
GDP - annual average % change										
Private Consumption	3.1	2.8	4.8	2.8	3.5	2.9	4.3	3.4	3.3	2.5
Government Consumption	3.1	2.7	2.4	2.1	1.0	2.6	2.3	2.5	1.1	1.0
Total Investment	6.8	2.5	6.4	6.4	3.7	2.1	5.6	7.1	4.2	1.9
Stocks - ppts cont'n to growth	0.5	-0.3	0.2	0.0	0.0	-0.3	0.2	0.2	-0.2	0.0
GNE	3.9	2.4	5.1	3.1	3.1	2.1	4.8	3.8	3.0	2.1
Exports	4.3	5.5	0.2	0.5	3.8	6.8	1.6	-1.8	4.0	4.1
Imports	7.4	2.1	6.0	4.0	3.7	3.6	4.2	4.9	3.7	3.2
Real Expenditure GDP	3.1	3.4	3.6	2.2	3.1	3.1	3.9	2.1	3.0	2.3
GDP (production)	**3.4**	**2.4**	**3.0**	**2.6**	**3.1**	**2.5**	**3.1**	**2.6**	**2.9**	**2.3**
GDP - annual % change (q/q)	*3.1*	*2.8*	*2.7*	*2.5*	*3.1*	*2.2*	*2.7*	*2.7*	*3.2*	*1.7*
Output Gap (ann avg, % dev)	0.8	0.8	1.1	1.2	1.1	0.8	1.1	1.2	1.2	0.8
Household Savings (gross, % disp. income)	1.8	1.2	0.5	0.0	-0.3					
Nominal Expenditure GDP - $bn	240.8	250.4	265.9	283.5	296.0	247.4	261.2	280.0	292.8	304.1
Prices and Employment - annual % change										
CPI	0.3	0.4	2.2	1.9	1.9	0.1	1.3	2.1	1.9	1.7
Employment	3.2	2.0	5.7	2.2	1.5	1.4	5.8	3.0	1.6	1.2
Unemployment Rate %	5.4	5.2	4.9	5.2	5.4	4.9	5.2	5.0	5.4	5.6
Wages - ahote	2.6	2.5	1.1	2.7	2.8	2.5	1.1	2.6	2.6	2.8
Productivity (ann av %)	-0.1	0.3	-2.6	-0.3	0.7	0.1	-1.7	-1.2	0.6	0.5
Unit Labour Costs (ann av %)	2.2	2.5	4.6	2.9	2.4	2.6	3.6	3.6	2.5	2.6
External Balance										
Current Account - $bn	-8.5	-7.8	-7.3	-7.2	-9.4	-8.3	-7.1	-7.1	-9.3	-9.6
Current Account - % of GDP	-3.5	-3.1	-2.8	-2.5	-3.2	-3.4	-2.7	-2.6	-3.2	-3.2
Government Accounts - June Yr, % of GDP										
OBEGAL (core operating balance)	0.2	0.7	0.6	1.2	1.6					
Net Core Crown Debt (excl NZS Fund Assets)	25.0	24.4	23.2	22.6	21.7					
Bond Programme - $bn	8.0	7.0	8.0	7.0	7.0					
Bond Programme - % of GDP	3.3	2.8	3.0	2.5	2.4					
Financial Variables (1)										
NZD/USD	0.75	0.67	0.70	0.68	0.71	0.67	0.70	0.67	0.69	0.73
USD/JPY	120	113	113	120	120	122	116	118	122	114
EUR/USD	1.08	1.11	1.07	1.15	1.20	1.09	1.05	1.13	1.19	1.23
NZD/AUD	0.97	0.90	0.92	0.96	1.01	0.93	0.96	0.96	0.99	1.00
NZD/GBP	0.50	0.47	0.57	0.54	0.56	0.45	0.56	0.53	0.57	0.57
NZD/EUR	0.69	0.61	0.66	0.59	0.59	0.62	0.67	0.59	0.58	0.59
NZD/YEN	89.9	76.0	79.2	81.0	84.6	82.1	81.7	79.1	84.2	83.2
TWI	78.3	72.2	76.5	75.7	78.2	73.2	78.1	75.1	76.9	79.1
Overnight Cash Rate (end qtr)	3.50	2.25	1.75	2.00	3.00	2.50	1.75	1.75	2.75	3.75
90-day Bank Bill Rate	3.63	2.42	1.98	2.33	3.38	2.74	2.03	2.08	3.13	4.05
5-year Govt Bond	3.20	2.45	2.70	2.85	3.40	2.90	2.75	2.70	3.30	3.55
10-year Govt Bond	3.35	2.95	3.25	3.30	3.70	3.45	3.35	3.20	3.65	3.85
2-year Swap	3.55	2.30	2.35	2.80	3.50	2.80	2.40	2.50	3.40	3.75
5-year Swap	3.65	2.60	3.00	3.15	3.70	3.15	3.00	3.00	3.60	3.85
US 10-year Bonds	2.05	1.90	2.50	2.50	2.75	2.25	2.50	2.50	2.75	2.75
NZ-US 10-year Spread	1.30	1.05	0.75	0.80	0.95	1.20	0.85	0.70	0.90	1.10

(1) *Average for the last month in the quarter*

Calendar

	Forecast	Median	Last
Friday 2 June			
NZ, Credit Aggregates (new format/series), April			
US, International Trade, April		-$46.1b	-$43.7b
US, Fed's Harker Speaks, Economic Outlook			
US, Non-Farm Payrolls, May		+180k	+211k
Monday 5 June			
NZ, Holiday, Queen's Birthday			
Aus, Company Profits, Q1			+20.1%
China, Services PMI (Caixin), May			51.5
UK, Markit/CIPS Services, May			55.8
US, Factory Orders, April		-0.2%	+0.2%
US, ISM Non-Manuf, May		57.0	57.5
Tuesday 6 June			
NZ, Building Work Put In Place, Q1 vol s.a.			+1.9%
NZ, Wholesale Trade, Q1 ($) s.a.			+0.7%
NZ, ANZ Comdty Prices (world), May			-0.2%
Aus, Current Account, Q1			-$3.9b
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
Wednesday 7 June			
NZ, Dairy Auction, GDT Price Index			+3.2%
NZ, Manufacturing Sales, Q1 vol s.a.			-1.8%
Aus, GDP, Q1			+1.1%
Euro, GDP, Q1 2nd estimate			+0.5%P
Germ, Factory Orders, April			+1.0%
Thursday 8 June			
Aus, International Trade, April			+$3.11b
China, Trade Balance, May			+CNY262b
Jpn, GDP, Q1 2nd est			+0.5%P
Euro, ECB Policy Announcement, Main Refi		0.00%	0.00%
Germ, Industrial Production, April			-0.4%
UK, Snap Election			
Friday 9 June			
Aus, Housing Finance, April			-0.5%
China, CPI/PPI, May y/y		+1.4/+5.4%	+1.2/+6.4%
UK, Industrial Production, April			-0.5%
Monday 12 June			
NZ, Electronic Card Transactions, May	+0.5%		+0.5%
Aus, Holiday, Queen's Birthday			
Jpn, Machinery Orders, April			+1.4%
Tuesday 13 June			
Aus, NAB Business Survey, May			+13
Jpn, BSI Business Survey, Q2			+1.3
Germ, ZEW Sentiment, June			+20.6
UK, CPI, May y/y			+2.7%
US, NFIB Small Business Optimism, May			104.5
US, PPI ex-food/energy, May y/y			+1.9%
Wednesday 14 June			
NZ, Food Price Index, April	+1.1%	-0.8%	

	Forecast	Median	Last
Wednesday 14 June cont'd…			
NZ, Balance of Payments, Q1	-2.8%		-2.7%
Aus, Consumer Sentiment - Wpac, June			98.0
China, Industrial Production, May y/y			+6.5%
China, Retail Sales, May y/y			+10.7%
Euro, Industrial Production, March			-0.1%
Euro, Eurozone Employment, Q1 y/y			+1.1%
UK, Unemployment Rate (ILO), April			4.6%
US, CPI ex food/energy, April y/y			+1.9%
US, Retail Sales, April		+0.1%	+0.4%
US, FOMC Policy Announcement, Upper Bound		1.00%	1.00%
Thursday 15 June			
NZ, GDP, Q1	+0.7%		+0.4%
Aus, Employment, May			+37k
UK, Retail Sales vol., May			+2.3%
US, Philly Fed Index, June			+38.8
US, Industrial Production, May		+0.2%	+1.0%
US, Empire Manufacturing, June			-1.0
US, NAHB Housing Index, June			70
Friday 16 June			
NZ, BNZ PMI (Manufacturing), May			56.8
NZ, ANZ-RM Consumer Confidence, June			123.9
Jpn, BOJ Policy Announcement, Policy Rate		-0.1%	-0.1%
Euro, CPI, May y/y 2nd est			+1.4%P
Euro, Labour Costs, Q1 y/y			+1.6%
US, Housing Starts, May			1,172k
US, Mich Cons Confidence, June 1st est			97.1
Monday 19 June			
NZ, BNZ PSI (Services), May			52.8
China, Property Prices, May			
Jpn, Merchandise Trade Balance, May			+Y482b
Tuesday 20 June			
Aus, RBA Minutes, 6 June Meeting			
Aus, House Prices, Q1 y/y			+7.7%
China, Leading Index (Conference Bd), May			+1.2%
US, Current Account, Q1 s.a.			-$112.4b
Wednesday 21 June			
Jpn, BOJ Minutes, 26/27 Apr Meeting			
US, Existing Home Sales, May			5.57m
Thursday 22 June			
NZ, External Migration, May s.a.			+5,780
NZ, RBNZ OCR Review	1.75%	1.75%	1.75%
Euro, ECB Economic Bulletin			
Euro, Consumer Confidence, June 1st est			-3.3
US, Leading Indicator, May			+0.3%
Friday 23 June			
US, Fed's Mester Speaks			
US, New Home Sales, May			569k

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