21 September 2017

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Economic Outlook

There might yet be some important implications for New Zealand's economic outlook from Saturday's election. But with that race still looking so tight, and coalition permutations reasonably many, it seems pointless to conjecture about how our economic views might need to change. With today's Q2 GDP report coming in as expected (0.8% for the quarter and 2.5% y/y) attention turns to "what next?" Recent economic surveys still signal a solid growth path underfoot, in spite of the election coming into sharp focus. Consumer sentiment is robust. And we will get further insight into the minds of business with the 26 September ANZ survey. Then there's the 3 October NZIER Quarterly Survey of Business Opinion to check out – which respondents will have also have filled out pre-election. The more interesting surveys will be those reflecting post-election sentiment and activity, including for the housing market.

Interest Rate Outlook and Strategy

We still see NZ short end yields range bound, anchored by an on hold RBNZ. Economic developments have not been sufficiently different to August MPS projections to warrant any change of cash rate (1.75%), or rhetoric, from the Bank at its meeting next week, especially amid likely post-election noise and it being the first OCR review from the Acting Governor, Grant Spencer. Meanwhile, we remain of the view that long end yields will track higher driven by expected increases offshore including in Australia and the US. The latter reflects our expectations for more Fed funds tightening than implied by current front end pricing and a higher term premium as the Fed balance sheet reduction proceeds and the ECB and other central banks slowly unwind accommodative policy.

Currency Outlook

Central bank statements and expectations can kick around currencies over the very short term but we think other drivers are more important over the medium term. Relationships between NZ-global rate spreads and the NZD have weakened over recent years. Risk appetite and commodity price trends are more important drivers of the NZD than interest rate differentials. Our monetary policy expectations don't have a significant bearing on our outlook for the NZD over the next year or two. High risk appetite – its highest level this year – supports the current level of the NZD. Our (unchanged) projections for a weaker NZD into year end and early next year assumes that risk appetite peels back from its current giddy heights. A weaker commodity price dynamic is expected to give further weight to that view.

A Centrist GDP Outcome

- **Q2 NZ GDP expands 0.8% (2.5% y/y)**
- **No real surprise (for RBNZ included)**
- **But nominal GDP growth "just" 5.4% y/y**
- **No great fodder for election debate**
- **As growth indicators remain robust in Q3**
- **But immigration falls again in August**

GDP (Production) - 2017 Q2				
	Actual	Mkt Expected	Aug MPS	Previous
s.a qtr % chg	**+0.8**	+0.8	+0.9	+0.6R
qtr on qtr year ago %	**+2.5**	+2.5		+2.5
annual average % chg	**+2.7**			+2.9
R - revised				

New Zealand's economic activity remains bumpy in its componentry. However, overall, it continues to make its way forward at a creditable pace (as do the leading indicators of growth, going into Saturday's election). June quarter production GDP expanded 0.8%. This was in line with market expectations, and ours. As was the annual growth result, of 2.5% (even with a slight upgrade to March quarter growth itself – to 0.6%, from 0.5%).

As solid as this appeared, there will no doubt be those still questioning just how strong the GDP accounts really are. In this we acknowledge that per capita GDP growth in Q2, for instance, was 0.3%, and 0.4% at an annual rate. This was even with the one-off benefits from the major sports events that New Zealand hosted in the June quarter. And even the big increase in goods exports in Q2 was mainly catch-up from a poor run over prior quarters.

The 0.8% increase in Q2 GDP, overall, also harboured further slippage in construction activity, a reduction in on-farm output, a third successive fall in mining activity, and was aided by an outsized 1.8% expansion in central government services (+4.8% y/y).

But to come to the defence of the latest GDP report card, it also had to digest a big run-down in inventory in the June quarter, from manufacturing. Even with this, the expenditure measure of real GDP lifted 1.1% in the June quarter, none too shabby. Private consumption expenditure, meanwhile, kept chugging forth at +0.9% in Q2, to be 4.0% stronger than a year ago (nothing to do with tourist spending, by definition). And while investment in plant and machinery slipped 0.9% in Q2, this was after big gains in Q4 and Q1, such that annual growth came in near 10%.

To be sure, the housing market remains vulnerable to a correction, given the heights it has got to (in the context of very low interest rates). However, we don't believe the reported slippage in construction activity over the first half of 2017 confirms the start of a downturn, more a consolidation from a big leg up during 2015/16. There is, however, an underlying abatement occurring in Canterbury's reconstruction cycle that is important to recognise. This is weighing on the national total.

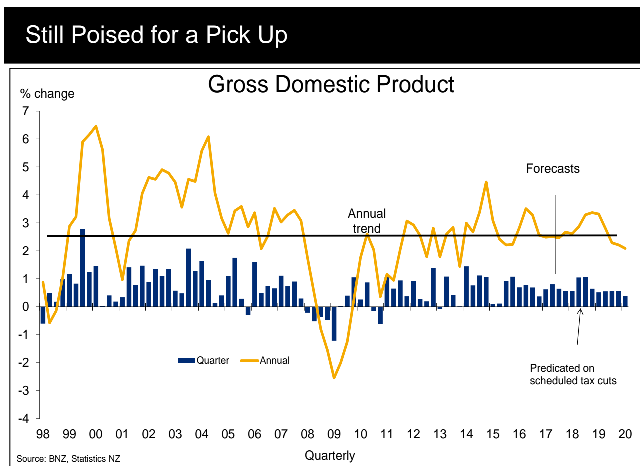
In many ways New Zealand's construction industry is also at the forefront of the capacity-constraint story we are pushing. It's hard to keep expanding when resources are being stretched, and when the marginal resources being employed, as the cycle matures, they are probably dragging the averages down. This process seems relevant to the productivity debate regarding the economy more generally. While CPI inflation might be slow in picking up, to our mind there are abundant signs that the economy is getting stretched on the supply side.

The GDP deflator also continues to lag. In fact, it fell 0.8% in the June quarter. We are still scratching our heads over this, as the price of the principal components of expenditure GDP – consumption, investment and net exports of goods and services – all rose, albeit not by much. The under-shoot of the GDP deflator was the reason annual nominal GDP growth chimed in at 5.4% in Q2, rather than the 8.0% we anticipated.

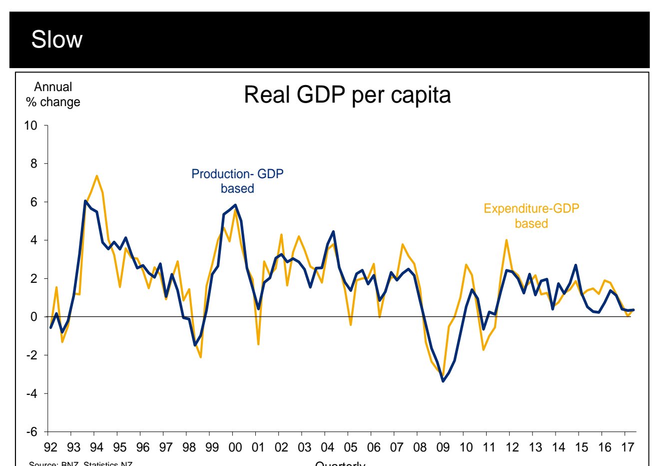
As for how Q2 GDP compared to Reserve Bank expectations, in real terms it was pretty close. The Bank expected 0.9% on Q2 GDP growth and the outcome was 0.8%; nothing to see there.

It's not as if there are signs of deceleration in the economy. If anything, the pointers are edging the other

Still Poised for a Pick Up



Slow



way, even with the election front of face. That GDP growth will probably pick up over the coming 6-12 months – at least on an annual basis. The BNZ/Business New Zealand PMI and PSI measures proved the latest cheerleaders of this.

Of course, there might yet be some important implications for New Zealand's economic outlook from Saturday's election. But with that race still looking very tight we cannot presume to amend our views on anything at this point. Today's Q2 GDP report certainly can't be considered fodder for one side of the election debate or the other, when it comes to arguing the underlying health of the economy.

Meanwhile, the economic data keep on being printed. Perhaps lost amid the spotlight on this morning's GDP account was the concurrent release of figures showing a second monthly drop in immigration. The seasonally adjusted 5,490 net inflow in August was down a bit further from July's 5,760, which was itself back from June's near record high of 6310. This has been entirely due to fewer arrivals (which have declined by 820) with the number of departures steady.

The coming months' data will be important to see if this is indeed the beginning of some moderation along the lines of what is built into our macroeconomic forecasts, including for the housing and labour markets. A marked slowdown in net migration may render both RBNZ and Treasury growth forecasts a bit optimistic in a headline sense, although implications for output gap assessments, and thus (core) inflation, would be equivocal.

Meanwhile, Statistics NZ also reported this morning that annual growth in visitor arrivals settled at 5.8% in August from 4.8% in July. This is after averaging more than 12% y/y through the period April-June boosted, as it was, by the hordes for the World Masters Games and Lions Rugby tour that New Zealand hosted. This points to an obvious unwind in tourism related activity in Q3 relative to Q2.

Nonetheless, there seems plenty of momentum in many other areas of the economy to keep GDP expanding at a respectable clip – and enough to keep pressure on the supply side of the economy.

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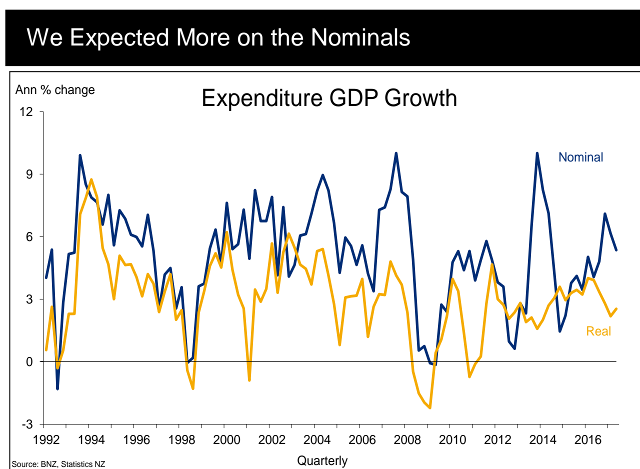
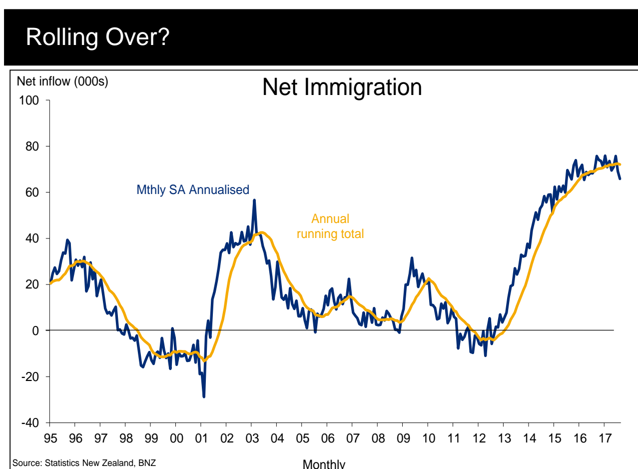
We Expected More on the Nominals



Rolling Over?



US Economic Update – A Fairly Hawkish FOMC Affair

- **11 of 16 FOMC members sees one more hike this year**
- **2017 and 2018 median 'dots' unchanged (i.e. still 1 hike in 2017, 3 in 2018)**
- **Longer term median dot down ¼% to 2.75%, Funds rate seen above here in 2020**
- **Statement little changed, Hurricane impacts seen temporary**
- **Balance sheet unwind to start in October at pace previously indicated**
- **Inflation forecasts lowered by 0.2% in 2017, 0.1% for 2018**
- **Unemployment rate seen at 4.1% in 2018 and 2019 from 4.2% previously**
- **Bond yields and USD both higher out of FOMC**
- **All up a somewhat more hawkish FOMC affair compared to pre-meeting expectations**

The September FOMC outcome has gone pretty much to script with a broadly unchanged post meeting statement, unchanged median 'dots' for both this year and next and confirmation that Fed balance sheet reduction will commence in October and at the pace previously indicated ($10bn per month rising in 3 monthly increments to a maximum of $50bn per month, split 60:40 for Treasuries and MBS).

The 'hawkish' surprise is that no-one has joined the four FOMC members who previously saw no need for a further rate rise this year, and that the number lowering their 2018 dot is so small (only two).

The ''dovish' surprise is that the long term median dot has been lowered from 3% to 2.75% and the 2019 median dot by 25bps to 2.625% (the previous 2018 median at 2.938% has simply been shifted to 2019, with the new 2020 median dot at 2.875%). This implies that on latest projections the current FOMC line up sees policy becoming slightly restrictive in 2019 relative to a long run neutral rate of 2.75%.

Of course the FOMC line up will look vastly different from 2018, rendering the dot plot even more of an academic exercise than usual, but at face value we'd view the 2017 and 2018 projections as more significant than the 2019+ changes, rendering this a somewhat more hawkish FOMC affair than expected going into the meeting.

Today's FOMC statement is not much different from July. The opening paragraph starts the same as July, viz: "Information received since the Federal Open Market Committee met in July indicates that the labor market has continued to strengthen and that economic activity has been rising moderately so far this year. Job gains have remained solid in recent months, and the unemployment rate has stayed low (previously 'has declined', so merely acknowledging the lack of a further fall since July).

The Statement then repeats that household spending has been expanding (previously 'picked up') but omits the July reference to 'business fixed investment has continued to expand'. So an implicit downgrade here, again acknowledging the reality (Q2 GDP data). Inflation language is unchanged, the Fed noting that, "On a 12-month basis, overall inflation and the measure excluding food and energy prices have declined this year and are running below 2 percent. Market-based measures of inflation compensation remain low; survey-based measures of longer-term inflation expectations are little changed, on balance".

Short term impacts from the devastation caused by Hurricanes Harvey, Irma and Maria are acknowledged but the statement says "past experience suggests that the storms are unlikely to materially alter the course of the national economy over the medium term" (meaning they have not impacted Fed member projections).

The rest of the statement is unremarkable and largely unchanged. On the 'dots', 11 of 16 members have one more rate rise in their forecast for this year. The 4 dots for 'unchanged' in July remains, while 3 of the 4 dots for 2 more rise this year is now reduced to just one. The failure of anyone to drop into the 'no change' from 'one more' camp is the hawkish surprise here.

For 2018, the median for 3 hikes remains, but there are now 5 dots below the median (from 4 previously) and one less dot above the median. So while a dovish tilt, this is less than might reasonably have been expected so again hawkish, at least relative to expectations

On the Fed forecasts: 2017 GDP is now seen 2.4% from 2.2%; 2018 is unchanged at 2.1%, 2019 lifted to 2% from 1.9% and the longer run unchanged at 1.8%. On PCE inflation, headline is unchanged at 1.6% this year but core lowered to 1.5% from 1.7%; 2018 is now 1.9% for headline down from 2.0% and core also 1.9% down from 2.0%. So the Fed Funds projections imply significant further tightening even before inflation reaches 2% (not now expected until 2019).

The unemployment rate is now seen reaching a low of 4.1% in both 2018 and 2019, down from 4.2% previously, the implication being there is a bit more slack in the labour market than previously perceived.

Incoming data, if strong and consistent with a December Fed hike, can see initial moves of higher Treasury yields and USD extend.

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NZD: Rates a secondary force only

- **Central bank statements and expectations can kick around currencies over the very short term but we think other drivers are more important over the medium-term. Relationships between NZ-global rate spreads and the NZD have weakened over recent years.**
- **Risk appetite and commodity price trends are more important drivers of the NZD than interest rate differentials. Our monetary policy expectations don't have a significant bearing on our outlook for the NZD over the next year or two.**
- **High risk appetite - its highest level this year - supports the current level of the NZD. Our projections for a weaker NZD into year end and early next year assume that eventually risk appetite must surely fall from its giddy heights. A weaker commodity price dynamic is expected to give further weight to that view.**

The pummelling dealt to the NZD during August where it was down 5% on most of the crosses is now a distant memory. For September so far the NZD is up about 2½% and the same on a TWI basis.

Short term movements can often be explained by central bank statements and expectations of policy ahead, as evident by GBP and CAD movements this month and a mild recovery in the USD after this morning's FOMC Statement. A positive tone this month for the AUD can also be pinned to some extent by analysts bringing forward rate hike expectations.

The NZD has been caught up in this global trend, with local rates going up accordingly and market pricing for the first RBNZ hike brought forward to September 2018. But an added tailwind for the NZD recently has been the increase in risk appetite. Our risk appetite index reached its highest level this year overnight to 83%, a reflection of the VIX index moving below 10 and low credit spreads.

As a result, our short term fair value NZD estimate has now reached 0.7625. Admittedly, that model has tended to over-estimate the NZD this year and if we adjust for the average valuation gap current fair value reduces to 0.7320.

The recovery in the NZD has come despite the forthcoming election. We've always seen the election as a bit of red herring, despite the NZD moving up and down as the polls get updated. It's going to be a close race and we don't see any sustained implication for the NZD whichever way the result goes.

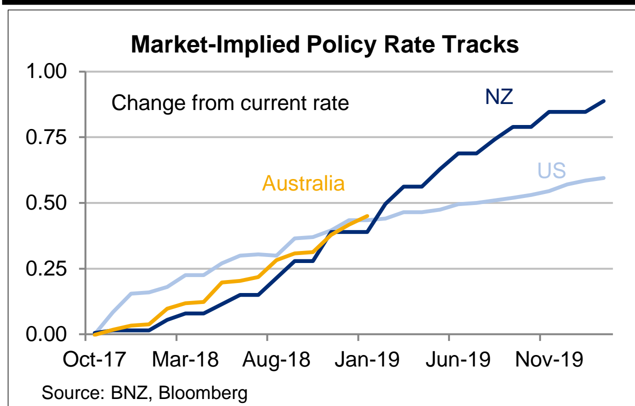
Turning back to monetary policy, market-implied rate tracks for the US, NZ, and Australia all show a period of tighter policy ahead. In the near term, the US is seen to have a greater chance of a rate hike, with another 25bps hike ahead of NZ and Australia. Based on current market pricing, the market sees a greater chance of the RBA moving earlier than the RBNZ, although the implied rate tracks are not materially different from each other through to early 2019.

The implied US policy track curve is flatter, so that by late 2018-early 2019, cumulative pricing of rate hikes across the US, NZ and Australia is similar. With that in mind, monetary policy is unlikely to be a significant force on the dollar-bloc currencies over this period. There will be some variation in interest rate spreads over that time but they are unlikely to be material enough to have a sustained impact on the currencies.

When it comes to analysing currency markets, central banks receive a lot of attention, but perhaps more so than they deserve. Our working assumption is that central bank rate decisions often have short term impacts on currencies, as we've seen through September, but over time their influence is washed out by greater fundamental forces.

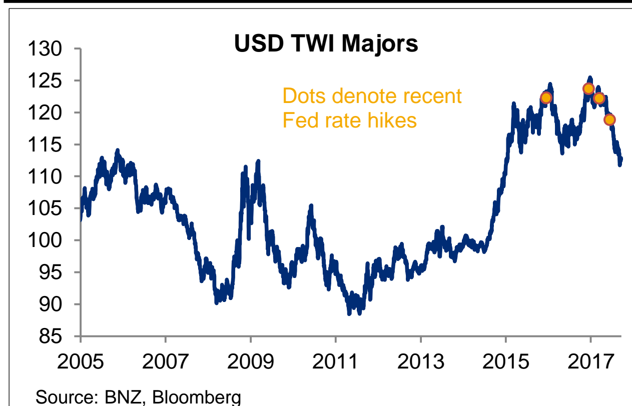
This can be illustrated by a chart of the USD major currency TWI and highlighting its path since the Fed stood out and began a tightening cycle well ahead of every other

Market Expects Rate Hikes Ahead



Source: BNZ, Bloomberg

USD Lower During Fed Tightening Cycle



Source: BNZ, Bloomberg

major central bank. Since that first tightening back in December 2015, the USD TWI has fallen by around 8%, with three additional hikes in the mix.

Our USD model which is mainly driven by US-global rate spreads also looks to have completely broken down. The difference between the actual USD TWI and estimate fair value has blown out to 8½% which is more than a 4 standard deviations event! Either the model is saying that the USD is extremely oversold or the model is broken. The truth is probably somewhere in between – that is, the USD is likely modestly undervalued and interest rate differentials are now a weaker factor in explaining USD currency movements.

The NZD is no different. Indeed, we have always thought of NZ interest rates and differentials to other countries as very much a secondary consideration in explaining the NZD. NZ-US interest rate differentials are one of the three variables in our short term fair value model, but the significance of that factor pales in comparison to the other two factors, risk appetite and commodity prices.

During the last easing cycle, the NZD spent much of the time trending higher, with a positive global growth dynamic and generally rising export commodity prices in the driving seat.

The link between NZ-US interest rate spreads and the NZD isn't particularly strong. The correlation between the NZ-US 2-year swap spread and the NZD is close to zero at present. Our research shows a better link when using real interest rate differentials than nominal differentials, but even these show a lack of correlation over the past couple of years.

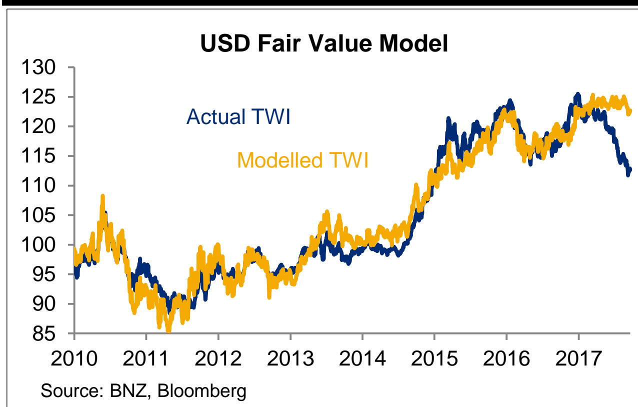
The same goes for other NZD cross rates. The link between the NZD/AUD and the NZ-Australia 2-year swap spread has weakened over recent years. Relative commodity prices between NZ and Australia do a much better job explaining short term gyrations in the NZD/AUD cross.

With the Bank of Canada in the spotlight recently after two rate hikes this cycle already, we took a closer look at NZD/CAD, rate spreads and relative terms of trade. The link between the NZD/CAD and NZ-Canada rate spreads has been fairly weak over the past few years. Relative (commodity) terms of trade between NZ and Canada have much greater explanatory power for NZD/CAD, a relationship that has stood the test of time.

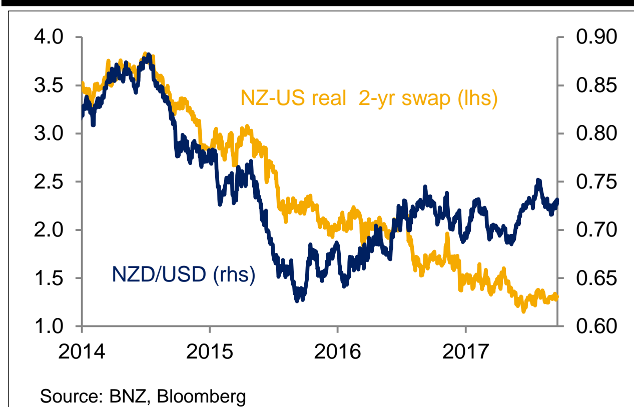
In summary, central bank policy decisions get a lot of attention by the market, largely because they can have short term implications for currency markets. But for investors and corporates with a longer term horizon, other factors are much more important in our view. Risk appetite and commodity price trends are more important drivers of the NZD than interest rate differentials. Our monetary policy expectations don't have a significant bearing on our outlook for the NZD over the next year or two.

Risk appetite is impossible to forecast, but it is mean-reverting, so it would be highly unusual for it be to sustained at such a high level for an extended period of

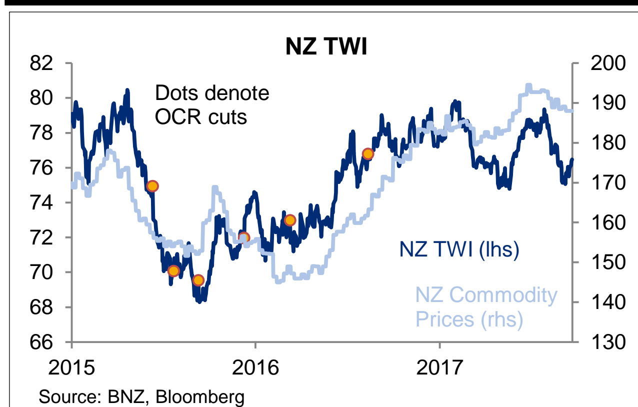
USD Model Has Broken Down



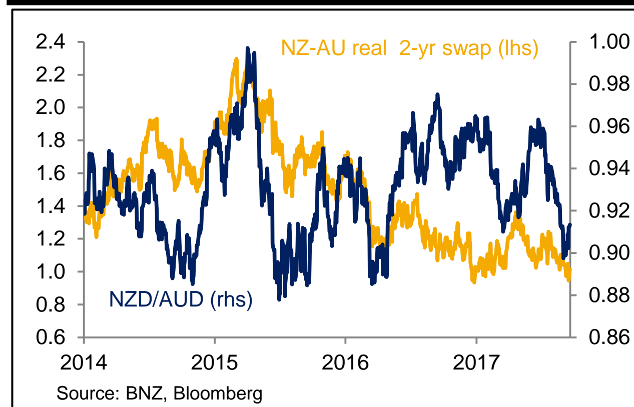
No Link Between NZD and Rate Gap in Recent Times



NZD Lined More to Commodities Than OCR Changes



NZD/AUD and Rate Spread Relationship is Weak



time. A fall in risk appetite to a more normal level represents a downside risk factor for the NZD.

Commodity prices are also difficult to forecast, but after their strong run from early 2016 the vulnerability is to the downside, and this represents a downside risk for the NZD over the medium term.

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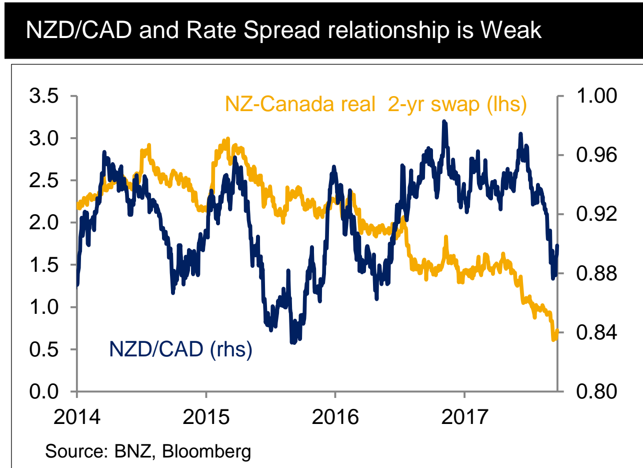
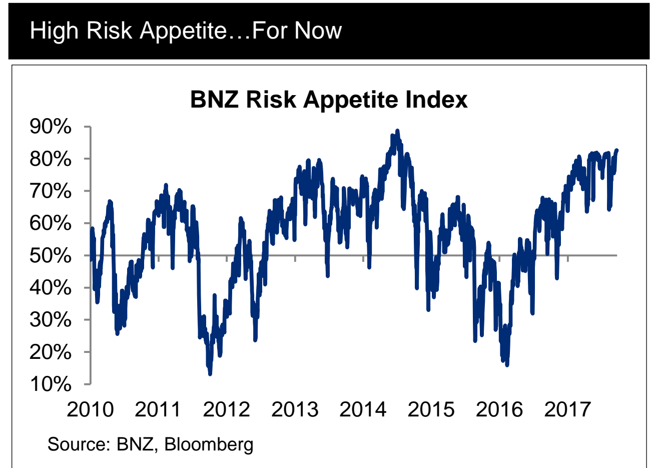
NZD/CAD and Rate Spread relationship is Weak



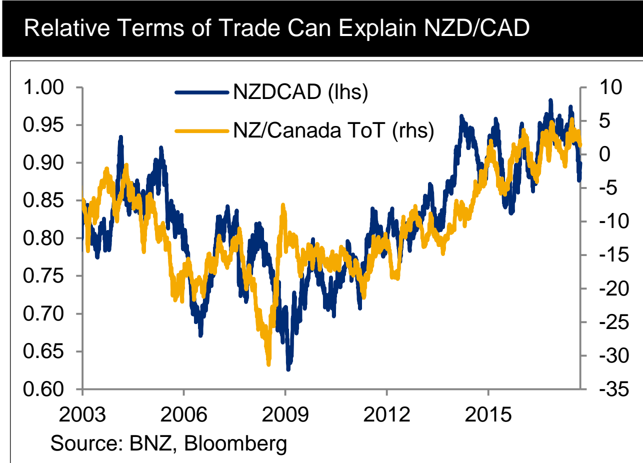
Source: BNZ, Bloomberg

High Risk Appetite…For Now



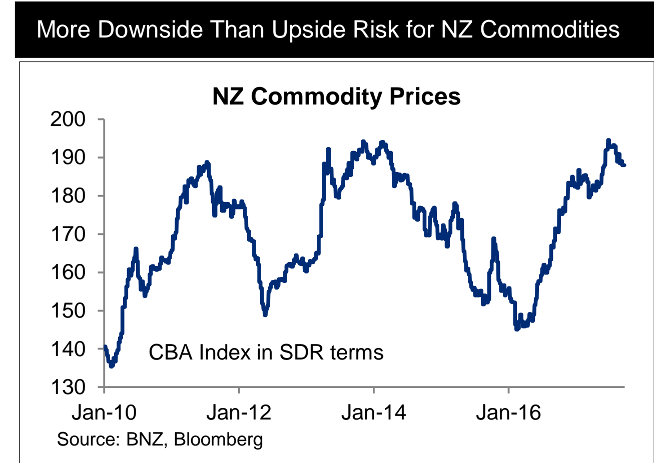
Source: BNZ, Bloomberg

Relative Terms of Trade Can Explain NZD/CAD



Source: BNZ, Bloomberg

More Downside Than Upside Risk for NZ Commodities



Source: BNZ, Bloomberg

The BNZ OIS-ter: Hawkish Fed and BoE Gets Rates Higher

- **In this morning's FOMC Statement the Fed held its line about the policy outlook that still sees another hike in December, three more hikes next year and still further hikes thereafter, while "quantitative tightening" would begin next month. The market was expecting a slight softening in the Fed's stance, so rates moved up across the curve. Still, market pricing remains well below the Fed's projection.**
- **This followed a more hawkish BoE, which followed the more hawkish Bank of Canada a fortnight ago. A pattern has certainly developed, with central banks more strident about normalising rates from such a low base. The BoE signalled a possible rate hike in coming months, which shocked the market, resulting in a chunky move higher in the rates curve.**
- **NZ and Australian rate curves have moved higher in sympathy. The first full rate hike in NZ is priced by September 2018 and for Australia by June 2018.**

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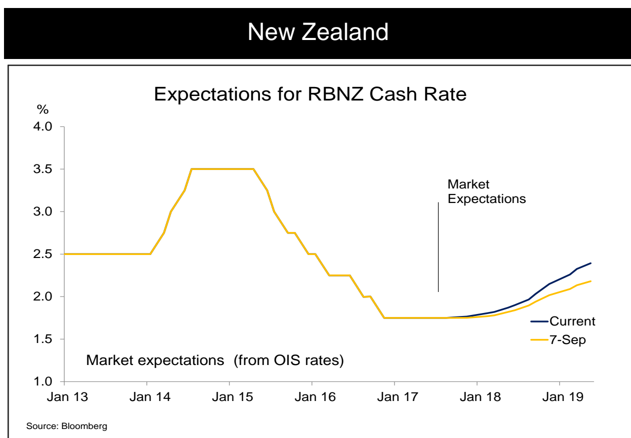
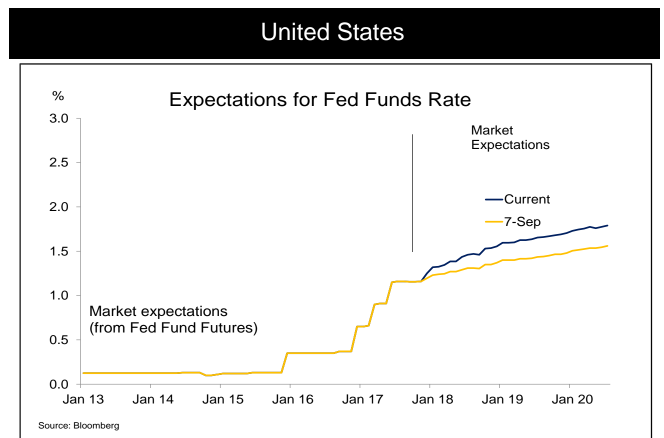
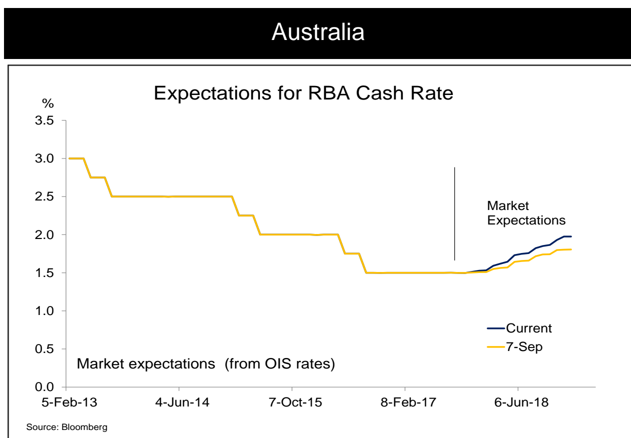
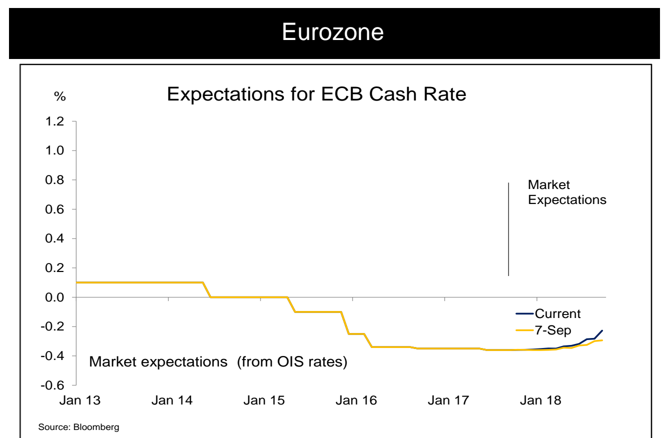
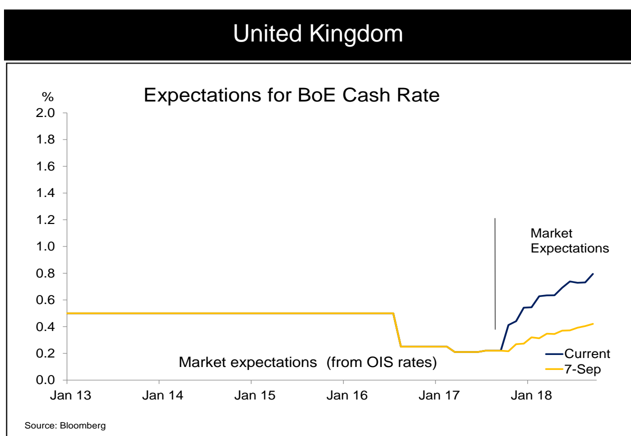
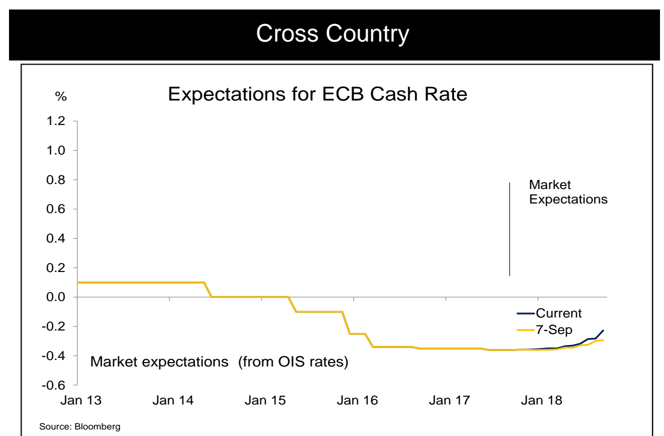












Interest Rate Strategy:

- We continue to forecast higher long end bond yields, but have slightly lowered the near term path.
- We look for the US 10y yield to reach 2.60% by year-end, 2.75% in H1 2018 and 3.0% by the end of 2018.
- US forecasts and NAB's expectation for RBA tightening next year point to the ACGB 10y yield reaching 3.0% by end 2017 and 3.4% by end 2018. The Aus-US 10y spread is heading to 30bp, before re-widening in H2 2018 as RBA tightening begins.
- Higher US and Aussie yields flow through to higher NZGB 10y yield forecasts.
- Our view for higher yields is driven by expectations for more Fed funds tightening than implied by current front end pricing and a higher term premium as the Fed balance sheet reduction proceeds and the ECB and other global central banks slowly unwind accommodative policy.

Since March, we have been expecting US 10yrs to finish the year around 2.75%. We have frequently emphasised risks to this point forecast and our views on duration and curve strategy assumed lower short term trading ranges for US 10yrs. Nonetheless, we have still been looking for a more forceful sell-off to eventually take hold. We still expect yields to rise as much as previously, but the near term path has been lowered slightly for the US. That flows through to our forecast for Aussie yields as well. But AU domestic pressures are expected to add upward pressure to yields as well. NAB’s expectation for RBA tightening next year sees a wider Aus-US 10y spread than earlier assumed, but mostly in H2 next year. Front end yields are also expected to rise next year as tightening comes into focus, leading to a less steep path for the yield curve. We consider the direction of yield forecasts to be more important rather than the precision of point estimates. Our key message is that yields are expected to rise further than current levels and the forward curve.

Pushing out higher US 10y yield forecast

The following factors have supported bonds in recent months and lead us to lower the near term path and push out the timing of most of the forecast rise in yields:

- Lower than expected US inflation. The pace of core inflation has failed to accelerate over the last few months.

- Reduced upside risk for rates from fiscal easing. Much of the post-US election sell-off was underpinned by expectations of fiscal easing. While there have been some signs that a tax cut package is still possible, the lack of progress on a range of legislative issues has undermined market confidence in stimulus. Debt ceiling uncertainty also contributed to the rally over the last two months.

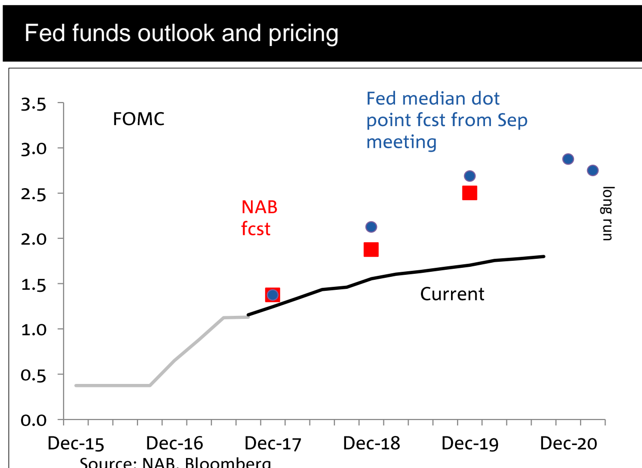
- Geopolitical risks. Various North Korea headlines were a major contributor to the rally in late August to early September that saw US 10yrs test a low of 2.01%. The market has shown increasing resilience to these headlines over the last two weeks.

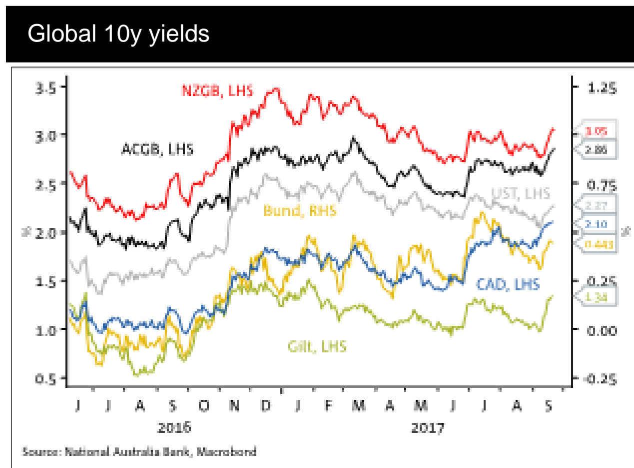
Why we still expect higher yields

Ultimately, we think US 10yrs will reach 2.60% this year and the sell-off will extend in 2018 towards 3.0%. We see the following three factors as crucial to this call:

1) US Fed Funds pricing is too pessimistic. The next hike is not fully priced until June 2018 and a negative real funds rate is priced until 5yrs ahead. NAB economists forecast for a 2.0-2.25% Fed Funds rate by the end of 2018, as indicators point to strengthening growth momentum and the labour market continues to tighten, leading to a pickup in inflation. Risks to this forecast are to the downside, but as the chart shows, even if we’re half right, market pricing is too low. The front end of the US curve will bear the brunt of Fed funds repricing, particularly if the FOMC’s longer term dots continue to fall. The 10yr yield will still push higher, although it will perhaps be led more by real yields than BEIs if the FOMC continues to be proactive in tightening ahead of the expected pick-up in inflation.

2) Fed Balance sheet run-off. Our previous research shows this could add upwards of 60bp to the 10y term premium over 3 years. This pressure will initially be slow to come through given the gradual pace of run-off confirmed by the FOMC this morning.





3) Global growth improving and central banks outside the Fed are looking to unwind easy policy. Since June, major central banks have signalled intentions to exit highly accommodative policy settings. Growth momentum is supporting this policy tilt. In Q2, GDP growth among G7 economies eclipsed 2% y/y for the first time since H1 2015 and more timely leading indicators point to further improvement. For the market, the ECB's QE tapering will be a major driver of bond valuations next year. Notwithstanding the elevated EUR, we see the ECB starting tapering in early 2018. The market isn't priced for tapering with 10y Bunds still at 0.44%.

Aussie 10y yields to follow US higher, but less tight path for Aus-US 10y spread

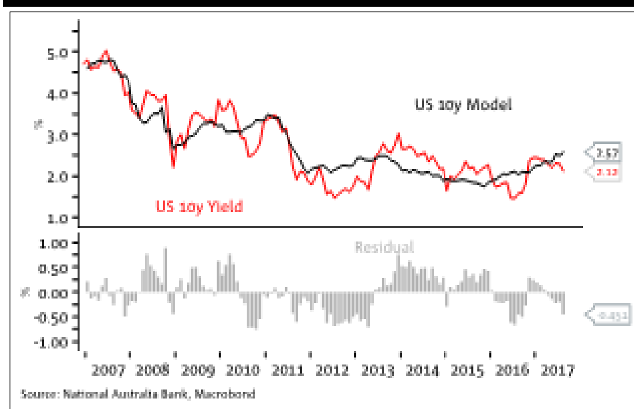
Our US 10yr yield and Aus-US spread forecasts have the Aussie 10yr yield reaching 3.0% by year-end before rising to 3.4% by the end of 2018.

Higher US yields are expected to flow through to ACGBs, but domestic Aussie factors will contribute to higher yields as well over the next year as the RBA tightens. The correlation between US and Aussie 10yrs has broken down somewhat over the last few months. The Aus-US 10yr spread hit 60bp earlier in the month as bonds rallied and compressed only modestly in the sell-off over the last week. The wider Aus-US spread mainly reflects a divergence in RBA and Fed policy expectations. While we expect greater relative US rates repricing late this year and into next year, as of last week NAB looks for 50bp of RBA tightening in H2 2018 and 50bp in 2019. Relative RBA-Fed short end pricing points to a gradual compression in the Aus-US 10y spread towards 30bp by early 2018 before a modest widening in mid to late 2018 as the RBA lifts rates. The spread is likely to be more volatile as the market grapples with both central banks tightening policy next year.

Risks to forecasts

There are plenty of risks to our base case forecasts for higher yields. The biggest risk is the outlook for inflation. The deceleration in US CPI has been relatively broad-based and contrary to the strength in jobs growth. Wages growth has also disappointed and there's a risk this turns out to be more structural than we currently assume. In Australia, the labour market will be the key risk. NAB economists' expectation for RBA tightening depends on further improvement in jobs growth and less slack in the economy. Other uncertainties to grapple with are the make-up of the FOMC with new appointments expected and the ECB's reaction to a higher EUR (we think their sensitivity for policy kicks in around 1.25-1.30). Geopolitical risks are harder to predict, but as the last few years shows, can have a profound impact on markets. Our forecasts assume no major derailment in risk assets from higher yields and tighter global policy, amid a positive global growth backdrop. A US tax package of some kind is still on the cards and could conceivably provide an upside risk to forecasts.

US 10y yield model (monthly, to end-August)*



A longer term perspective on US 10y valuation

We don't rely on model-driven outcomes when coming up with forecasts, which at the end of the day are a base case guide to our thinking on yields. However, from time-to-time we do look at various models for policy rates, term premia and outright yields to provide additional insight. The chart shows a simple regression model for US 10yrs using a range of factors to capture growth, inflation expectations, Fed balance sheet policy and global yields. The model suggests that, as of the end of August, US 10yrs were around 45bp too low and about 25bp too low now.

Of course, there are many statistical caveats and ambivalence between the choice of model factors and a conclusion that yields are either too high or low. We tested a range of other models for yields and term premia and find significance of yield drivers varies considerably over the years. It has become difficult to capture the impact of global policy and flows on US yields over the last few years. US-EU short end rates and balance sheet expectations offer a timely signal, reflecting the large impact ECB QE and particularly negative rate policy has on suppressing US yields. If we remove global factors, the model points to a 10Y yield closer to 3.0%. Pre-crisis models without QE factors suggest yields will go much higher. The key conclusion is that as the Fed, ECB and other global central banks exit highly accommodative policies over the coming years, US yields have much further to rise.

NZ yields to follow UST and ACGB higher

We have made smaller changes to NZ than to Aussie forecasts, as our RBNZ views haven't changed. However, our expectation for a move higher in US and Aussie 10yrs flows through to NZGB 10yrs. We see NZGB 10yrs reaching 3.20% by year-end and 3.70% by the end of 2018. The NZ-US 10yr spread is forecast to tighten to 50bp by early next year, before widening back towards 70bp as BNZ's forecast for RBNZ tightening comes through.

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NZ Economic Review

Manufacturing Sales (Q2) – 8 September
Manufacturing sales volumes rose 1.0% in the June quarter, implying a similar sized increase in production after accounting for inventory change. It is a decent gain, although not as much as we were looking for so we trimmed our Q2 GDP growth forecast to 0.8%

Electronic Card Transactions (Aug) – 11 September
August electronic card transactions increased a seasonally adjusted 0.6%. This was a little disappointing in that it only reversed the percentage drop in July. It makes it even more likely that Q3 retail volumes will fall (if only because of unwind from a huge Q2 that was boosted by the Lions Rugby Tour and World Masters Games).

Food Price Index (Aug) – 13 September
Food prices rose 0.6% in August, above our expectations of a small fall. This nudges our near term CPI estimates up to 0.4% (1.8% y/y) in Q3 and 0.5% (1.9% y/y) in Q4.

ANZ-RM Consumer Confidence (Sep) – 14 September
Election uncertainty, what election uncertainty? This measure of consumer confidence strengthened to 129.9 in September, from 126.2 in August. It was better still, after adjusting for seasonality, poking up to 132.9. Anything above 130 has typically, denoted a purple patch. All up, it points to a pickup in the underlying pace of consumer spending. Meanwhile, consumer inflation expectations have stabilised while house price inflation expectations continued to moderate but remain positive.

REINZ Housing Report (Aug) – 15 September
The residential property market continued to look slow to slower in August, driven by Auckland, but the data were arguably not as soft as expected, especially when considering the impending election. Yes, sales were down 20% on a year ago. But they were -22.8% y/y in July and -22.0% in June. Meanwhile, the SPAR house price index increased 0.5% in the month and over the past 12 months. The SPAR index for Auckland was down 2.9% on a year ago, while for the rest of the country it was up 7.0%.

BNZ PMI (Aug) – 15 September
While the election polls are equivocal, the Performance of Manufacturing Index (PMI) is nothing of the sort. It picked up to 57.9 in August, after a reading of 55.5 in July. That is perky, implying rather rapid growth, including in jobs.

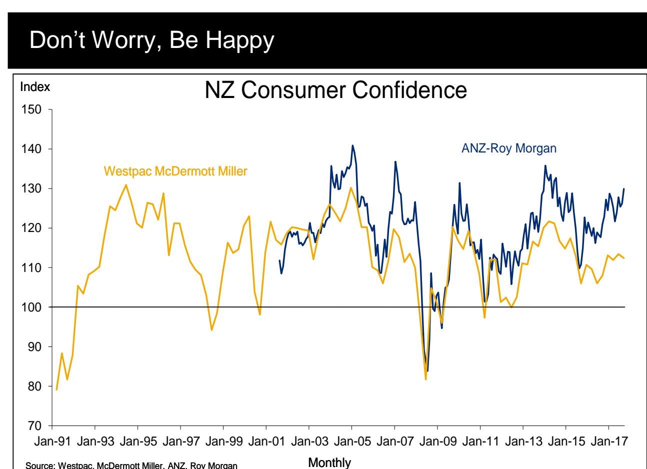
BNZ PSI (Aug) – 18 September
The Performance of Services Index (PSI) acquitted itself very well in August, rising to a seasonally adjusted 57.3 from 56.0 in July. Together, the PSI and PMI, form a picture of rude growth in the NZ economy, overall. Indeed, the composite index continues to point to annual GDP growth running in the order of 3 to 4% (a bit more than the 2.5 to 3.0% we are formally forecasting).

WMM Consumer Confidence (Q3) – 19 September
This index slipped to 112.4 in Q3, from 113.4 in Q2. After accounting for seasonality, we estimate a modest gain to 115.0, from 113.4. The barely above average result here is in contrast to fair brimming confidence in the monthly ANZ-RM index.

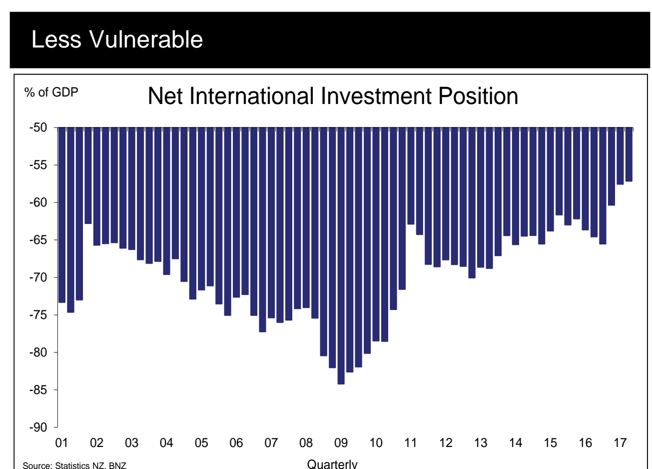
GDT Dairy Auction – 20 September
The GDT Price Index rose 0.9% to be up 17.8% on a year ago. Milkfat prices continue to outperform milk powder prices. Risks around a $6.75 milk price forecast for 2017/18 seem reasonably balanced if marginally to the upside.

Balance of Payments (Q2) – 20 September
New Zealand's external accounts are looking more and more benign by the day. The current account deficit narrowed to 2.8% of GDP in the year to June 2017, a smaller deficit than the market expected. Further deficit reduction is expected. NZ's net external debt as a share of the economy continues to drop. The net international investment position sat at -57.5% of GDP as at the end of June, maintaining a trend improvement from a peak of around -84% in early 2009. This is a significant reduction in NZ's external risks.

Don't Worry, Be Happy



Less Vulnerable



GDP (Q2) – 20 September
GDP expanded 0.8% in Q2, to be up 2.5% on a year ago. This met market and our expectations. For more analysis on the details, please see the front article in today's *Strategist*.

Int'l Travel and Migration (Aug) – 21 September
There are more signs that the recently strong migrant net inflow is starting to ease. A month or two is hardly conclusive evidence, but the seasonally adjusted 5,490 net inflow in August was down from July's 5,760 which itself was already back from June's near record high of 6,310. Fewer arrivals have driven the dip in the net inflow over recent months. The coming months' data will be important to see if this is indeed the beginning of some moderation along the lines of what is built into our macroeconomic forecasts including for the housing and labour markets. Meanwhile, annual growth in short term visitor arrivals settled at 5.8% in August, from 4.8% in July, after averaging more than 12% through April-June boosted by an influx due to the World Masters Games and Lions Rugby tour of NZ. This indicates an obvious unwind in tourism related activity in Q3 relative to Q2 on a seasonally adjusted basis, but, equally, the continuation of solid underlying tourism growth.

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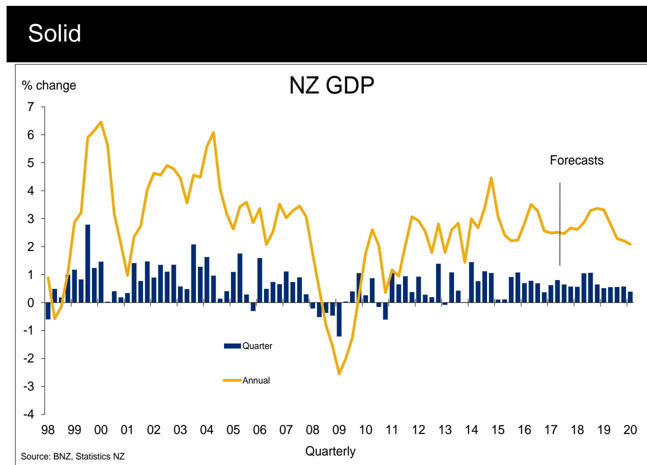
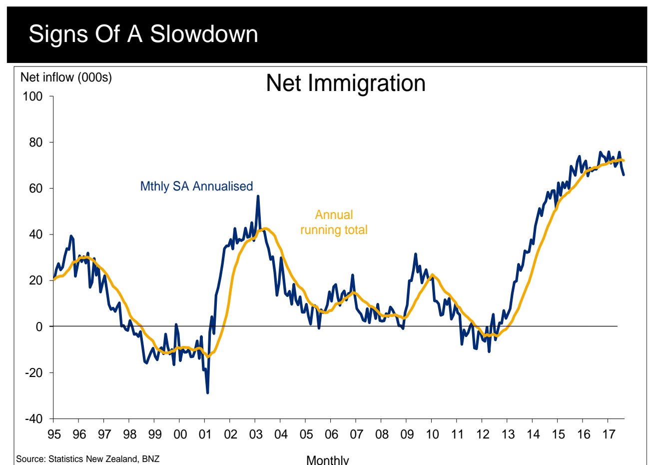




NZ Upcoming Data/Events

General Election – 23 September
The polls say this will be a very close run thing, with many possible outcomes. We'll take the results as they come and report back on any material implications for our economic views.

Daylight Saving Starts – 24 September
NZ clocks move forward one hour to UTC +1300.

Fonterra Annual Result (2016/17) – 25 September
Equity analyst focus will be on the co-ops profit, but also confirmation of the final 2016/17 milk price close to, if not exactly at, $6.15 and reiteration of a forecast $6.75 for 2017/18. Fonterra's current 2016/17 earnings guidance is 45c to 55c per share, as it is for 2017/18.

Merchandise Trade (Aug) – 26 September
We expect exports to be 13% higher in August compared to a year earlier, driven by primary product prices. We see imports 8% higher than a year ago, supported by solid domestic demand. All this would see a $1,170m trade deficit in the month, enough to see the annual trade deficit shrink to $3.1b, from $3.2b in July.

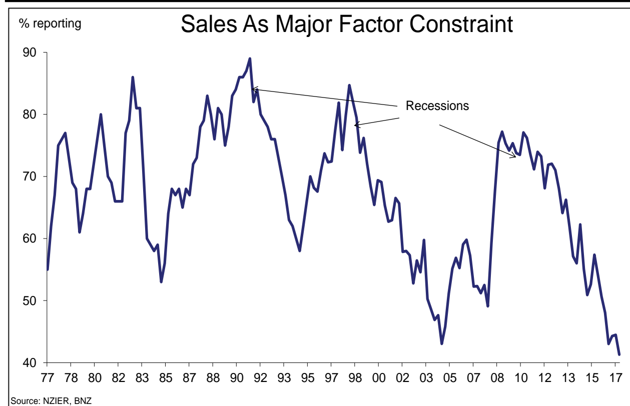
ANZ Business Survey (Sep) – 26 September
Might there be some last minute nervousness in this pre-election business survey or might the fuel pipeline leak dent confidence? To date, there has been no sign of election jitters with confidence and activity expectations staying strong at 18.3 and 38.2 respectively in August. Keep an eye on the inflation indicators too.

New Residential Mortgages (Aug) – 26 September
New residential lending in July was down 24% on the same month a year ago. This is of similar order to the drop in house sales over the period, as further tightening of LVR restrictions, higher interest rates, and tighter lending criteria took effect. The negative annual comparisons may start abating soon.

RBNZ OCR Review – 28 September
We expect the Reserve Bank to make no changes to the OCR or to its policy guidance at this review. Economic growth has been marginally slower than the RBNZ expected, but so too has been the NZD. Overall, developments have hardly deviated enough from the August MPS projections to cause any change in policy or guidance, especially as Acting Governor Grant Spencer delivers his first OCR review in the likely post-election noise. There are many reasons to expect a holding pattern.

Building Consents (Aug) – 29 September
Residential building consents eased 0.7% in July, endorsing a trend levelling off at a higher level as Canterbury consents decline. Lead indicators remain positive, although that need not necessarily translate into gains in any particular month.

No Lack of Demand



Credit Aggregates (Aug) – 29 September
Annual growth in housing credit most likely continued slowing in August, from July's 7.1% pace. Meanwhile, we wonder if consumer credit has continued to accelerate, after picking up to 6.9% y/y in July. For reference, business credit was running at 5.7% y/y in July, while agriculture had edged up to 2.9% y/y.

NZIER QSBO (Q3) – 3 October
The previous Quarterly Survey of Business Opinion kept telling of above-trend rates of growth, capacity constraints, and firmness in inflation. We would expect something similar here, even with the survey occurring in the heart of the election campaign, given other confidence indicators to date. Might the fuel pipeline leak show up as another constraint to activity?

GDT Dairy Auction – 4 October
It is too early to call this one, but the downside seems somewhat protected near term as early season NZ milk production is hampered by persistent wet weather.

QVNZ Housing Report (Sep) – 4 October
Further slowing in this measure of annual house price inflation seems inevitable from August's 4.8% pace. More interesting will be the report's anecdote, especially around how much the election is, or isn't, affecting activity, to gain a sense of the underlying trends.

ANZ Job Ads (Sep) – 4 October
Through the recent monthly wiggles there is a sense job ads may be starting to flatten off at a high level. However, it might take a few months, post-election, to confirm or deny if this is indeed the case.

ANZ Commodity Export Prices (Sep) – 4 October
We expect the world price index to be broadly flat in September, as mild ups and downs broadly offset each other. However, a lower NZD in the month will likely see the NZ dollar price index push a bit higher. Overall, it's consolidation at healthy levels.

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Quarterly Forecasts

Forecasts as at 21 September 2017

Key Economic Forecasts

Quarterly % change unless otherwise specified — Forecasts: Sep-17 to Jun-18

	Mar-16	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
GDP (production s.a.)	0.7	0.8	0.7	0.4	0.6	0.8	0.7	0.6	0.6	1.0
Retail trade (real s.a.)	0.8	2.0	0.8	0.9	1.6	2.0	-0.6	0.8	0.7	1.6
Current account (ytd, % GDP)	-2.9	-2.7	-2.8	-2.5	-2.9	-2.8	-2.6	-2.2	-1.9	-2.1
CPI (q/q)	0.2	0.4	0.3	0.4	1.0	0.0	0.4	0.5	0.6	0.4
Employment	1.2	2.4	1.4	0.7	1.1	-0.1	0.8	0.7	0.7	0.6
Unemployment rate %	5.2	5.1	4.9	5.2	4.9	4.8	4.7	4.7	4.7	4.7
Avg hourly earnings (ann %)	2.5	2.1	1.6	1.1	1.1	1.2	2.0	2.7	2.8	2.6
Trading partner GDP (ann %)	3.1	3.4	3.2	3.5	3.5	3.5	3.6	3.4	3.6	3.5
CPI (y/y)	0.4	0.4	0.4	1.3	2.2	1.7	1.8	1.9	1.5	2.0
GDP (production s.a., y/y))	2.8	3.5	3.3	2.6	2.5	2.5	2.5	2.7	2.7	2.9

Interest Rates

Historical data - qtr average; Forecast data - end quarter

		Government Stock			Swaps			US Rates		Spread
	Cash	90 Day Bank Bills	5 Year	10 Year	2 Year	5 Year	10 Year	Libor 3 month	US 10 yr	NZ-US Ten year
2016 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	1.95	2.25	2.05	2.15	2.50	0.80	1.55	0.70
Dec	1.85	2.10	2.45	2.95	2.25	2.65	3.10	0.90	2.10	0.80
2017 Mar	1.75	2.00	2.70	3.25	2.35	3.00	3.50	1.15	2.50	0.80
Jun	1.75	1.95	2.45	2.95	2.25	2.80	3.25	1.25	2.20	0.60
Forecasts										
Sep	1.75	1.95	2.50	2.95	2.20	2.75	3.25	1.30	2.25	0.70
Dec	1.75	1.95	2.65	3.10	2.20	2.90	3.40	1.45	2.75	0.35
2018 Mar	1.75	1.95	2.90	3.35	2.30	3.15	3.65	1.55	3.00	0.35
Jun	1.75	2.05	2.95	3.40	2.40	3.20	3.70	1.70	3.00	0.40
Sep	2.00	2.30	3.05	3.50	2.60	3.30	3.80	1.95	3.00	0.50
Dec	2.25	2.55	3.15	3.60	2.85	3.40	3.90	2.20	3.00	0.60
2019 Mar	2.50	2.80	3.25	3.70	3.10	3.50	4.00	2.30	3.00	0.70
Jun	2.75	3.05	3.30	3.75	3.20	3.50	4.00	2.30	3.00	0.75
Sep	3.00	3.20	3.35	3.80	3.30	3.50	4.00	2.30	3.00	0.80

Exchange Rates (End Period)

	USD Forecasts					NZD Forecasts					
	NZD/USD	AUD/USD	EUR/USD	GBP/USD	USD/JPY	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI-17
Current	0.73	0.80	1.19	1.35	112	0.73	0.92	0.62	0.54	82.5	76.9
Sep-17	0.72	0.79	1.19	1.34	112	0.72	0.92	0.61	0.54	81.1	76.2
Dec-17	0.70	0.75	1.17	1.33	116	0.70	0.93	0.60	0.53	81.2	75.3
Mar-18	0.69	0.74	1.18	1.30	118	0.69	0.93	0.59	0.53	81.4	74.5
Jun-18	0.69	0.73	1.20	1.31	118	0.69	0.95	0.58	0.53	81.4	74.5
Sep-18	0.70	0.73	1.22	1.28	118	0.70	0.95	0.57	0.54	82.0	74.9
Dec-18	0.70	0.73	1.20	1.26	120	0.70	0.96	0.58	0.56	84.0	75.7
Mar-19	0.71	0.74	1.20	1.25	120	0.71	0.96	0.59	0.57	85.2	76.5
Jun-19	0.72	0.75	1.18	1.24	120	0.72	0.96	0.61	0.58	86.4	77.5
Sep-19	0.73	0.76	1.18	1.25	118	0.73	0.95	0.61	0.58	85.6	77.4
Dec-19	0.73	0.76	1.17	1.24	117	0.73	0.95	0.62	0.59	84.8	77.4
						TWI Weights					
						14.0%	20.7%	11.3%	4.6%	6.4%	

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

Annual Forecasts

As at 21 September 2017

	March Years					December Years				
	Actuals		Forecasts			Actuals		Forecasts		
	2016	2017	2018	2019	2020	2015	2016	2017	2018	2019
GDP - annual average % change										
Private Consumption	2.8	4.8	3.5	3.5	2.2	2.9	4.3	4.0	3.4	2.6
Government Consumption	2.6	2.4	3.2	1.6	1.3	2.6	2.2	3.5	1.8	1.2
Total Investment	2.5	5.6	2.0	3.9	2.9	2.1	5.5	2.7	3.4	3.3
Stocks - ppts cont'n to growth	-0.2	-0.3	0.0	0.2	0.0	-0.3	0.0	0.0	0.1	0.0
GNE	2.5	4.3	3.1	3.5	2.2	2.3	4.1	3.6	3.3	2.5
Exports	5.6	0.7	3.9	3.5	4.1	6.9	1.6	1.9	4.0	4.1
Imports	2.0	5.1	4.4	3.8	3.4	3.7	3.4	5.1	3.8	3.6
Real Expenditure GDP	3.5	3.0	3.0	3.3	2.3	3.2	3.5	2.7	3.3	2.6
GDP (production)	**2.4**	**2.9**	**2.6**	**3.2**	**2.3**	**2.5**	**3.0**	**2.6**	**3.1**	**2.6**
GDP - annual % change (q/q)	*2.8*	*2.5*	*2.7*	*3.3*	*2.1*	*2.2*	*2.6*	*2.7*	*3.4*	*2.2*
Output Gap (ann avg, % dev)	0.8	0.9	0.6	1.2	1.0	0.8	0.9	0.7	1.1	1.1
Household Savings (gross, % disp. income)	1.2	0.1	-0.5	-0.3	0.4					
Nominal Expenditure GDP - $bn	250.7	264.7	278.3	290.5	302.4	247.6	260.7	275.3	287.5	299.4
Prices and Employment - annual % change										
CPI	0.4	2.2	1.5	1.9	1.8	0.1	1.3	1.9	1.7	1.8
Employment	2.0	5.7	2.0	2.4	1.7	1.4	5.8	2.5	2.5	2.0
Unemployment Rate %	5.2	4.9	4.7	4.7	4.8	4.9	5.2	4.7	4.7	4.8
Wages - ahote	2.5	1.1	2.8	2.8	2.7	2.5	1.1	2.7	2.6	2.8
Productivity (ann av %)	0.3	-2.6	-0.3	0.6	0.3	0.1	-1.7	-1.1	0.5	0.4
Unit Labour Costs (ann av %)	2.4	4.7	2.9	2.4	2.7	2.6	3.6	3.6	2.6	2.6
External Balance										
Current Account - $bn	-7.3	-7.7	-5.3	-7.2	-7.9	-8.0	-6.6	-6.1	-7.1	-7.7
Current Account - % of GDP	-2.9	-2.9	-1.9	-2.5	-2.6	-3.2	-2.5	-2.2	-2.5	-2.6
Government Accounts - June Yr, % of GDP										
OBEGAL (core operating balance)	0.7	1.4	1.0	1.2	1.9					
Net Core Crown Debt (excl NZS Fund Assets)	24.5	22.5	22.0	21.5	20.0					
Bond Programme - $bn	7.0	8.0	7.0	7.0	7.0					
Bond Programme - % of GDP	2.8	3.0	2.5	2.4	2.3					
Financial Variables (1)										
NZD/USD	0.67	0.70	0.69	0.71	0.73	0.68	0.70	0.70	0.70	0.73
USD/JPY	113	113	118	120	116	122	116	116	120	117
EUR/USD	1.11	1.07	1.18	1.20	1.19	1.09	1.05	1.17	1.20	1.17
NZD/AUD	0.90	0.92	0.93	0.96	0.96	0.93	0.96	0.93	0.96	0.95
NZD/GBP	0.47	0.57	0.53	0.57	0.58	0.45	0.56	0.53	0.56	0.59
NZD/EUR	0.61	0.66	0.59	0.59	0.61	0.62	0.67	0.60	0.58	0.62
NZD/YEN	76.2	79.1	81.4	85.2	84.7	82.1	81.6	81.2	84.0	84.8
TWI	72.2	76.5	74.5	76.5	77.5	73.4	78.1	75.3	75.7	77.4
Overnight Cash Rate (end qtr)	2.25	1.75	1.75	2.50	3.00	2.50	1.75	1.75	2.25	3.00
90-day Bank Bill Rate	2.41	1.98	1.95	2.78	3.12	2.78	2.02	1.95	2.53	3.20
5-year Govt Bond	2.40	2.70	2.90	3.25	3.45	2.95	2.75	2.65	3.15	3.40
10-year Govt Bond	2.90	3.25	3.35	3.70	3.90	3.45	3.30	3.10	3.60	3.85
2-year Swap	2.30	2.30	2.30	3.10	3.20	2.80	2.40	2.20	2.85	3.30
5-year Swap	2.60	3.00	3.15	3.50	3.70	3.15	3.00	2.90	3.40	3.65
US 10-year Bonds	1.90	2.50	3.00	3.00	3.00	2.25	2.50	2.75	3.00	3.00
NZ-US 10-year Spread	1.00	0.75	0.35	0.70	0.90	1.20	0.80	0.35	0.60	0.85

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

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

Calendar

	Forecast	Median	Last
Friday 22 September			
Euro, PMI/PSI, September 1st est		57.2/54.8	57.4/54.7
UK, CBI Industrial Trends, September		+13	+13
US, Markit PMI/PSI, September 1st est		53.0/53.7	52.8/56.0
Saturday 23 September			
NZ, General Election			
Sunday 24 September			
NZ, Daylight Saving Begins, +1hr to +13:00GMT			
Germ, Election			
Monday 25 September			
NZ, Fonterra Full-year Results			
China, Leading Index (Conference Bd), August			
Germ, IFO Index, September			115.9
Tuesday 26 September			
NZ, ANZ Business Survey, September			+18.3
NZ, Merchandise Trade, August			+$85m
NZ, Residential Lending, August y/y			-23.8%
Jpn, BOJ Minutes, 19/20 July Meeting			
US, New Home Sales, August		600k	571k
US, Consumer Confidence, September		119.3	122.9
Wednesday 27 September			
UK, CBI Distribution Reported Sales, September			+2
US, Durables Orders, August 1st est		+0.9%	-6.8%
Thursday 28 September			
NZ, RBNZ OCR Review	1.75%	1.75%	1.75%
Euro, Economic Confidence, September			111.9
Germ, CPI, Sep y/y 1st est			+1.8%
US, International Goods Trade, August adv.		-$65.1b	-$63.9b
US, GDP, Q2 3rd est		+3.1%	+3.0%P
Friday 29 September			
NZ, Building Consents, August (res, #)			-0.7%
NZ, Credit Aggregates, August (housing y/y)			+7.1%
Aus, Private Sector Credit, August			+0.5%
China, PMI (Caixin), September			51.6
Jpn, Industrial Production, August 1st est			-0.8%
Jpn, BOJ Summary of Latest Meeting, 20/21 Sept Meeting			
Jpn, CPI, August y/y			+0.4%
Euro, CPI, Sept y/y 1st est			+1.5%
UK, GDP, Q2 3rd est			+0.3%P
US, Personal Spending, August		+0.1%	+0.3%
US, Chicago PMI, September		57.5	58.9
Saturday 30 September			
China, Non-manufacturing PMI, September			53.4
China, PMI (NBS), September			51.7
Monday 2 October			
Jpn, Tankan (lge manuf), Q3			+17UK,
Markit/CIPS Manuf Survey, September			56.9
US, Construction Spending, August			-0.6%
US, ISM Manufacturing, September			58.8

	Forecast	Median	Last
Tuesday 3 October			
NZ, QSBO, Q3			+18
Aus, Building Approvals, August			-1.7%
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
Wednesday 4 October			
NZ, Dairy Auction, GDT Price Index			+0.9%
NZ, QVNZ House Prices, September y/y			+4.8%
NZ, ANZ Comdty Prices (world), September			-0.8%
UK, Markit/CIPS Services, September			53.2
US, ISM Non-Manuf, September			55.3
US, ADP Employment, September			+237k
Thursday 5 October			
Aus, Retail Trade, August			flat
Aus, International Trade, August			+$0.46b
Euro, ECB Minutes, 7 Sept Meeting			
US, International Trade, August			-$43.7b
US, Factory Orders, August			-3.3%
Friday 6 October			
Germ, Factory Orders, August			-0.7%
US, Non-Farm Payrolls, September			+156k
Monday 9 October			
China, Services PMI (Caixin), September			52.7
Germ, Industrial Production, August			flat
Tuesday 10 October			
NZ, Electronic Card Transactions, September			+0.6%
Aus, NAB Business Survey, September			+5
UK, Industrial Production, August			+0.2%
Wednesday 11 October			
Aus, Consumer Sentiment - Wpac, October			97.9
Jpn, Machinery Orders, August +8.0%			
US, FOMC Minutes, 20 Sept meeting			
Thursday 12 October			
NZ, ANZ-RM Consumer Confidence, October			129.9
NZ, Food Price Index, September			0.6%
Aus, Housing Finance, August			+2.9%
Euro, Industrial Production, August			+0.1%
US, PPI ex-food/energy, September y/y			+2.0%
Friday 13 October			
NZ, BNZ PMI (Manufacturing), September			57.9
Aus, Financial Stability Review			
China, Trade Balance, September			+CNY286b
US, CPI ex food/energy, September y/y			+1.7%
US, Retail Sales, September			-0.2%

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