19 October 2017

Contents

Economic Outlook

As we await the (full) details of the new government's policies, we do wonder what their net effect will be on inflation, amongst other things. Annual CPI inflation has firmed already, of course. In Q3 it got to 1.9%, from 1.7%. Not only was this higher than the 1.6% expected by the RBNZ but the source of the surprise was, in part, due to a rise in non-tradables inflation – the bit that the Bank, in theory, has more control over. Standard measures of core inflation have also firmed up, to around 2.0% y/y. However, the sectoral factor model version that the RBNZ computes, and puts emphasis on, kept lagging at 1.4% y/y. While this is important to note, it's also worth pointing out that this measure of core inflation has not, in the past, been the be all and end all of OCR ups and downs. Of the upcoming data, October's ANZ business survey (31 October) will be tangled up in government formation hiatus. However, we expect the Q3 labour market reports (1 November) to be robust to the election process.

Interest Rate Outlook and Strategy

Volatility in NZ front end rates remains exceptionally low. NZ 2-year swap is at 2.21% and has traded in just a 5bp range all month. A small sell-off on a stronger than expected CPI print this week couldn't be sustained after the RBNZ's preferred annual core inflation estimate showed no change at 1.4%. We look to the early-November labour market data, including wage measures, as the next significant local data release. NZ long end yields are following global bond direction where our bias remains for higher yields. NZGB-ACGGB 10-year spread looks too tight relative to front end pricing. NZGB Apr-23s look rich on fly against Apr-20 and Apr-27.

Currency Outlook

In our view there is a big difference between saying an exchange rate is high or strong and saying that it is overvalued. At current levels there is no doubt, in a long-term historical context, New Zealand's real exchange rate is high, but this can be easily explained by the nation's strong terms of trade. Moreover, adjusting the IMF's estimates for currency over/under valuation for recent NZ TWI movements suggests that the NZD real exchange rate is currently fairly priced on a medium to long-term basis. Our near-term assessment is unchanged from our re-estimated NZD/USD short-term model that suggests the NZD is currently a little oversold relative to fair value around 0.73. We also look at Singapore's managed exchange rate process and see it as impractical for NZ to adopt.

Inflation – A Core Problem

- **CPI says tighten sooner**
- **RBNZ's core measure says quite the opposite**
- **But core outcomes validate past actions more than they dictate future policy**
- **Headline increase will pressure wages**
- **We still have a tightening bias**

Recent consumer price inflation suggests that monetary conditions might need to firm faster than the RBNZ has assumed and, perhaps, even faster (or further, at least) than the market has priced. Not only was the headline pace of price expansion higher than expected but the source of the surprise was, in part, due to a rise in non-tradables inflation – the bit of inflation that the RBNZ, in theory, has more control over.

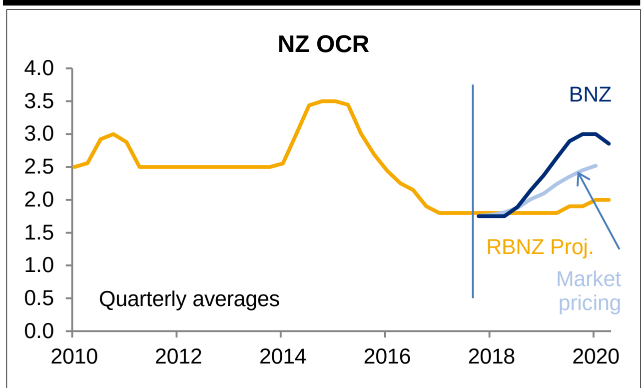
In addition, Statistics New Zealand's measures of core inflation predominantly settled around the 2.0% mark and were up, in some cases well up, on year earlier levels.

But just when it looked like the worm might be finally turning, along came the release of the Reserve Bank's sectoral factor model of inflation. In stark contrast to almost every other measure, this view of price pressure showed annual inflation not only unchanged but well shy of the RBNZ's target of 2.0%. Whatever its merits, this news is very important as the sectoral factor model is the RBNZ's preferred measure of central tendency for inflation. Accordingly, it might be argued that this news will dominate the Bank's thinking.

This may well be the case, but we would caution that it is not a given. It will only be to the extent that the data influence the Bank's forecasts that this outturn matters. The low core rate will certainly add weight to the Bank's perception that past policy settings were appropriate but this says nothing about the appropriateness, or otherwise, of maintaining current settings.

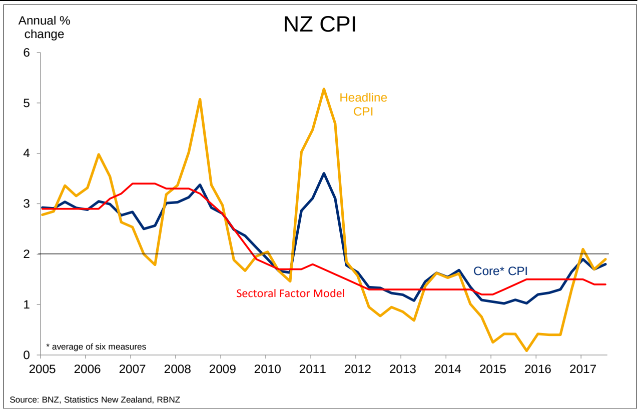
History shows us that the Bank has been willing to shift policy, sometimes aggressively, even when core inflation has deviated substantively from its target:

Upward pressure on rates grows



Source: BNZ, Bloomberg

Sectoral Factor Undershoots Core



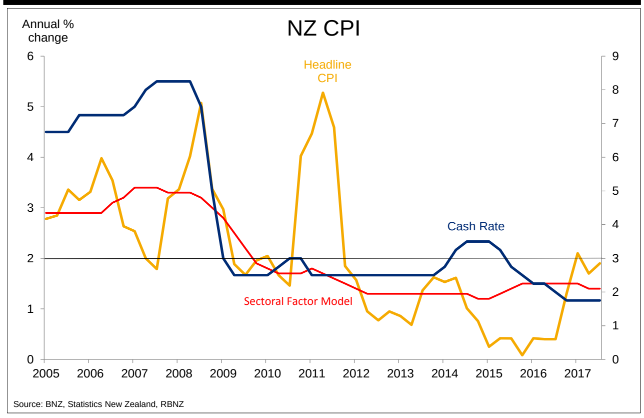
Source: BNZ, Statistics New Zealand, RBNZ

- interest rates were slashed in 2008 and 2009 even as core inflation held up;
- the cash rate was increased in 2010 and 2014/15 when core inflation was below target; and
- the cash rate was progressively reduced through 2015 and 2016 even as the sectoral factor model showed no change in inflation.

Indeed the cash rate has ranged between 1.75% and 3.50% during a period when the sectoral factor model of inflation has been in a very tight range of 1.2 to 1.5%.

One could argue that with core inflation moderating to 1.4% the balance of risk has shifted toward a rate cut. We don't see it that way. Indeed, this is where the headline rate comes in. We believe that the tightness in wage pressure is beginning to finally reveal itself in wage negotiations. Recently, we have had far more enquiry about current and prospective inflation by those involved in wage setting processes than has routinely been the case. Accordingly, we can only assume that rising headline inflation will start to feed through into wages. To the extent that this impacts demand and/or restricts

Cash rate forecast driven



Source: BNZ, Statistics New Zealand, RBNZ corporate margins it could well add to future CPI inflation. (As an aside, we are also hearing anecdotes about some businesses contemplating paying Auckland allowances to compensate for the increased cost of living in that city.)

In a similar vein, falling headline inflation across 2014 drove inflation expectations lower and generated a RBNZ response.

More generally, we quite like the idea of the sectoral factor model as it does provide a stable view of the general movement in prices and should help prevent knee-jerk reactions from policy makers. On the other hand, it is difficult to replicate, even more difficult to forecast and, conceptually, very difficult to “sell” to the wider population.

Be that as it may, it is central to the RBNZ’s thinking but, we reiterate, it is not the be all and end all in its decision making process. Treat its message with importance but with equal amounts of caution.

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Australia By State

- **Non-mining recovery becoming increasingly synchronised**
- **Final demand strongest in Victoria and NSW**
- **LNG exports to boost Queensland and WA**

Overview

The gradual non-mining recovery is becoming increasingly synchronised across Australia's states and territories. Economic growth in most states is expected to strengthen somewhat in 2017-18 before moderating a little in 2018-19 as dwelling investment and LNG exports peak. The unemployment rate is forecast to decline in most states and territories with the exception of the ACT and the NT.

Victoria and New South Wales will remain ahead of the pack in terms of state final demand growth, as non-mining business investment, infrastructure spending and services spending support growth as dwelling construction peaks. However, Victoria is forecast to experience the strongest growth in Gross State Product (just!) in 2017-18, thanks to faster population growth, despite the closure of key automotive manufacturing plants this year. Queensland and WA will also experience very strong growth in 2017-18 in particular as exports surge. NSW however will see a lower rate of unemployment, bettered only by the NT and the ACT (although unemployment is forecast to rise in both territories).

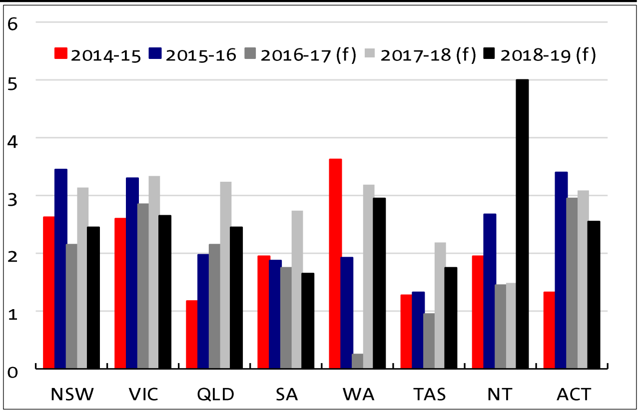
LNG exports will add significantly to growth in both Queensland and Western Australia, especially in 2017-18. There are also signs of stabilisation in WA as mining projects reach completion, although a pick up towards solid domestic demand growth remains someway off. Domestic demand in Queensland meanwhile has rebounded strongly, although will slow somewhat now that the 3 large LNG projects have completed construction and support from dwelling investment starts to wane.

Not only has the recovery in growth broadened across the states, it has also broadened across industries in most jurisdictions. This is particularly the case in NSW and Victoria, but also in South Australia where state final demand and business conditions have rebounded strongly. Tasmania and South Australia now boast the strongest business conditions.

The outlook for investment has improved the most for NSW and Victoria, with private capex expectations higher for 2017-18. Government infrastructure spending is also running at record levels in NSW, Victoria and SA, although will add less to growth from 2018-19 based on the current pipeline.

Consumer spending is outpacing household income growth across all states and territories, as wages growth remains weak across the country, suggesting that

Gross State Product Forecasts – Annual % change



households are dipping into their savings to fund spending (with the notable exception of Tasmania). With wages growth to pick up only gradually, we expect only gradual acceleration in consumer spending growth in most states, despite the widespread pick up in employment growth. Consumer spending is strongest in the NT, but likely to weaken there as population growth slows as the Icthys LNG project is completed. Meanwhile, high household debt levels will also be cause for consumer caution, particularly in the largest south-eastern states.

Tourism spending (both domestic and international) and education exports will continue to expand in most states, particularly if our forecasts for renewed AUD depreciation prove correct.

After shooting the lights out in 2016, agricultural conditions are likely to be much more challenging this year. Parts of NSW and Queensland have seen record breaking temperatures in close proximity to frosts, while southern WA, and more recently south-east Queensland, have seen soaking rains. We have again cut our wheat production forecast to 18.7 million tonnes – the lowest in a decade.

State Summaries

NSW: We are relatively upbeat about the outlook for New South Wales, despite recent surprise slowing in state final demand. Business investment should rebound somewhat, bolstered by a combination of solid business conditions, and public infrastructure spending is at record levels, which will help to offset the shrinking contribution (and eventual headwinds) that is likely to come from dwelling investment as the construction cycle approaches its peak. After leading the pack in terms of state final demand in recent years however, NSW is likely to be overtaken by Victoria.

Victoria: Victoria will be the key standout across the states in 2017-18, thanks to strong population growth (particularly from overseas migration) and a positive outlook for business and government investment which will help offset headwinds from declining auto manufacturing and peaking dwelling construction (although stronger than expected demand will support housing prices). Strong jobs growth should continue to support consumer spending, as will tourism, although low wages and productivity growth will be headwinds.

South Australia: South Australia is experiencing a cyclical recovery, with infrastructure spending, international education and tourism, and manufacturing (outside of auto and steel, including wine) performing well. There are some key challenges ahead however, including the closure of auto manufacturing, and a peak in dwelling construction and infrastructure investment, although the National Shipbuilding Plan will provide a welcome boost in coming years.

Australian Capital Territory: The Australian Capital Territory economy will continue to expand at a healthy pace, albeit more moderately than in the past few years, while the unemployment rate is forecast to remain below the national average.

Queensland: Queensland continues to transition post the resources investment boom towards more broad-based economic growth. However while the labour market has strengthened, the economy remains prone to external shocks such as weather and global demand changes. Growth is forecast to pick up in 2017-18 as exports surge - to almost rival Victoria - and then moderate in 2018-19 as the contribution from LNG exports and dwelling construction flatten off while the domestic economy slowly recovers.

Western Australia: The headwinds from the mining sector continue to be felt across Western Australia. While there are some encouraging signs that the worst has passed, many economic indicators have stabilised, and there are tentative signs of improvement in non-mining business investment, it will likely take quite some time before domestic demand can rebound. Overall, while economic growth will pick up from here, this is largely due to a very large contribution from LNG exports.

Tasmania: Tasmania continues to experience rapid rates of state final demand, as well as strong tourism and agriculture growth. The unemployment rate however remains elevated, much of the growth has been concentrated in southern Tasmania and demographic challenges remain. Noting that agricultural production will come under pressure, real GSP growth is expected to be higher in 2017-18, but will remain below the national average.

Northern Territory: The Northern Territory economy has surprised on the upside, although the approaching completion of the Icthys LNG project will likely see downward pressure on population growth, the labour market, domestic demand and the housing market, despite exports driving above-national growth in GSP.

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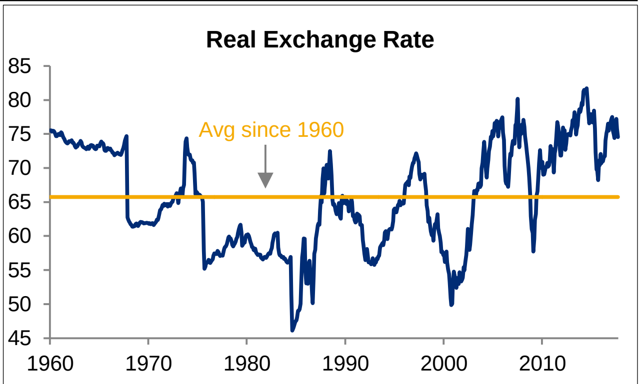
NAB growth and unemployment rate forecasts for the states

	Gross State Product YoY				Unemployment Rate			
	15-16	16-17f	17-18f	18-19f	15-16	16-17	17-18f	18-19f
NSW	3.5	2.2	3.1	2.5	5.4	5.0	4.7	4.7
VIC	3.3	2.9	3.3	2.7	6.0	5.9	5.8	5.4
QLD	2.0	2.2	3.2	2.5	6.2	6.2	6.0	5.9
SA	1.9	1.8	2.7	1.7	7.3	6.7	6.5	6.5
WA	1.9	0.3	3.2	3.0	6.0	6.2	6.2	5.9
TAS	1.3	1.0	2.2	1.8	6.5	6.1	6.0	6.0
NT	2.7	1.5	1.5	5.0	4.2	3.5	4.0	4.2
ACT	3.4	3.0	3.1	2.6	4.5	3.8	4.8	4.8
Australia	**2.7**	**2.0**	**3.2**	**2.5**	**5.9**	**5.7**	**5.4**	**5.3**

NZD Fairly Priced

- **In a long-term historical context, NZ's real exchange rate is high, but this can be easily explained by NZ's strong terms of trade. The call by some commentators that the NZD is over-valued in this context is a value judgment, but supporting evidence is scant.**
- **NZ First Leader Winston Peters supports a weaker NZD and a move to a Singapore-style exchange rate mechanism. On many levels, the difference between NZ and Singapore macroeconomic drivers are significant and for NZ to adopt such a managed exchange rate process is impractical.**
- **We re-estimate our short term NZD/USD model with new data and come out with unchanged conclusions. With fair value around 0.73, the NZD is a little oversold. But the softer GDT dairy auction this week reminded us why we have the NZD tracking towards 0.69-70 over the next 3-6 months. The hue of the government has no bearing on this, with global forces in charge.**

Yes, NZ's Real Exchange Rates is "High"



Source: RBNZ, BNZ

One of those urban myths out there is that the NZD is over-valued in a medium-long term context. It's a judgment that we've frequently fought against in our research. The RBNZ often runs this line, without supporting evidence, and we largely see its comments more as a tactical stance to encourage a lower NZD and higher inflation.

NZ First Leader Winston Peters is in favour of a weaker NZD. When asked last week if policies being discussed during coalition negotiations will keep the currency going down, Peters said "If you are an export-dependent nation why would you go ahead and persist with an inflated dollar when even the IMF says its over-valued? Why do you just ignore all the best advice in the world".

For the record, in its May 2017 Article IV report on NZ, the IMF said that the exchange rate was "moderately over-valued", based on the December 2016 NZD exchange rate. In Table 1 below we show the IMF's NZD real exchange rate assessment against its various models and provide a rough-and-ready estimate based on the current exchange rate.

The IMF's language of a moderately over-valued NZD back in December was based on model estimates ranging between 2-8%. Accounting for the fall in the NZ TWI since then, that range would drop to between -2 to 4%. In other words, if the IMF were to come out today with an assessment of the NZD, we think it would probably say that the real exchange rate was "fairly priced" on a medium-long term basis.

Table 1: IMF NZD real exchange rate models
% over/under valued

	@ Dec-16	@ Oct-17*
REER index regression	8%	4%
Current account regression	4%	0%
External sustainability	2%	-2%

* BNZ estimate based on exchange rate movement since December
Source: IMF Article IV, BNZ

In our view there is a big difference between saying an exchange rate is "strong" or "high" and saying that it is "over-valued".

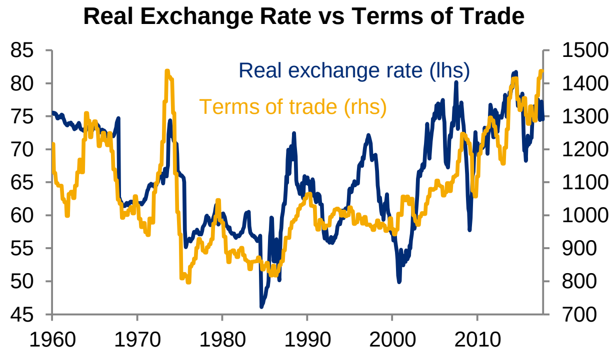
It is hard to deny the fact that the NZD is strong or high in a medium-long term context. The above chart shows the real NZD exchange rate back to 1960. NZ's real exchange rate has been above the long-term average for much of the past 15 years and the current real exchange rate is about 12% above that average. So yes, NZ does have a strong or high real exchange rate.

But is it over-valued? To us, to say it is over-valued would be passing a judgment that for some reason the strength of the NZD is inexplicable, not justified and causing significant harm to the economy – perhaps associated with a large and rising current account deficit, a deteriorating net international investment position, exporters crying out for help, and a hollowing out of NZ's export sector.

None of those factors have been in play for some time. NZ's current account deficit has been smaller than average for much of the past eight years, NZ's net international investment deficit is the lowest in over 20, maybe 30 years, and our frequent contact with exporters tells us they're generally doing well and are satisfied with the current level of the exchange rate.

It is instructive to overlay NZ's real exchange rate series with NZ's terms of trade. After all, NZ's commodity prices and terms of trade are a key factor that drives the NZD. The following chart shows the close link between NZ's

Very Strong Terms of Trade Explains High NZD



Source: RBNZ, BNZ

real exchange rate and the terms of trade over the past 50 years or so.

Based on this single key variable, it is not hard to explain NZ's strong real exchange rate. NZ's terms of trade are near a record high (we have data back to 1860 showing this). To be sure, not all sectors of the economy welcome the strong exchange rate and we imagine there are pockets of exporters who are not exposed to higher commodity prices who are feeling the pinch. But overall, we see NZ better off with strong terms of trade and a strong exchange rate than if both of those variables were weak.

A weak exchange rate for NZ would normally be associated with some or all of: weak terms of trade, a weak domestic economy, or a weak global economy. Wishing for a lower NZD is akin to wishing export prices were much weaker or that the global economy headed towards recession.

If the NZD isn't particularly over-valued then attempts to drive it weaker will be futile. It is no surprise that the RBNZ's attempts to talk the NZD down over the years have been unsuccessful. On the day, the Bank can have an impact, but soon after fundamental forces come back in play.

The Singapore Model

NZ First's exchange rate/monetary policy is to adopt the framework of Singapore. We presume that the party believes that adopting that model is a better way forward for NZ, to achieve Peters' desire for an export-growth oriented economy with a weaker exchange rate. Singapore has adopted a "managed exchange rate" regime which we'll explain soon.

We think the Singapore model is not the right fit for NZ and is unworkable in practice. The NZ Treasury has analysed the Singapore model and agrees, noting that "no other country has followed its example in terms of exchange rate regime".

The same IMF report noted earlier also says of New Zealand, that the Executive Board "endorsed the authorities' flexible exchange rate policy and overall macroeconomic policy stance". So no mention of needing to change NZ's model there.

There are four main features of Singapore's exchange rate system:

(i) Manage the Singapore dollar against a basket of currencies, loosely based on (undisclosed) trade weights.

(ii) Allow the "TWI" to fluctuate within an undisclosed policy band. Buy or sell foreign exchange to keep the exchange rate within the band.

(iii) Periodically review the band, approximately every three months.

(iv) With free capital movements, the monetary authority effectively gives up control of domestic interest rates and money supply.

For the system to operate effectively the central bank must have utmost credibility to achieve its exchange rate objective. This requires a substantial balance sheet, with large foreign reserves.

Singapore's foreign reserves held by the central bank are currently 91% of GDP, compared to the RBNZ's 10%. To achieve a similar proportion of foreign reserves as Singapore, the RBNZ would have to accumulate an extra NZD 245bn of foreign reserves.

But the impracticalities of NZ adopting the Singapore system don't end there. Singapore's large current account surpluses and large positive net international investment position (alongside a very high savings rate) allow the country to comfortably sustain low interest rates. Singapore's large export to GDP ratio (currently 114%), means that it makes sense to have more control of the exchange rate's destiny, at the expense of stability in domestic activity indicators. Indeed, Singapore's relative stability in the exchange rate comes at the "cost" of much more variable GDP growth.

NZ is largely a polar opposite, with a low savings rate, ongoing current account deficits and a large negative net international investment position. These features require higher levels of interest rates than most other developed countries to attract capital and support economic growth. Exports to GDP is less than 30%, so having a stable currency, while desirable, is less important than Singapore. NZ's highly leveraged economy is highly sensitive to interest rates. The price of adopting a more stable currency would be a much more volatile economy, with more frequent boom-bust conditions likely under a managed exchange rate.

NZD/USD Model Update

Recently CBA rebased and revamped its NZ commodity price index. This index feeds into our NZD short term fair value models.

We've taken the opportunity of this to re-estimate our NZD/USD model making the following changes (1) use the new CBA NZ commodity price index (2) extend the estimation period through to September 2017 (starting point remains 2004); (3) estimate the model using a real NZ-US rate spread for the entire period – we previously fudged the model and used real rates only over the more recent period.

So for the record, our model uses three key inputs:

(i) The CBA NZ commodity price index in USD terms.

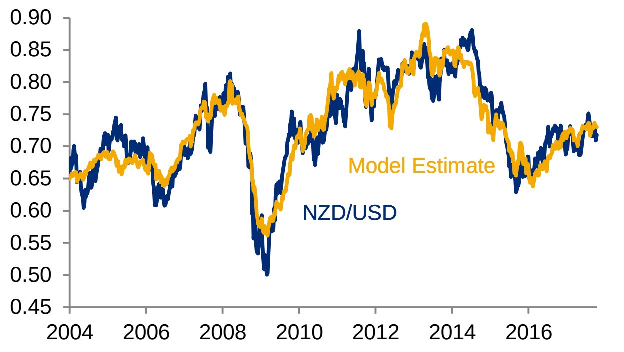
(ii) The BNZ risk appetite index.

(iii) Real NZ-US 1-year swap rate spread (using break-even 10-year inflation rates for the US and core CPI inflation for NZ averaging four Statistics NZ measures for this. Over the zero-lower bound period for US rates we adjust rate using Krippner's shadow US short rate).

The new model has a lower standard error than the previous model because real rate differentials work much better than nominal rate differentials when explaining currencies. The upward bias for the model estimate through 2017 has now largely disappeared, which means we no longer need to account for this bias when explaining the current estimate.

Current fair value on the updated model is USD0.73, which is the same level we noted in our Weekly on Monday (after accounting for the old model bias). So there is no change to our view that the NZD looks marginally over-sold at present, having not kept pace this year with the positive risk appetite backdrop.

NZD/USD Fairly Priced on Updated Model



Source: BNZ, Bloomberg

However, another disappointing GDT dairy auction this week saw us revise down our projected milk payout this season from $6.75 to $6.30. We see downward pressure on dairy prices persisting over the near term, with EU stockpiles of skim milk overhanging the market, and dairy prices still look a bit stretched relative to international oil and grain prices.

Lower dairy prices support our view of the NZD heading to our year-end target of USD0.70 by year end, and being anchored around 0.69 through the first half of next year.

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The BNZ OIS-ter: NZ hike still a year away post-CPI

- **Over the past fortnight, there hasn't been much change in market expectations for monetary policy. NZ's Q3 CPI result was much higher than RBNZ expectations, but the Bank's preferred core measure was stable at a still-low 1.4%. The market's view that the first rate hike is still more than a year away in November 2018 remained unmoved.**
- **Fed hike pricing nudged up a bit, with the market seeing an 80% chance of a hike in December, despite another month of soft CPI data. We await Trump's announcement of the new Fed Chair from early next year, which will guide expectations for rate hikes through 2018. At present just over one more hike is priced in for next year.**
- **The BoE looks like the next central bank to hike rates, with more than an 80% chance of a hike priced in for its meeting next month.**

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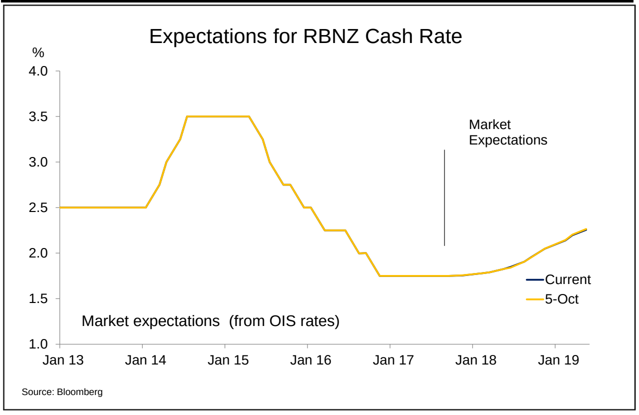
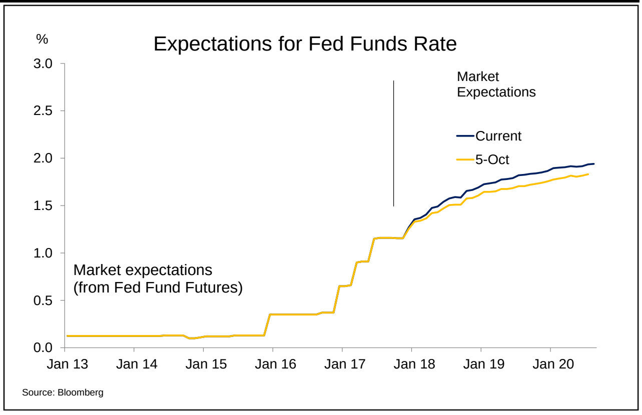
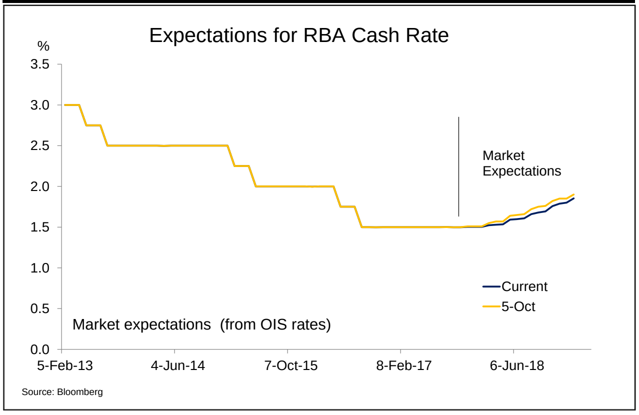
New Zealand



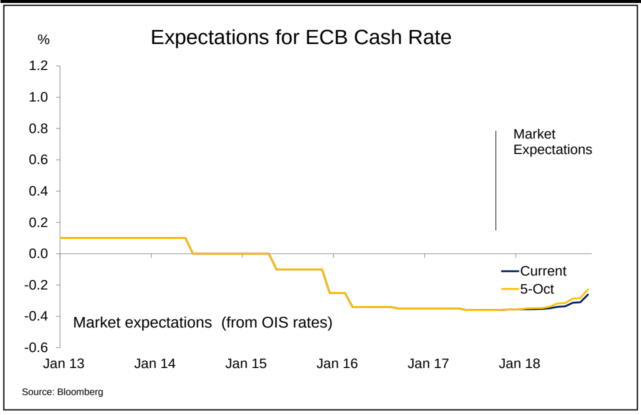
United States



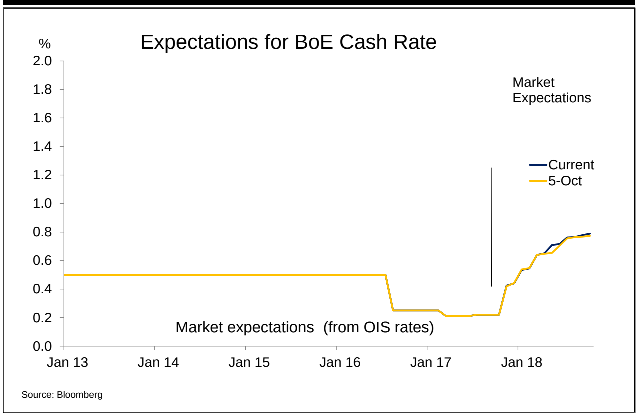
Australia



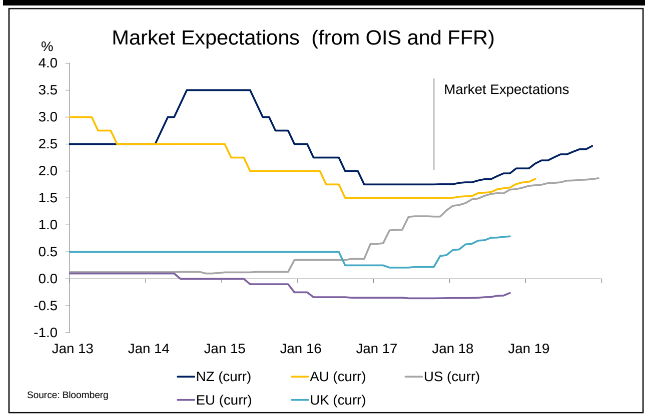
Eurozone



United Kingdom



Cross Country



Interest Rate Strategy:

- **NZ front end rates vol remains low and direction driven by offshore. Bias remains for higher global yields.**
- **NZGB and ACGB outperforming UST, but NZGB-ACGB 10yr spread too tight relative to front end pricing.**
- **NZGB Apr-23s rich on fly against Apr-20 and Apr-27**

NZ front rates vol low, long end following global yields

Volatility in NZ front end rates remains exceptionally low. NZ 2y swap is at 2.21% and has been in just a 5bp range all month. A small sell-off on a stronger than expected CPI print this week couldn't be sustained after the RBNZ's preferred annual core inflation estimate showed no change at 1.4%.

NZ long end yields are following global bond direction. US 10yrs, at 2.35%, are just below the key 2.40% technical level that was briefly tested in early October. Another underwhelming US CPI print last week has supported the market. Various Fed speakers continue to indicate a willingness to further tighten policy despite only a limited pickup in inflation. This approach risks compressing BEIs and a further flattening of US curve. However, our bias remains for a higher US 10yr yield, with that view predicated on both Fed tightening and a pickup in wages and inflation in the coming months.

Unlike the last time the US 10yr yield tested 2.40% in early July, the US has led this move, rather than Bunds and the broader shift in global central bank policy momentum. As such, the 10yr UST-Bund spread, at 195bp, is over 20bp wider since early September. Renewed hope of US tax cuts is adding pressure to yields, while speculation on the next Fed Chair is adding noise.

NZGBs and ACGBs outperforming UST, but NZGB-ACGB 10y spread rich vs front end pricing

Both NZGB and ACGB 10yr spreads to UST have compressed with the US-led sell-off. This is largely consistent with the re-pricing in US rates expectations. This move has further to run, in our view, with the US front end priced for 50bp of tightening by December 2018 (we look for four hikes). Both Australia and NZ front OIS curves point to around 34bp hikes by the RBA and RBNZ, respectively, by the end of 2018. While we ultimately see upside to that pricing, more for NZ than Australia, there are few catalysts for a major change in the near future.

From time-to-time, we use simple regression models to compare 10yr Australia and NZ yield spreads to UST to front end pricing and the level of currencies. This exercise currently shows the NZ-US 10y spread is close to fair, while AU-US is cheap. So the implication is to prefer ACGBs to NZGBs against UST to position for further US-led compression. Alternatively, as Chart 3 shows, a simple

Chart 1: NZ swap rates and US 10y yield

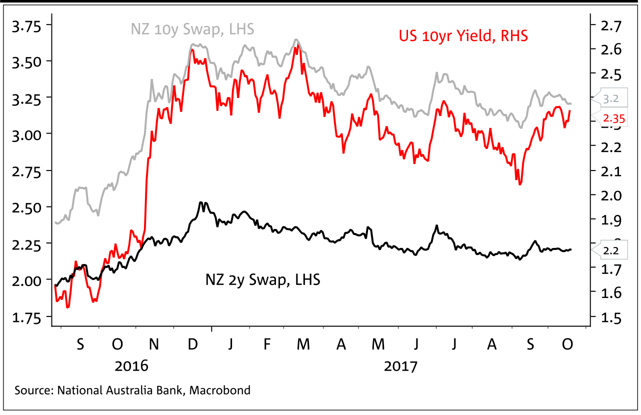


Chart 2: NZ-US and AU-US 10yr spreads contract

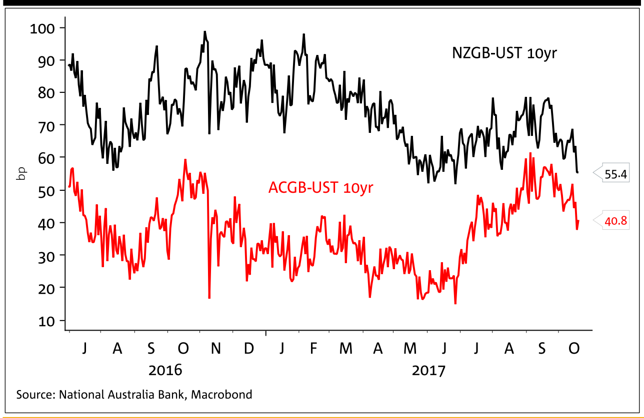


Chart 3: NZGB 10yrs rich vs ACGBs

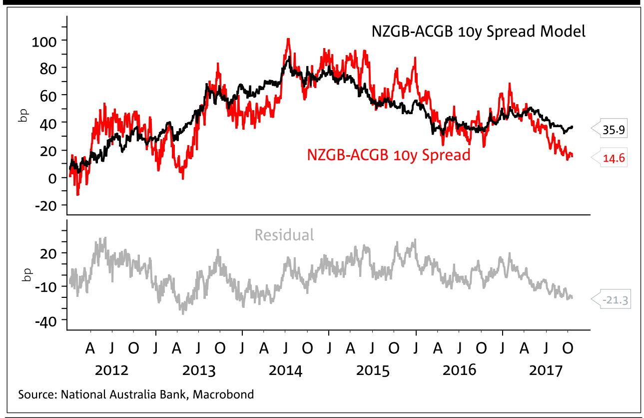
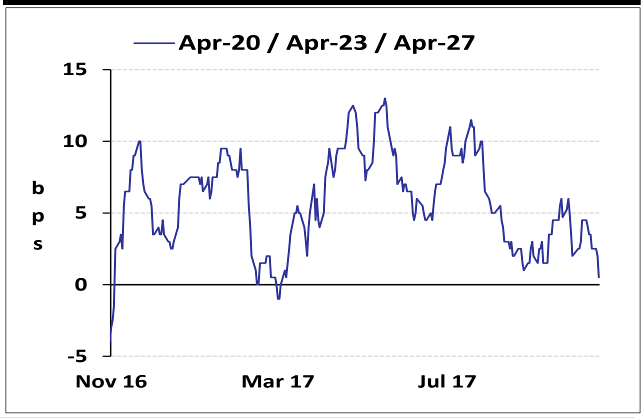


Chart 4: NZGB Apr-23s richen vs Apr-20 and Apr-27



regression puts the NZGB-ACGB 10yr spread 21bp too tight relative to front end pricing (10yr spread a function of 2y3m swap and NZD/AUD exchange rate).

NZGB RV: Apr-23s rich on fly against Apr-20 and Apr-27

The Apr-23s have richened on the NZ curve against the Apr-20s and Apr-27s (Chart 4). The Apr-23s have traditionally been a favoured bond by global investors and is perhaps again the desired point to add longs amid an outperformance to UST and ACGB and expectations of a lower for longer RBNZ rate. Meanwhile uncertainty over the government formation outcome or timing of the Apr-29 issue could be contributing to relative steepness in the Apr-23/Apr-27 wing.

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NZ Economic Review

Final Election Vote Count – 7 October
In keeping with historical tendencies, the final party vote count detracted (2 seats) from the National party, to the benefit of (1 each for) the Greens and the Labour party. So the final seat tallies were 56 for National, 46 for Labour, 8 for the Greens, (an unrevised) 9 seats for the NZ First party and 1 for ACT.

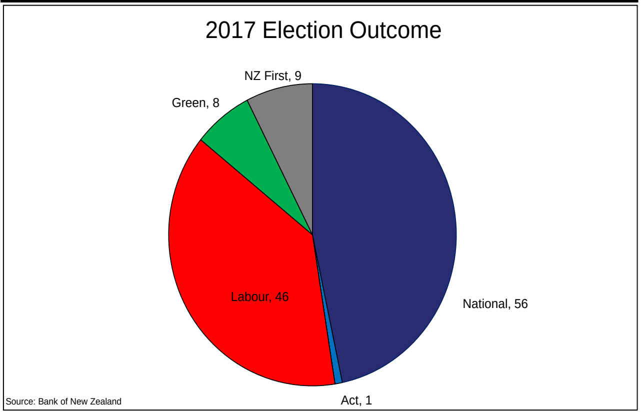
Electronic Card Transactions (Sep) – 10 October
September's electronic card transactions eased 0.1%, leaving its trend measure next to flat for the last six months. This ups the odds of seeing a clear fall in Q3 retail trade volumes, albeit after they sky-rocketed 1.9% in Q2, and with the broader indicators for consumer spending still looking encouraging, on balance.

REINZ Housing Report (Sep) – 12 October
Much like all the other property data of late (including lifestyle blocks and farms) the Real Estate Institute's residential results for September continued to give very mixed messages. Its sales were even softer, no question. They were down 26% on year-ago levels – to the weakest September in 6 years, in fact. This inferred a 7% drop in the latest month alone, based on our seasonally adjusted estimates.

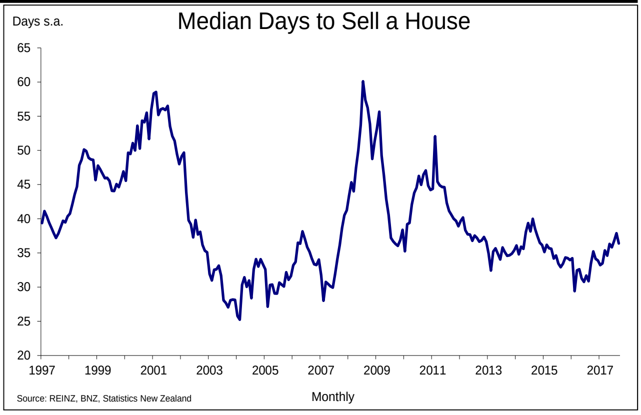
Yet sale prices are not giving any ground on their altitude. Indeed, the REINZ's new composition-controlled SPAR home price index – arguably the most informative in the market nowadays – increased 0.7% in September, after a 0.4% gain in August. Interestingly, Auckland is in on this, as much as the rest of the country is. Talk of a clear fall in Auckland house prices is not backed up by the REINZ data.

Somewhere in between the weak-sales/big-prices extremes is the REINZ median days-to-sell measure. This was 34 in September. While this was 3 days longer than in September 2016, we judge a seasonally adjusted level of 36, which is actually a bit below its long-term average of 40 days. So, yes, this says the market has come off the boil since 2016. But not that much, and is miles away from looking cold.

It's The Final Count-Down



Housing Loses Heat, But Far From Cold

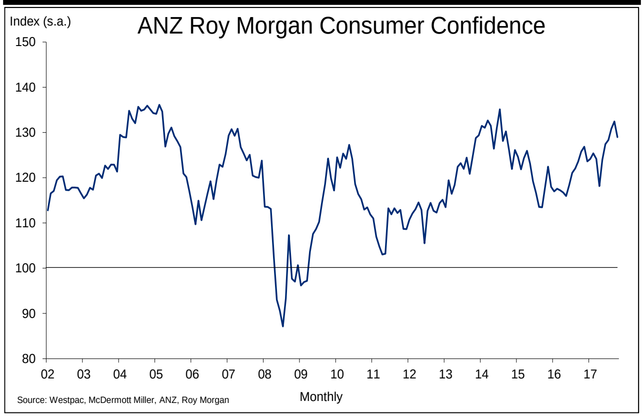


Food Price Index (Sep) – 12 October
The food price index typically falls a bit in September and this year's edition did not break with that tradition. It dipped 0.2%. This meant for annual inflation of 3.0%, or 2.4% ex the volatile fruit and vegetable component.

ANZ-RM Consumer Confidence (Oct) – 12 October
Were NZ consumers feeling nervous after September's inconclusive election? Not by the look of this survey. Sure, it showed consumer confidence easing to 126.3 in October, from 129.9 in September. But it's all within margin of error. Seasonally adjusted, we judge a level of 129.0 for October, which is still decidedly above its long term norm (of 119.2).

BNZ PMI (Sep) – 13 October
September's Performance of Manufacturing Index (PMI) proved to be about as strong as it was in August. In seasonally adjusted terms it was 57.5 from 57.9. Aside from remaining well above its long-term average (of 53.4) it was a particularly encouraging result considering the proximity of 23 September general election.

Consumers Hardly Upset By Tight Election Outcome



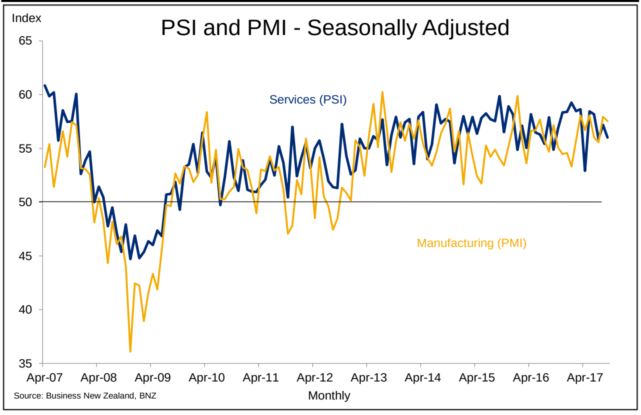
BNZ PSI (Sep) – 16 October

The Performance of Services Index (PSI) has remained stoutly expansive over recent months. Sure, it cooled marginally to 56.0 in September from 57.2 in August, but it remains well above its long term average of 54.4. That is not to say that the election was not on the minds of many PSI respondents. Indeed, just like in the PMI, of the respondents citing the major factor on their business as being a negative one, about a quarter of these noted the election.

CPI (Q3) – 17 October

New Zealand's CPI expanded 0.5% in the September quarter. This nudged its annual rate of inflation up to 1.9%, from 1.7%. The Reserve Bank expected 1.6%, as per its last set of published forecasts. Some of the deviation can be put down to factors that will be quickly played down such as stronger-than-expected petrol and food prices. But other aspects of the data, such as the above-forecast increase in non-tradables inflation (0.7% for the quarter, 2.6% for the year) need to be seen as a genuine pressure. Yet the Reserve Bank's preferred measure of core inflation – from sectoral-factor methods – remained at just 1.4% y/y in Q3. This is even though the more orthodox underlying inflation measures, such as the weighted-median and trimmed means, were now running around about 2%, y/y.

Robust Despite Noted Election Negatives



GDT Dairy Auction – 18 October

The further 1.0% fall in prices at this auction, following the 2.4% drop recorded at the one before, has us trimming our expectation on Fonterra's 2017/18 milk price to $6.30, from $6.75. Downward price dynamics in skim-milk powder, especially as they relate to the EU, are the latest issue being digested in the global dairy product markets.

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NZ Upcoming Data/Events

Int'l Travel and Migration (Sep) – 20 October
Any further fall in net inward migration for September would represent three on the trot, which would start to look interesting. As for short-term visitor arrivals for the month, these look to be roughly flat on a year ago.

Holiday – Labour Day – 23 October

Merchandise Trade (Sep) – 26 October
New Zealand's merchandise trade balance is seasonally weak in September. So the monthly deficit of $1,360m we anticipate will simply hold the 12-month running deficit at around $3.2b, no worse. This is based on September's goods exports being 12% up on a year ago and imports 8% higher. We expect the September-quarter nominal exports total to infer a small correction in volumes and in the case of imports a moderate rise.

New Residential Lending (Sep) – 26 October
August's new residential lending by local banks was down 16.4% on a year ago. Yet it wasn't as negative as July's (-23.8%) or June's (-25.1%). In this there were signs that the worst of its (LVR-driven?) slowdown might well be passing. For September, however, there was the added headwind of the general election taking place.

Building Consents (Sep) – 31 October
Having shown signs of renewed spark in August, building consents for September will be perused for further confirmation of this.

ANZ Business Survey (Oct) – 31 October
This edition would have been collated largely in the thick of the government formation negotiations. So its net confidence reading might struggle to return to positive territory, having sunk to zero in September. Then again, this index tends to bounce in October, on seasonal grounds alone. Call it a spring in its step.

Credit Aggregates (Sep) – 31 October
Annual growth in household credit has slowed quite a bit this year, but, even with the LVR imposts, hasn't slumped altogether. And for reference, the stock of business credit in August proved 6.2% higher than a year prior – a pick-up from its 5.2% annual pace in July. Agriculture credit slowed to 2.5% y/y, from 2.9% in July, continuing its moderate rate of expansion through 2017.

Labour Market Reports (Q3) – 1 November
Even with a closely fought election bearing upon them, businesses reported, via various surveys, a robust view around hiring – ex post and ex ante. But how this translates into the quarterly Household Labour Force Survey (HLFS) is always a bit of a lottery. We say this with the Q2 HLFS having registered a 0.1% fall in employment, yet a further moderation in the jobless rate, to 4.8%, as the participation rate came down from its all-time high of 70.6% in Q2, to 70.0%. For Q3 we propose a 0.8% rebound in the HLFS's employment and a 0.1 fall in its unemployment rate, to 4.7%.

Regards wages and salaries, we expect the Q3 Labour Cost Index to rise 0.7%. This would lift its annual inflation to 1.9%, from 1.6%. Just bear in mind that this brings in the care-workers' pay-equity settlement with the government, which meant for some hefty pay increases in many cases. This, by the way, would also suggest the unadjusted LCI measure will be running noticeably above 3% at an annual pace in Q3, as a preferred sense of nominal wage inflation.

QVNZ Housing Report (Oct) – 2 November
Even without the prolonged government formation process, October's Quotable Value NZ home price index looked set to confirm slower inflation. So the real interest in this report is whether it can inform on any late-in-the-month market reaction to the announcement of the new government.

ANZ Job Ads (Oct) – 2 November
Even during the month of a close-run election, ANZ job ads managed to rise a further 0.4%, after increasing 1.0% in August. Its annual rate of growth was 8.5%. October's results will be the bigger test, however.

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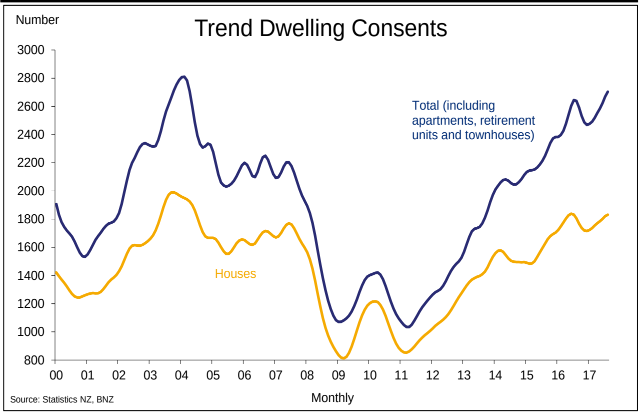
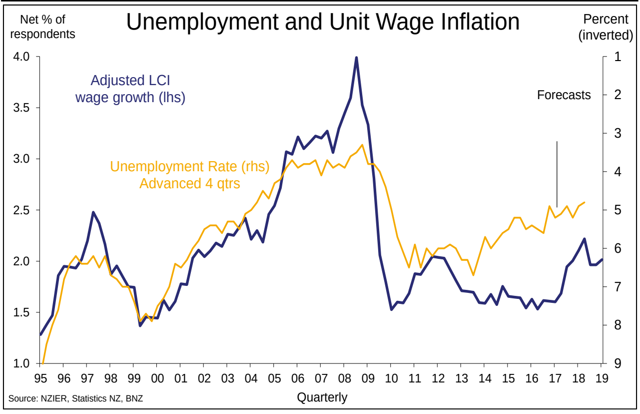
Rebuilding



And Mind That Pay-Equity Settlement



Quarterly Forecasts

As at 19 October 2017

Key Economic Forecasts

Quarterly % change unless otherwise specified

Forecasts

	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	0.5	0.5	1.0
Retail trade (real s.a.)	0.8	2.0	0.8	0.9	1.6	2.0	-1.0	0.8	0.7	1.6
Current account (ytd, % GDP)	-2.9	-2.7	-2.8	-2.5	-2.9	-2.8	-2.6	-2.4	-2.2	-2.5
CPI (q/q)	0.2	0.4	0.3	0.4	1.0	0.0	0.5	0.3	0.7	0.2
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	3.7	3.5	3.6	3.5
CPI (y/y)	0.4	0.4	0.4	1.3	2.2	1.7	1.9	1.8	1.5	1.8
GDP (production s.a., y/y))	2.8	3.5	3.3	2.6	2.5	2.5	2.5	2.6	2.5	2.7

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 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	0.75
Sep	1.75	1.95	2.45	2.95	2.20	2.70	3.20	1.30	2.20	0.75
Forecasts										
Dec	1.75	1.95	2.75	3.20	2.20	3.00	3.50	1.45	2.60	0.60
Mar	1.75	1.95	2.80	3.25	2.30	3.05	3.55	1.55	2.75	0.50
2018 Jun	1.75	2.05	2.80	3.25	2.40	3.05	3.55	1.70	2.75	0.50
Sep	2.00	2.30	3.15	3.60	2.60	3.40	3.90	1.95	3.00	0.60
Dec	2.25	2.55	3.25	3.70	2.85	3.50	4.00	2.20	3.00	0.70
Mar	2.50	2.80	3.25	3.70	3.10	3.50	4.00	2.30	3.00	0.70
2019 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
Dec	3.00	3.20	3.40	3.85	3.30	3.55	4.05	2.30	3.00	0.85

Exchange Rates (End Period)

USD Forecasts

	NZD/USD	AUD/USD	EUR/USD	GBP/USD	USD/JPY
Current	0.72	0.78	1.18	1.32	112
Dec-17	0.70	0.75	1.17	1.33	116
Mar-18	0.69	0.74	1.18	1.30	118
Jun-18	0.69	0.73	1.20	1.31	118
Sep-18	0.70	0.73	1.22	1.28	118
Dec-18	0.70	0.73	1.20	1.26	120
Mar-19	0.71	0.74	1.20	1.25	120
Jun-19	0.72	0.75	1.18	1.24	120
Sep-19	0.73	0.76	1.18	1.25	118
Dec-19	0.73	0.76	1.17	1.24	117
Mar-20	0.73	0.76	1.19	1.26	116

NZD Forecasts

	NZD/USD	NZD/AUD	NZD/EUR	NZD/GBP	NZD/JPY	TWI-17
Current	0.72	0.91	0.61	0.54	80.4	75.6
Dec-17	0.70	0.93	0.60	0.53	81.2	75.3
Mar-18	0.69	0.93	0.59	0.53	81.4	74.5
Jun-18	0.69	0.95	0.58	0.53	81.4	74.5
Sep-18	0.70	0.95	0.57	0.54	82.0	74.9
Dec-18	0.70	0.96	0.58	0.56	84.0	75.7
Mar-19	0.71	0.96	0.59	0.57	85.2	76.5
Jun-19	0.72	0.96	0.61	0.58	86.4	77.5
Sep-19	0.73	0.95	0.61	0.58	85.6	77.4
Dec-19	0.73	0.95	0.62	0.59	84.8	77.4
Mar-20	0.73	0.96	0.61	0.58	84.7	77.5
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 19 October 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	3.4	2.2	2.3	4.1	3.6	3.2	2.5
Exports	5.6	0.7	2.4	2.7	4.3	6.9	1.6	1.0	2.6	4.2
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	2.6	3.1	2.4	3.2	3.5	2.5	2.9	2.7
GDP (production)	**2.4**	**2.9**	**2.5**	**3.1**	**2.4**	**2.5**	**3.0**	**2.5**	**2.9**	**2.7**
GDP - annual % change (q/q)	*2.8*	*2.5*	*2.5*	*3.3*	*2.1*	*2.2*	*2.6*	*2.6*	*3.3*	*2.2*
Output Gap (ann avg, % dev)	0.8	0.9	0.8	1.3	1.1	0.8	0.9	0.8	1.1	1.2
Household Savings (gross, % disp. income)	1.2	0.1	-0.5	-0.3	0.5					
Nominal Expenditure GDP - $bn	250.7	264.7	277.2	288.8	300.6	247.6	260.7	274.7	285.7	297.6
Prices and Employment - annual % change										
CPI	0.4	2.2	1.5	1.7	1.8	0.1	1.3	1.8	1.5	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	0.3	0.4
Unit Labour Costs (ann av %)	2.4	4.7	3.0	2.5	2.7	2.6	3.6	3.6	2.8	2.6
External Balance										
Current Account - $bn	-7.3	-7.7	-6.2	-8.7	-9.5	-8.0	-6.6	-6.7	-8.5	-9.3
Current Account - % of GDP	-2.9	-2.9	-2.2	-3.0	-3.1	-3.2	-2.5	-2.4	-3.0	-3.1
Government Accounts - June Yr, % of GDP										
OBEGAL (core operating balance)	0.7	1.5	1.0	1.2	1.9					
Net Core Crown Debt (excl NZS Fund Assets)	24.5	22.4	21.9	21.4	19.9					
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	2.80	3.25	3.45	2.95	2.75	2.75	3.25	3.40
10-year Govt Bond	2.90	3.25	3.25	3.70	3.90	3.45	3.30	3.20	3.70	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	3.05	3.50	3.70	3.15	3.00	3.00	3.50	3.65
US 10-year Bonds	1.90	2.50	2.75	3.00	3.00	2.25	2.50	2.60	3.00	3.00
NZ-US 10-year Spread	1.00	0.75	0.50	0.70	0.90	1.20	0.80	0.60	0.70	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 20 October			
NZ, External Migration, September s.a.			+5,490
US, Yellen Speaks, Monetary Policy post GFC			
US, Existing Home Sales, September		5.30m	5.35m
Monday 23 October			
NZ, Holiday, Labour Day			
China, Property Prices, September			
UK, CBI Industrial Trends, October			+7
Tuesday 24 October			
China, Leading Index (Conference Bd), September			
Euro, PMI Manufacturing/Services, Oct. 1st est			58.1/55.8
US, Markit PMI/PSI, Oct 1st est		53.0/55.0	53.1/55.3
Wednesday 25 October			
Aus, CPI, Q3			+0.2%
Germ, IFO Index, October			115.2
UK, GDP, Q3 1st est		+0.3%	+0.3%
US, Durables Orders, Sept. 1st est		+1.0%	+2.0%
US, New Home Sales, September		550k	560k
Can, BOC Policy Announcement			1.00%
Thursday 26 October			
NZ, Merchandise Trade, Sept	-$1,360m		-$1,235m
NZ, Residential Lending, Sep y/y			-16.4%
Aus, Terms of Trade, Q3			-5.7%
Aus, RBA's Debelle Speaks			
Euro, ECB Policy Announcement, Refi	0.00%	0.00%	0.00%
UK, CBI Distribution Reported Sales, October			+44
US, Wholesale Inventories, Sept. 1st est			+0.9%
US, International Goods Trade, Sept advance		-$64.0b	-$62.9b
Friday 27 October			
Aus, Producer Prices, Q3 y/y			+1.7%
China, Industrial Profits, September y/y			+24.0%
Jpn, CPI, September y/y			+0.7%
US, GDP, Q3 1st est		+2.6%	+3.1%
Monday 30 October			
Jpn, Retail Sales, September y/y			+1.7%
Euro, Economic Confidence, October			113.0
Germ, CPI, Oct y/y1st est			+1.8%
US, Personal Spending, September		+0.9%	+0.1%
Tuesday 31 October			
NZ, ANZ Business Survey, October			flat
NZ, Building Consents, September (res, #)			+10.2%
NZ, Credit Aggregates, Sept. (housing y/y)			+6.7%
Aus, Private Sector Credit, September			+0.5%
China, PMI (NBS), October			52.4
China, Non-manufacturing PMI, October			55.4
Jpn, BOJ Policy Announcement, Policy Rate		-0.1%	-0.1%
Jpn, Household Spending, September y/y			+0.6%
Jpn, Industrial Production, Sept. 1st est			+2.0%
Euro, CPI, Oct y/y 1st est			+1.5%
Euro, GDP, Q3 1st estimate			+0.6%
Euro, Unemployment Rate, September			9.1%
US, Chicago PMI, September		60.0	65.2
US, Consumer Confidence, October		120.0	119.8
US, Employment Cost Index, Q3		+0.6%	+0.5%

	Forecast	Median	Last
Wednesday 1 November			
NZ, HLFS Employment, Q3	+0.8%		-0.2%
NZ, HLFS Unemployment Rate, Q3	4.7%		4.8%
NZ, LCI Priv Ord Wages, Q3 y/y	+1.9%		+1.6%
Aus, CoreLogic HPI, October			+0.3%
China, PMI (Caixin), October			51.0
UK, Markit/CIPS Manuf Survey, October			55.9
US, FOMC Policy Announcement	1.25%	1.25%	1.25%
US, Construction Spending, September		-0.2%	+0.5%
US, ISM Manufacturing, October		58.5	60.8
US, ADP Employment, October			+135k
Thursday 2 November			
NZ, QVNZ House Prices, October y/y			+4.3%
NZ, ANZ Job Ads, October			+0.4%
Aus, International Trade, September			+$0.99b
Aus, Building Approvals, September			+0.4%
Germ, Unemployment Rate, October s.a.			5.6%
UK, BOE Inflation Report			
UK, BOE Policy Announcement	0.25%	0.25%	0.25%
Friday 3 November			
Aus, Retail Trade, September			-0.6%
China, Services PMI (Caixin), October			50.6
UK, Markit/CIPS Services, October			53.6
US, Non-Farm Payrolls, October		+300k	-33k
US, ISM Non-Manuf, October		58.2	59.8
US, Factory Orders, September			+1.2%
US, International Trade, September		-$43.5b	-$42.4b
Monday 6 November			
NZ, RBNZ 2yr Inflation Expectations, Q4			+2.09%
NZ, ANZ Comdty Prices (world), October			+0.8%
Jpn, BOJ Minutes, 20/21 Sept. Meeting			
Germ, Factory Orders, September			+3.6%
US, Fed's Dudley Speaks, Econ Club NY			
Tuesday 7 November			
Aus, RBA Policy Announcement	1.50%	1.50%	1.50%
Euro, Retail Sales, September			-0.5%
Germ, Industrial Production, September			+2.6%
Wednesday 8 November			
NZ, Dairy Auction, GDT Price Index			-1.0%
Thursday 9 November			
NZ, RBNZ MPS	1.75%	1.75%	1.75%
Aus, Housing Finance, September			+1.0%
China, CPI, October y/y			+1.6%
Jpn, Machinery Orders, September			+3.4%
Jpn, BOJ Summary of Latest Meeting, 30/31 Oct. Meeting			
Euro, ECB Economic Bulletin			
UK, Industrial Production, September			+0.2%
Friday 10 November			
NZ, Electronic Card Transactions, October			-0.1%
Aus, Qtly Monetary Statement			

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