21 November 2016

Economic Momentum Strong, Pre-Quake

- Earthquake poses some near term risk to GDP
- But economic momentum strong
- Consumers optimistic, dairy recovering, inflation appearing
- Post-earthquake data release disrupted
- And maybe the HYEFU too?

One week on from the M7.8 Kaikoura earthquake (and hundreds of aftershocks later) and our initial broad economic assessment still holds. That is, in the first instance, there is likely to be some small near term hit to GDP, although significantly less than that following the Christchurch quakes in 2010 and 2011.

The small township of Kaikoura has been severely affected. The road and rail links through the area that are very important for much of the South Island have suffered massive damage. While alternatives are available, this will affect logistics for a considerable time.

It is now clear that there has been a bit more damage in and around Wellington than we initially appreciated. The odd building in the capital has been declared at risk of collapsing, rendering them no go areas (this includes some car parking buildings – with more than 3,000 car parks reportedly affected). The disruption from such things, as alternative arrangements are made, will add to the indirect costs of the quake. We have firsthand experience of this, as we will be publishing our research under disaster recovery conditions from alternative accommodation for a while. Please bear with us if there are any glitches!

Note that New Zealand's economic data flow has also been disrupted, following damage to Statistics New Zealand's main Wellington building. Statistics New Zealand's website has now been partially restored, but November's remaining data release dates are currently labelled 'delayed'. This includes the tourism and migration data and overseas merchandise trade figures that were previously scheduled for tomorrow and Friday respectively. Watch for updates to the release calendar at 1pm daily.

Note we expect October's net migration inflow and tourist arrivals to show ongoing strength, when these data are ultimately released. But much more interest will now be in the months ahead to gauge any influence from the earthquake. For October's trade figures, we anticipate an $887m monthly deficit that would result from both exports and imports being 2% below year earlier levels (both affected by the strength of the NZ dollar over the year).

Also on the upcoming data front, we note that Finance Minister Bill English suggested this morning that the Government's Half Year Economic and Fiscal Update may be delayed a week from its currently scheduled 8 December release date. Watch this space.

The Minister suggested that the earthquake, at this point, will not stop the Government from doing other things over the medium term. The Minister did not rule out tax cuts. But it is clear where a reasonable chunk of the projected surpluses will now be headed. In time, the substantial transport infrastructure work required in the top half of the east Coast of the South Island will lift economic activity.

One data point that hasn't been delayed is October's new residential lending figures due Thursday. We'd suggest focusing on the level of these as much as any change from previous periods. New residential lending was 10.3% lower in September than a year earlier. Yes, some of this is likely to do with the new LVR restrictions (new high-LVR lending fell by 16.7% y/y). But the high base in September last year (associated with other policy-induced changes at that time) also needs to be borne in mind. If October's level of new lending simply matched that of the previous month, it would imply the overall stock of lending is still expanding at a brisk pace. We'll see.

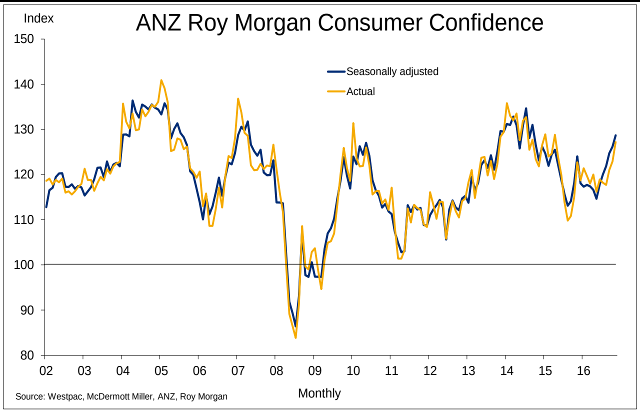
More generally, contemplating the economy, near term, post-earthquake, we simply reiterate that there is some downside risk to our GDP forecasts for the final quarter of 2016 and first quarter of 2017. We current anticipate 0.8% q/q growth in each of these quarters. But we are quick to point out that this does not necessarily mean that our current forecasts will ultimately prove too high. We say this acknowledging that the economy had a fair head of steam built up before the earthquake struck. There is a reasonable chance that the effects of the earthquake simply offsets some of the upside risks to growth that were brewing in the economy as a whole.

The recent strength in the economy was reinforced by information released last Friday.

First, the ANZ-RM consumer confidence reading for November, but mostly surveyed prior to the shaking, was another indicator getting even stronger from already strong levels. It lifted to a seasonally adjusted 128.7 in

November, from 126.2 in October, to now be a full 10 points above its long term average.

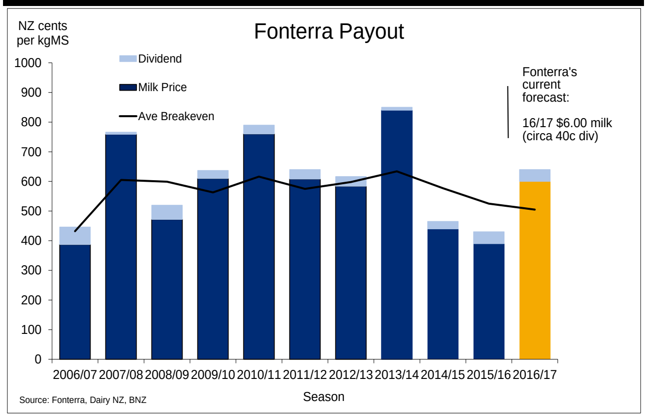
Consumers Optimistic



Second, the dairy sector, a previous sore point in the economy, is showing further signs of healing. Last Friday, Fonterra lifted its 2016/17 milk price forecast to $6.00 per kilogram of milksolids. Our own forecast is $6.00 but we see upside risk to this forecast given the current level and momentum in international prices and value of the NZD.

Fonterra also held their earnings guidance at 50c to 60c per share. This suggests a dividend of around 40c and implies total payments to farmers of $6.40. This is well above estimated average breakeven (of just over $5) and a world away from the previous season's total of $4.30. We calculate the current forecast implies a lift in dairy industry revenue from the previous season is circa $3.2b, even if NZ milk volumes fall by about 7% (which is the decline that Fonterra sees for its own collections, although total NZ production may not be down quite this much).

Better Dairy Payments Forecast



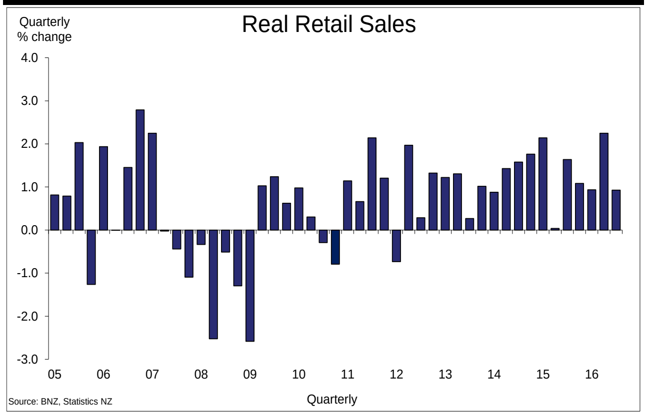
This is a big income boost to the country via a lift in the terms of trade. But don't look for it too early in real GDP. Indeed, at least initially, real GDP will be dampened by lower milk volumes.

Third, retail sales volumes rose 0.9% in the third quarter, in line with market expectations. Note that this was reported by Bloomberg late on Friday afternoon causing some confusion, at first, because Statistics NZ had said this information was to be released today.

This is robust retail sales growth in its own right, but exceptionally so given that it followed a very strong 2.2% gain in Q2. Retail sales volumes are 5.0% higher than a year earlier. These are the latest figures showing the NZ consumer has been loosening the purse strings.

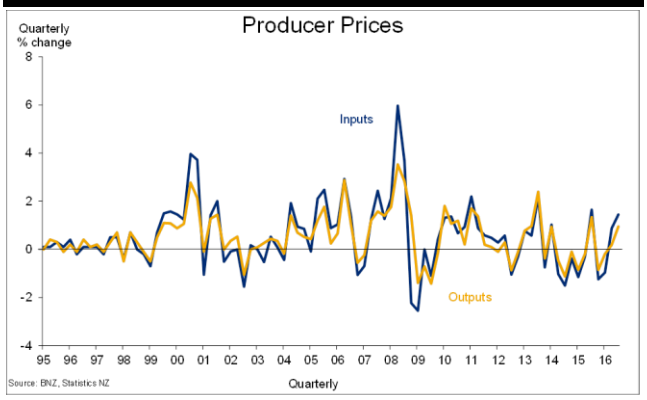
As an aside, we wonder if that latter point will be touched on in a RBNZ speech entitled 'Changing Dynamics in Household Behaviour' to be delivered tomorrow evening by Deputy Governor Geoff Bascand in Canberra. But given the timing (it will be on the RBNZ website at 7.30pm NZT), we suspect it will not be particularly market sensitive but it will nonetheless be worth a browse.

Very Robust



The fourth data set released on Friday was on producer price inflation. This was released and reported late on Friday afternoon under similarly baffling circumstances as for retail sales noted above.

Signs Of Life



Producer price inflation is showing some signs of life. While annual inflation was still very subdued at 0.1% in Q3 for both output and input prices, there was more pep in quarter itself. Producer output prices rose 1.0% q/q and input prices lifted 1.5% as the recent upswing in dairy prices starts to come through adding to the ongoing firm inflationary pulse emanating from the construction sector. There is certainly nothing here to dissuade us from our view that annual consumer price inflation will re-enter the RBNZ's target band in Q4 (that data is still due 19 January, at this stage).

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Global Watch

- Offshore risk events: A quieter week this week with the US Thanksgiving Day Holiday and associated light trade Friday. Geopolitical events to dominate with eyes on polls ahead of the Italian referendum which PM Renzi has staked his leadership on (4 Dec), focus on OPEC with officials meeting Monday ahead of the formal meeting on 30 Nov. Data-wise we get the FOMC November Minutes, EU flash PMIs also Wednesday, German IFO Thursday, and Japanese CPI Friday.
- Australia: Construction Work Done on Wednesday the main data interest, a partial indicator ahead of Q3 GDP (out 7 December). RBA Assistant Governor (Economic) Chris Kent also speaks on "Australia's Economic Transition – State by State" on Tuesday evening.
- China: Very quiet week with mostly second tier data. Industrial Profits Sunday.
- US: Fed Governor Fischer speaks on Monday and the November FOMC Minutes are out Wednesday (8am Thursday NZT). The main data points are Durable Goods Orders, Jobless Claims, New Home Sales and the final (including post-election polling) Nov UoM Consumer Sentiment Survey all out Wednesday. The latter confidence reading is the first such major read since the election; the weekly Bloomberg Consumer Comfort Index for 13 November (post-election) was 6.4% above average October levels, a hint of a prospective upgrade. It's then quiet Thursday-Friday with Thanksgiving Day, though the Advance Goods Trade and Wholesale Inventories reports are out Friday.
- Japan: Trade Monday, CPI Friday. BoJ Board member Takako Masai speaks Monday.
- Euro: ECB's Draghi speaks to European Parliament on Monday. Most data interest will be in the flash Nov PMIs Wednesday. There's also Germany's revised Q3 GDP, Ifo Survey, and Gfk Consumer Confidence, all Thursday.
- UK: Public Finances, CBI Trends Tuesday, revised Q3 GDP Thursday, CBI Distributive Trades/CBI Retail Friday. UK Chancellor unveils his Autumn Statement Wednesday.
- Canada: The main interest will be Tuesday's September Retail Sales.

Australia

The major events this week start in earnest on Tuesday with two RBA speeches. First up is Chris Aylmer (Head of Domestic Markets) speaking to a Securitisation Conference at 10.25 AEDT. And then a speech be the RBA's Chief Economist Chris Kent on Tuesday evening (18.45 AEDT) to the Australian Business Economists' Forecasting Conference in Sydney. Kent is speaking to the topic "Australia's Economic Transition – State by State". The transition story for the economy has been an important one with the winding down on spending of the resources sector. So far, the transition toward growth in the East and within the non-mining sectors has been an encouraging one with Kent's speech set to provide more official colour on the economy's evolution.

Chart 1: Transition – Signs Of Slowing In The East

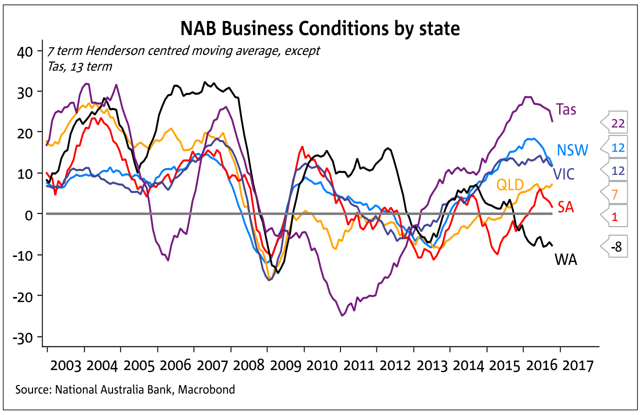


Chart 2: Italy Referendum The Next Risk Event (4 Dec)

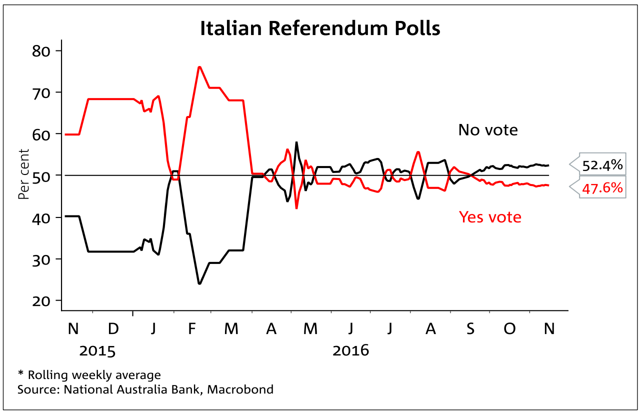
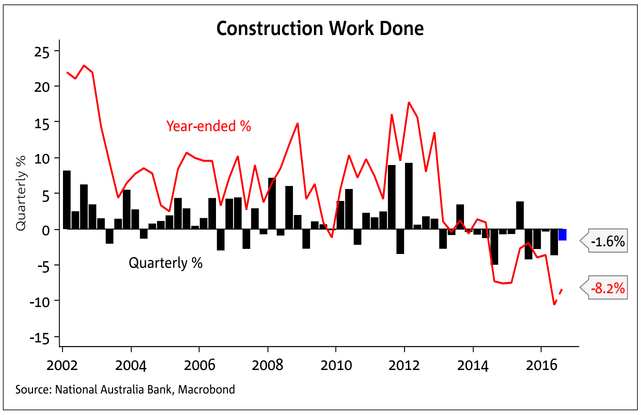


Chart 3: Construction Activity Still Likely To Be Weak



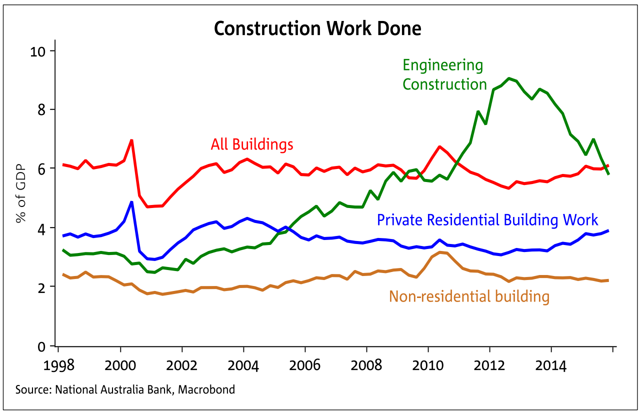
The only data of note in Austalia this week is Construction Work Done for the September quarter, out Wednesday. Construction Work Done fell by 3.7% in the June quarter, down 10.6% over the year, with activity haven fallen in every quarter bar two since the December quarter of 2012 when resource major project spending was peaking. With all three Gladstone LNG plants and Gorgon in WA now in their operational and exporting phases, a further decline from the wind-down in major project spending seems likely. (Private engineering construction has declined by 36.5% over the past year and by 53.8% from peak levels in the September quarter of 2012. Activity in that sector is back to levels at the start of the decade.)

Against that headwind is the upturn in dwelling investment and higher levels of government infrastructure spending in some states has filled some of the void.

NAB's forecast calls for a net decline in aggregate Construction Work Done of 1.6%, the boost from residential investment and public infrastructure spending more than offset by a further winding down of resource sector spending. The market consensus also sits at -1.6%.

Looking a little further ahead, it will be interesting to see from the September quarter New Private Capital Expenditure Survey (due the following week on Thursday 1 December and polled In October-November) whether Mining sector expectations of another hefty cut in Capex have been revisited and revised up somewhat in the light of the recent large rises in bulk resource commodity prices, to bring some mothballed mines back into operation and any necessary Capex to lift production at already operating mines.

Chart 4: Mostly Tailwinds So Far



The other releases due this week are the weekly ANZ-Roy Morgan Consumer Confidence release on Tuesday and Skilled Vacancies for October on Wednesday.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

We believe we have now reached the OCR trough for this cycle. We expect the RBNZ will keep the OCR steady at 1.75% throughout 2017, before beginning a gradual hiking cycle from late H1 2018. Market pricing has now moved close to this view. We therefore see 2-year swap 'fair value' around 2.20%. However, as previously discussed, we anticipate it will trade a 2.10-2.35% range in coming months around this level.

There are limited domestic data releases this week that are likely to impact on short-end yields. Due to damage incurred during the recent (ongoing) NZ earthquakes data releases by Statistics NZ have been disrupted.

Tuesday's net migration and credit card spending will however likely gain some attention. Recall, last month net migration was running at an historic high. This has complex implication for the RBNZ's outlook. On the one hand it is an important contributor to strong NZ growth. On the other, it adds to labour supply and demand for housing. At its simplest that suggests contained wage pressures, but continued pressure on a supply-constrained housing market. Not an easy balancing act for a CPI targeting Bank.

Over the medium-term we continue to see further upward pressure on the NZ mid-curve. This will be driven by further rises in offshore yields, and the market's reassessment of where the OCR will ultimately reach over the full cycle. Even after their recent surge higher, NZ mid-curve yields are consistent with pricing an OCR that does not get above 3.00-3.25% in this cycle. We ultimately anticipate a peak OCR of 3.75%. We expect the 1y3y swap curve, that has moved rapidly from -5bps, to 33bps currently, will ultimately trade as high as 60bps. That said, we wouldn't be surprised to see some near-term consolidation.

We see some potential for US 10-year yields to pullback from range-highs this week. Yields closed last week at 2.33%, nudging at range highs established in late-2015. In a relatively light US data week we anticipate yields might regroup after their shattering speed of ascent (post US election). We see offshore yields providing a brake on further near-term rises in US yields. For example, at 206bps, US-GE 10-year spreads have surpassed the top of long-term ranges. They now trade at a level not seen during the period since German reunification. At 203bps, US-JP 10-year spreads are at their widest since early-2011.

Auctions of US Treasuries this week will provide a good test of demand. On Wednesday morning 5-year USTs will be auctioned, while on Thursday morning, 7-year USTs are on offer. Will investors be enticed by the improved yields relative to offshore counterparts of remain wary of a further sell-off?

Both the ECB and US Fed will also be in the spotlight this week. Early Tues morning, ECB's Draghi will speak at the European Parliament. On Thursday morning the US FOMC Minutes from the early-November meeting will be released. However, it's difficult to see the latter prompting much market response.

The market is already 95% priced for a Fed hike on 14 December, and we don't expect the Minutes to throw cold water on that expectation. The Minutes also pre-date the recent US election, so any commentary around the medium-term trajectory for the Fed funds rate will likely be discounted as not reflecting the most recent information.

change (bps)	90 day bills	12/17 NZGB	04/27 NZGB	2yr swaps	10yr swaps	2yr/10yr swaps (bps)
14-Nov-16	2.07%	1.89%	3.13%	2.30%	3.35%	105
21-Nov-16	2.05%	1.92%	3.10%	2.27%	3.28%	102
Change (bps)	**-2**	**3**	**-4**	**-4**	**-7**	**-4**

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Key Fixed Interest Views

Category		19-Nov-16	Tactical (1w)	Strategic (6-12m)	Comments
NZ Money Markets	OCR	1.75%	→	→	We see the RBNZ keeping the OCR at a low of 1.75% throughout 2017.
NZ Swap Yields	2y	2.27%	→	→	Currently close to 'fair value'. Likely to trade a 2.10-2.35% range in the months ahead.
	5y	2.78%	→	↗	Expect some consolidation this week after recent surge higher.
	10y	3.28%	↘	↑	A near-term pullback may be in the offing, though hedgers should not expect a pullback to previous lows.
NZ Swap Curve	2s-10s	1.02%	↘	↑	Near-term, we anticpate the curve may pullback from its recent highs, though over medium-term we target 125bps.
NZ Bond Yields	NZGB 2027s	3.09%	↘	↗	Likely to take their cue from US yields this week.
NZ-AU Swap Spreads	2y	0.40%	→	↑	Widening to 100bps over longer-term as we see RBA easing next year while the RBNZ keeps the OCR at 1.75%.
NZ Swap-Bond Spread	2027s ASM	0.22%	→	↑	NZ swap and bond yields experiencing similar global pressures at present.
US Bond Yields	10y	2.33%	↘	↗	We would not be surprised to see yields pull back from range highs this week after their recent surge higher.
NZ-US Bond Spread	NZ-US 2027s	0.85%	→	→	We expect a 60-100bps range in the months ahead.
NZ-AU Bond Spread	NZ-AU 2027s	0.42%	→	↗	We expect widening within a 40-70bps trading range in the year ahead.

Source: Bloomberg, BNZ

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

The current theme is USD strength post the Trump election victory and the challenge over the short term is to determine how much longer it can punch higher. Net speculative positioning is already heavily in favour of the USD, technical indicators are suggesting the USD is becoming "overbought" and one cannot yet be sure of Trump's actual policies. These conditions might suggest increasing headwinds for the USD, after its strong run.

The strength of the USD has pushed NZD/USD lower by some 4½-5% since the Trump victory against the trend of stronger global risk appetite and higher NZ commodity prices. Thus, our short-term fair value estimate has actually moved higher over the past two weeks to around 0.7170. Two weeks ago, the NZD was looking a little over-valued, in the order of 5% on our model. Now it is looking about 2% cheap, such has been the power of the Trump factor.

We are conscious of the fact that the NZD performs well towards year-end, a reflection of positive seasonal factors. Thus, despite the NZD falling heavily down to the 0.70 mark, we are leaving our year-end target of 0.72 unchanged, a figure aligned to our fair value model. The 0.6950 mark is a key level of technical support over the short term.

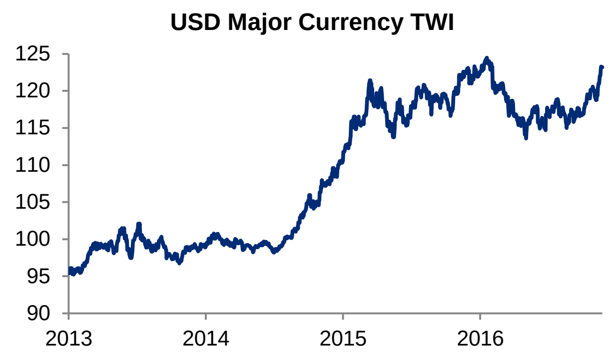
While NZD/USD is trading close to a 4-month low, it is clear that it's a story more about USD strength than NZD weakness. The NZD is actually higher against AUD and JPY and has held its ground against EUR since Trump's victory. Positive domestic forces, such as signs that growth continues to track above trend and strong NZ export commodity prices are NZD-supportive factors.

Our short-term NZD/AUD fair value model estimate has tracked down to 0.8910, driven by the surge in Australian coal prices. The actual NZD/AUD cross has been tracking above fair value for some time but we have not been beating the drum on this cross. We, and the market, are sceptical about the sustainability of that surge in coal prices. We have more faith in our other, medium-term focused, model which puts more weight on the relative AU/NZ unemployment rate. That model has suggested a fair value of AUD0.95 for some time.

Looking to the week ahead, it's quiet on the data front. Statistics NZ's release calendar remains disrupted by the earthquake. The next figures that will be released are migration and trade data which don't tend to be market moving. Offshore, it will be quiet as well, especially towards the end of the week, due to the US Thanksgiving holiday. The FOMC minutes of the November meeting on Thursday morning are the highlight, but that meeting was superseded by Trump's victory.

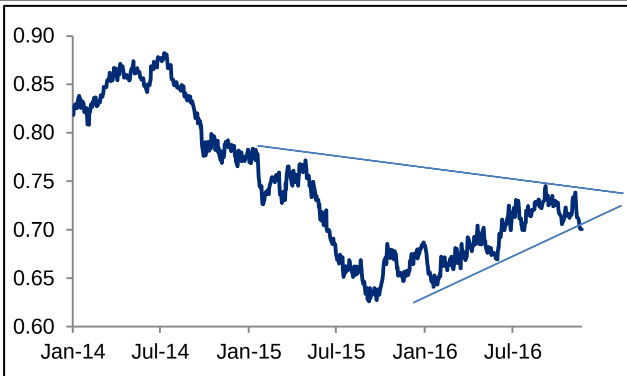
It's hard to see economic data driving the currency this week so it will be all about watching Trump and his appointments. Europe also remains a focus ahead of Italy's Constitutional reform referendum on 4 December. A vote for no change currently leads the polls, which could lead to some political disturbance, including Prime Minister Renzi's resignation. Accordingly, downward pressure on EUR is likely to remain over coming months which could see the year's high for NZD/EUR of 0.6735 broken in the not too distant future.

USD TWI Approaching Fresh Highs



Source: BNZ, Bloomberg

NZD Broken Down Through the Wedge



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7002	0.7000 - 0.7400
NZD/AUD	0.9558	0.9280 - 0.9650
NZD/GBP	0.5672	0.5170 - 0.6110
NZD/EUR	0.6602	0.6320 - 0.6730
NZD/JPY	77.67	73.70 - 77.90

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7170	-2%
NZD/AUD	0.8910	7%

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Technicals

NZD/USD

Outlook:	Support under threat
ST Resistance:	0.7270 (ahead of 0.7360)
ST Support:	0.6950 (ahead of 0.6690)

The NZD is trading below the 200-day moving average of 0.7030 but a key support level is 0.6950, a level not breached since June. A breach of that level opens up significant downside risk. Given the recent sharp fall, resistance levels are well above current spot and not under threat.

NZD/AUD

Outlook:	Trading range
ST Resistance:	0.9600 (ahead of 0.9700)
ST Support:	0.9350 (ahead of 0.9280)

The currency has spent much of the past 6 months oscilliating in a 0.93-0.96 range. Topside resistance is the current threat, which opens up 0.97 and upward.

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NZ 5-year Swap Rate

Outlook:	Higher
MT Resistance:	3.00
MT Support:	2.55

Market is trending higher and keep borrowed position until technical indicators turn down. Support at 2.55 now and keep this trendline as a trailing stop.

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

Outlook:	Steeper
ST Resistance:	+61
ST Support:	+43

Steepening has been dramatic, move stop up to previous break at +43 with a target now at +61.

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Key Upcoming Events

	Forecast	Median	Last
Monday 21 November			
NZ, Credit Card Billings, October			+2.6%
NZ, (pending) National Accounts, Year to March 2016			
China, Leading Index (Conference Bd),			
Jpn, All Industry Index, September	+0.2%		
Jpn, Merchandise Trade Balance, October		+¥583b	+¥498b
US, Chicago Fed Nat Activity Index, October			-0.14
US, Fed's Fischer Speaks			
Tuesday 22 November			
NZ, (circa) External Migration, October s.a.			+6,340
Aus, RBA's Kent Speaks, Economic Transition			
Euro, Consumer Confidence, November 1st est		-7.8	-8.0
UK, CBI Industrial Trends, November			-17
US, Existing Home Sales, October		5.44m	5.47m
Wednesday 23 November			
Aus, Construction Work Done, Q3		-1.5%	-3.7%
Euro, PMI Manufacturing, November 1st est		53.2	53.5
Euro, PMI Services, November 1st est		52.8	52.8
US, New Home Sales, October		590k	593k

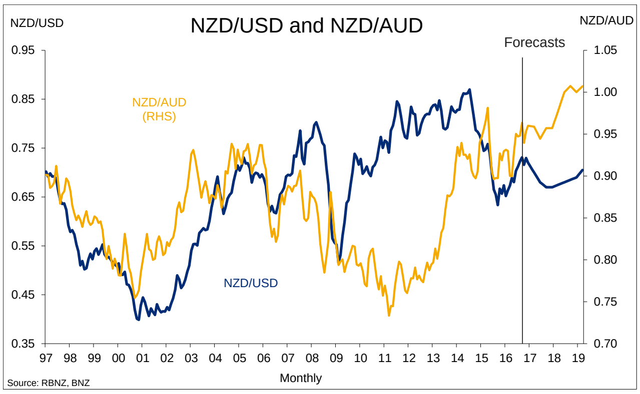
	Forecast	Median	Last
Wednesday 23 November...*continued*			
US, Markit PMI, November 1st est		53.5	53.4
US, Mich Cons Confidence, November 2nd est		91.6	91.6P
US, Jobless Claims, week ended 19/11			235k
US, Durables Orders, October 1st est		+1.1%	-0.3%
Thursday 24 November			
NZ, Residential Lending, October y/y			-10.3%
Germ, IFO Index, November			110.5
Germ, GDP, Q3 2nd est			+0.2%
US, Holiday, Thanksgiving			
US, FOMC Minutes, 1/2 Nov meeting			
Friday 25 November			
NZ, (circa) Merchandise Trade, Oct	-$887m	-$887m	-$1,436m
Jpn, CPI, October y/y		+0.2%	-0.5%
UK, GDP, Q3 3rd est			+0.5%P
UK, CBI Retailing Reported Sales, November			+21
US, Markit PSI, November 1st est		54.8	54.8
US, International Goods Trade, October 1st est		-$59.0b	-$56.1b
US, Wholesale Inventories, October 1st est		+0.3%	+0.1%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	2.00	2.75
1mth	1.93	1.96	2.16	2.87
2mth	1.98	2.02	2.15	2.87
3mth	2.03	2.07	2.14	2.87
6mth	2.08	2.12	2.15	2.91
GOVERNMENT STOCK				
12/17	1.93	1.88	1.87	2.60
03/19	2.13	2.11	1.89	2.71
04/20	2.31	0.00	1.96	2.86
05/21	2.47	2.46	2.03	2.97
04/23	2.76	2.71	2.21	3.19
04/25	3.00	2.92	2.38	0.00
04/27	3.11	3.04	2.51	3.54
04/33	3.45	0.00	2.83	3.88
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	113.5	111.00	104.00	120.00
N. AMERICA 5Y	76.73	79.80	75.55	85.69
EUROPE 5Y	82.18	78.30	73.92	74.24
SWAP RATES				
2 years	2.28	2.27	2.08	2.74
3 years	2.46	2.44	2.11	2.82
5 years	2.79	2.74	2.27	3.10
10 years	3.30	3.22	2.66	3.62

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6994	0.7130	0.7093	0.6543
NZD/AUD	0.9541	0.9448	0.9309	0.9189
NZD/JPY	77.586	76.415	73.935	80.083
NZD/EUR	0.6602	0.6568	0.6465	0.6091
NZD/GBP	0.5663	0.5666	0.5828	0.4297
NZD/CAD	0.9439	1.3542	0.9316	0.8710
TWI	77.40	78.05	76.44	71.36

NZD Outlook



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