13 March 2017

RBNZ Conundrum Intensifies

- Q4 GDP likely to print soft
- We forecast just 0.4% (RBNZ at 1.0%)
- But food prices push inflation ever higher
- March CPI 0.9%q, 2.1%y/y? (RBNZ 0.3% and 1.5%)
- External accounts remain well-behaved

We've got a sneaking feeling that the RBNZ may have a marketing headache ahead of it. If we are right with our near term projections then GDP growth will come out around half of what the RBNZ expects while CPI inflation will be more than double.

We'll get the first leg of the double on Thursday of this week with the release of Q4 GDP. Try as we may we can't produce a number anywhere near the 1.0% the RBNZ is projecting for the quarter. We, instead, are at 0.4%.

To be fair to the Reserve Bank, we have the benefit of having seen the partial indicators that go into the GDP calculation whereas the RBNZ's figure was put to bed before any of these were available. So we are not criticizing the Bank's forecast, per se, just noting that there is a very real chance that the published number may force the RBNZ into a rethink of sorts.

We should also note that the latest Bloomberg survey sees us the most pessimistic of 15 forecasters. But every forecaster produced an estimate less than 1.0%, and the 0.4% to 0.9% forecast range has a median of 0.7%.

Our general level of pessimism comes from the fact that the agriculture, forestry and logging, manufacturing and local government administration sectors are all expected to provide a negative contribution to total growth. Additionally, wholesale trade, owner occupied property and the education and training sectors are all predicted to record near zero change in activity. Cumulatively that means over a third of the economy will have recorded zero-or-less growth in the quarter.

We are quick to point out that this quarter seems to be a bit of an aberration and are already seeing signs that activity is picking up through Q1 in line with our 0.7% projection for that quarter.

This morning's February Food Price Index (FPI) helped confirm the second leg of the double. It's been a long time since we watched a monthly Food Price Index so closely but this one was critical in forming our Q1 CPI view. Prior to today's release we were forecasting the March CPI to rise 0.8% yielding an annual reading of 2.0%. Since receiving the FPI we have revised this forecast higher to 0.9% and 2.1% respectively.

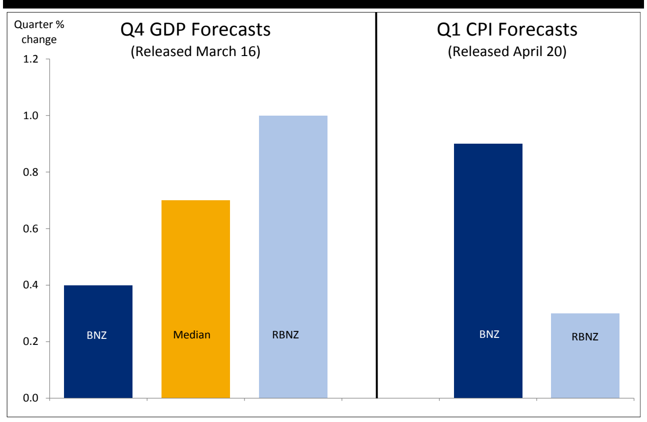
Our estimates are now miles away from the RBNZ's expectations. The Bank is forecasting 0.3% for the quarter and 1.5% for the year. By our reckoning the food price movement alone would give you a 0.4% CPI reading even if the rest of the CPI was unchanged.

The RBNZ may choose to look through the higher-than-expected CPI but, if headline inflation prints at 2.0% two years earlier than the Bank projects , inflation expectations are likely to head higher too. Moreover, don't forget that the NZD is currently 3.5% below where the RBNZ had assumed. If it stays here then this would add further upward pressure to the CPI in time.

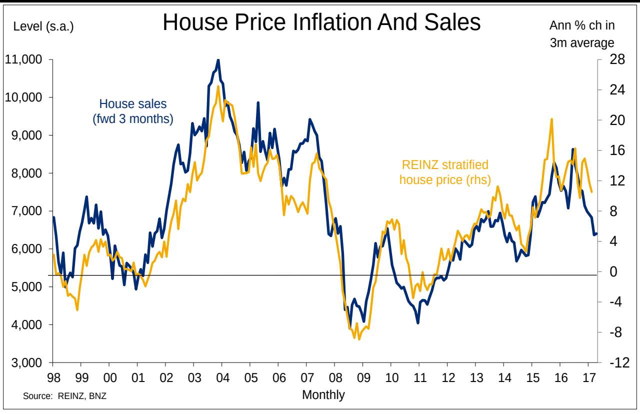
The magnitude of our forecasts could well prove exaggerated when push comes to shove. But we are more interested in risks to the consensus and the RBNZ's forecasts than the actual figures. With this in mind, it is very clear that there is one-sided risk to inflation (upside) and one-sided risk to GDP (downside). Not only will this be testing for the central bank but it will also be testing for markets. GDP comes out well before the CPI (due for release on April 20) and may provide the market with a short term dovish bias that won't be supported when the inflation figures are released.

We remain very strong in our view that the RBNZ will be forced into tightening well in advance of its published track. We remain equally convinced that, contrary to the Bank's recent comments, there is not equal risk that the next move in rates will be down as up. That said, the market is already priced for a rate increase well ahead of the RBNZ's suppositions so the potential for it to price a more aggressive rate track than it already has is limited.

A Potential Conundrum



Housing Activity Softens



Outside of the Consumer Price Index, house prices remain our primary inflation concern. In this regard this morning's REINZ data leave us little the wiser as to the state of the housing market. Pessimists will note that annual house price inflation continues to drift lower. REINZ's Stratified Index rose 10.5% for the year, in February, down from 11.7% in January. Optimists will defer to the 2.7% monthly increase in sales prices.

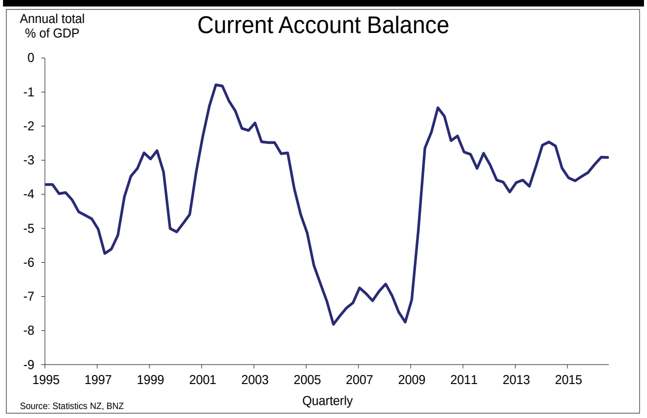
We all know that recent LVR changes have had a significant impact on the investor market, particularly in Auckland. Equally, we all know that demand continues to exceed supply (particularly in Auckland again).

Consequently, we would expect any moderation in house price inflation to be limited. Today's data may well be providing the first evidence of this.

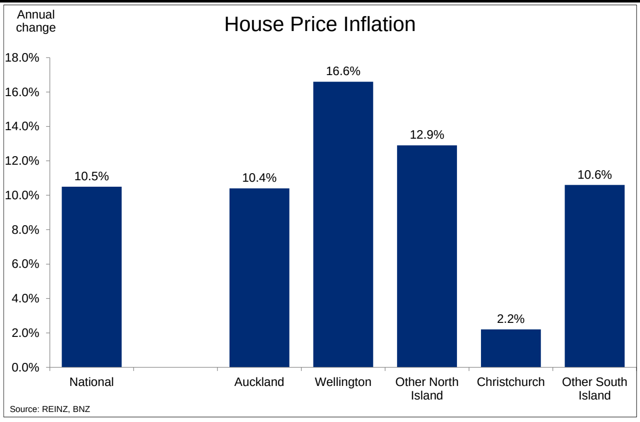
That said, house sales were down 8.9% (seasonally adjusted) on year earlier levels. Traditionally, this has been a good leading indicator of house price inflation so still cautions that significant downside pressure remains on annual house price inflation.

Regionally, Wellington house prices continue to forge ahead more quickly than elsewhere (rising 16.6%) while Christchurch lags (rising 2.2%) as post-quake supply meets demand.

External Accounts Stable



Wellington Leads The Way



On Wednesday we get another look at the state of New Zealand's external accounts. In a way, this has been the surprise package of the current economic cycle in that the external balances have remained well under control despite robust domestic demand and a tough environment for exporters. As at the end of the September quarter 2016 the annual current account deficit had fallen to just 2.9% of GDP. We are looking for this to fall even further to 2.6% when the December quarter data are published.

The merchandise trade balance will remain in the red to the tune of around 0.8% and the international investment income balance will sit at around 3.0% of GDP. Continuing to offset this, though, will be the balance on services which should sit at a surplus of 1.7% of GDP thanks mainly to the ongoing tourism revenues.

Friday sees the release of the BNZ-Business New Zealand PMI. This index fell sharply in January to its lowest level in two years. We await February's reading with interest to see whether the January reading was an aberration or not. Another outturn close to 50 will have us, and others, questioning the pace of the current expansion.

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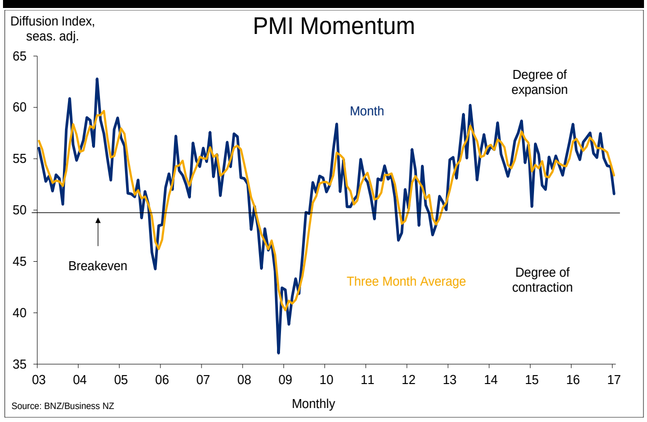
Aberration Or Indication?



Global Watch

- The Fed is expected to hike rates on Thursday; eyes on the dots
- Trump's initial Budget also due Thursday
- Dutch elections, China's NPC, and G20 meeting to monitor
- BoE, BoJ, SNB, and Norges Bank meet
- Lots of data including AU employment and NAB survey

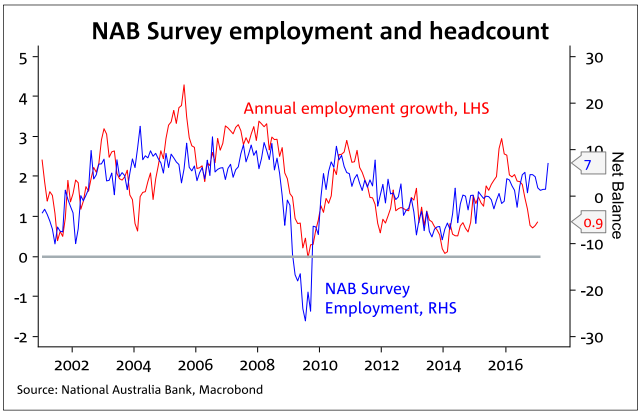
Australia

Tuesday's February NAB Survey and Thursday's employment are the main local market interest. NAB looks for an above-consensus 25K employment gain and a tenth dip in the unemployment rate to 5.6%, as suggested by positive leading labour demand indicators. Wednesday's Consumer Sentiment and Thursday's Consumer Inflationary expectations also under watch. RBA's Michelle Bullock (Assistant Governor, Financial System) speaks Tuesday morning. The RBA March quarter Bulletin is out Thursday with the latest suite of RBA research papers.

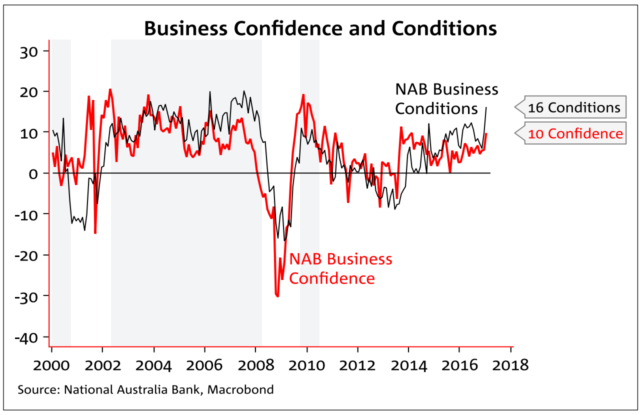
To refresh readers' minds of what happened in the last NAB Business Survey, the strength in December continued into January, with both business conditions and confidence jumping to much higher levels. These outcomes were pointing to an improvement in the domestic economy after a soft patch through much of the second half of last year. Even so, a degree of caution should be exercised given the diverse and rapidly-changing seasonal influences at the turn of the year, including potentially the shift in Chinese New Year to January this year.

Business conditions jumped by a solid 6 points in January, to +16 index points, effectively back to pre-GFC boom levels. There was another rise in trading conditions that partly contributed to the outcome, but there was also a noticeable jump in employment conditions, which bodes well for the generally under-performing labour market – the employment index hitting its highest level since 2011.

NAB Survey Hinting Of Employment Upturn



NAB Survey Higher Again In January



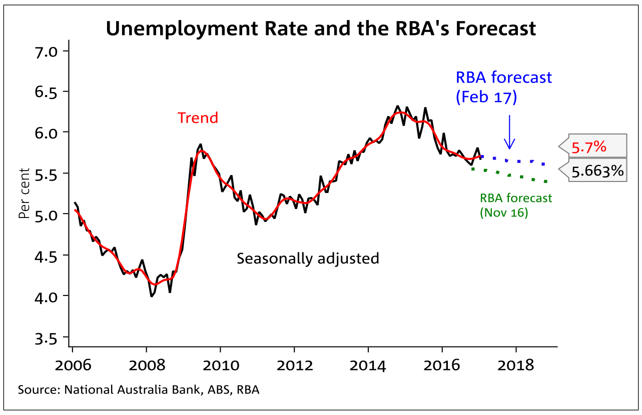
Business confidence also jumped in the month, aligning itself with the general enthusiasm seen in financial markets and more positive sentiment towards the global economic outlook. The business confidence index jumped 4 points to +10 index points in January, well above the series' long-run average. Responses on capital expenditure were also much more encouraging in January, consistent with a rise in capacity utilisation – although forward orders suggested a more temperate near term outlook. An improving Australian economic outlook is a positive for NZ.

NAB expects that Thursday's Labour Force release will unveil a 25K rise in employment after last month's 13.7k gain. The unemployment rate is expected to dip by a tenth from 5.7% to 5.6%. Lying behind this expected somewhat higher employment growth and tone have been stronger indicators of labour demand. For instance, recent readings on Employment from the NAB Survey (as well as the AiG surveys) have pointed to stronger employment growth. The trend in the NAB Employment index is consistent with employment growth of around 20k-plus per month. SEEK Job Ads have also picked up in recent months.

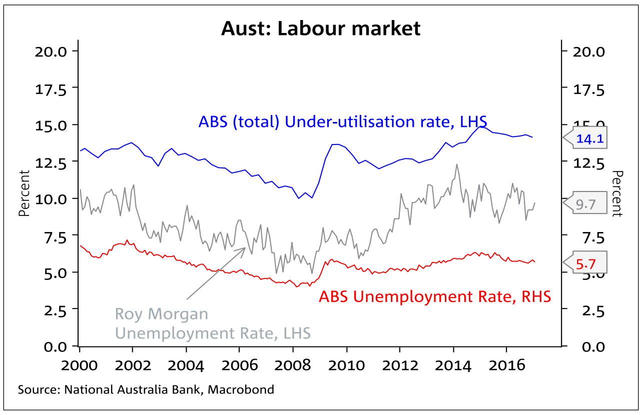
If the labour market is showing signs of improvement, then it's possible, even likely, job seekers might be encouraged to return to active job seeking. If that's the case with this month's release, then it's conceivable the participation rate could push a little higher. Any such rise in the participation rate would nullify to a degree the negative impact on the measured unemployment rate from faster employment growth.

As the mid-quarter survey, this week's release will provide an update on the Statistician's measure of under-utilisation, a broader measure of labour market slack. That measure eased somewhat in the final quarter of last year, though remained high at 14.1%.

Also on the data calendar for the week ahead are the weekly and monthly surveys of consumer confidence from the ANZ-Roy Morgan and Westpac-Melbourne Institute's survey. Wednesday's WMI Consumer Sentiment survey will also provide a quarterly update on where consumers see as the "Wisest Place to Invest", Still On The RBA's February Forecast Track?



Measuring Un- And Under-Employment



providing further hints on attitudes to saving and spending. It will be interesting to see whether Thursday's Melbourne Institute survey of Consumer Inflationary Expectations reveals any noticeable change in expectations. While petrol prices have been relatively steady, rising utility prices (and expectations of more) have been getting a lot of carriage in the recent press.

China

Tuesday's February Retail Sales, Industrial Production and Fixed Assets Investment data set to unveil somewhat stronger growth. The National People's Congress concludes Wednesday with a press conference from Premier Li Keqiang.

US

Thursday morning now has a Fed rate hike well factored in. Market on alert for any material change from the December expectation of a further two increases this year. (We think not.) Yellen's press conference always of heightened interest. The first public cut of the Administration's Budget for FY18 is expected Thursday, including its $US54bn military boost and expected spending offsets. As for data, PPI on Tuesday, CPI, Retail Sales and NAHB Housing on Wednesday, then Housing Starts, JOLTs Job Openings Thursday and IP and preliminary March UoM Consumer Sentiment Friday.

Japan

Apart from the BoJ Thursday, very quiet as far as key data goes.

Eurozone

ECB President speaks on Monday. Wednesday's Dutch elections expected to be Euro-friendly. Among the data, most focus will be on Thursday's CPI, the Euro sensitive to any high/low miss from an expected unchanged core CPI (0.9% y/y). The SNB and Norges Bank meet too, both Thursday. At the end of the week comes the two day G20 Finance Ministers & Central Bank heads meeting in Germany, no doubt with copious wire coverage.

UK

Focus still on the Brexit Bill's passage through Parliament. Thursday's BoE meeting and Minutes to reveal whether there's any growing unease at rising Sterling-induced inflation. Wednesday's labour market report tipped to reveal little change in earnings growth with employment growth to have trended higher.

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Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The short end of the NZ rates curve remains well anchored, with OIS pricing for November still pricing a 50/50 chance of a hike in November and the 2-year swap rate range-bound in a tight 2.30-2.40% range. Pricing of near-term monetary policy risks hasn't budged despite a near-5% tumble in the NZD TWI over the past month.

The significant fall in the TWI has come alongside a significant fall in dairy prices so to that extent, the implications for monetary policy are limited. Nevertheless, at the margin it adds to the picture of likely stronger CPI inflation in the year ahead compared to RBNZ projections. The higher food price index this morning confirmed the upside risk to Q1 CPI estimates. BNZ is already some 0.5 percentage points above the RBNZ's 1.5% y/y estimate. As inflation likely comes in stronger than expected, it'll test the resolve of the RBNZ to maintain its very easy policy stance and forward guidance. The Q1 CPI release is due 20 April. Until then, we expect the short end of the curve to remain well-anchored. The OCR review next week isn't expected to spring any surprises for the market.

On Thursday, NZ GDP data are released for Q4 2016. We expect growth of just 0.4%, below consensus. Any market reaction to this in the form of lower rates would be expected to be temporary to the extent that the data are dated and they belie the underlying robustness to the NZ economy.

The headline act this week is the US FOMC statement and updated Fed economic and rate projections. A Fed rate hike is now well-priced by the market and itself wouldn't have much implication for the rates market, with US rates well up since Dudley gave the nod a couple of weeks ago. More crucial is the FOMC's "dot plot" which, in December, showed 3 projected rate hikes for 2017, 2018 and 2019. The market's working assumption is that this will not change. If the Fed added in another rate hike or two to the projection, then that would put upward pressure on rates. A broadly unchanged set of projections alongside a rate hike should not result in any sustained market reaction.

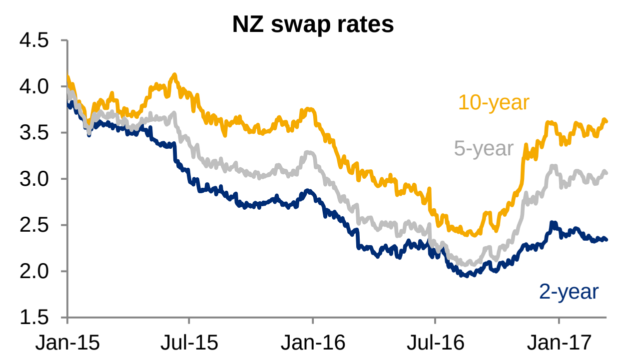
On the data front, US CPI, retail sales, housing market and consumer sentiment data are released. Soft retail sales and moderate core CPI data, due prior to the Fed's announcement, are unlikely to inspire an increased pace of Fed hikes.

The US 10-year Treasury rate broke up through the top of the well-established 2.30-2.60% range on Friday, but the move up in rates wasn't sustained, and it closed the week at 2.57%. If the Fed meets market expectations with regards to Thursday's announcement, then we'd expect that range to hold. The Fed, in raising rates earlier than expected only a few weeks ago and maintaining projections above market pricing, can hardly be criticised for being behind the curve. To that extent the Fed's move is supportive for the long-end of the curve and supports a US yield curve flattening. The US2s10s curve has range traded within 115-135bps over the past few months.

With a focus on US fiscal policy at present under the new Trump Administration the White House's release of a "skinny" Budget this week will be closely scrutinised. A big fiscal easing and associated rise in US debt levels is negative for US Treasuries (upward pressure on rates) but the risk is that any announcements on this front continue to underwhelm over the short term. Political realities are likely to see Trump's plans watered down.

NZ long-term rates remain closely linked to US Treasuries with the spread remaining in a tight range. Our views haven't changed so far this year. As a general rule we see upside pressure to rates over the course of the year, but with a market that is already short the long end of the curve, there is a reasonable hurdle rate for yields to push higher. In the meantime, the range trading environment is expected to persist.

Range-bound rates market over the year to date



Source: BNZ., Bloomberg

Current Rtaes/Spreads And Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.96	1.96 - 2.02
NZ 2yr swap (%)	2.34	2.32 - 2.36
NZ 5yr swap (%)	3.06	2.93 - 3.09
NZ 10yr swap (%)	3.62	3.43 - 3.65
2s10s swap curve (bps)	128	112 - 128
NZ 10yr swap-govt (bps)	25	22 - 25
NZ 10yr govt (%)	3.37	3.20 - 3.40
US 10yr govt (%)	2.57	2.31 - 2.62
NZ-US 10yr (bps)	80	79 - 90
NZ-AU 2yr swap (bps)	33	29 - 42
NZ-AU 10yr govt (bps)	43	42 - 53

*Indicative range over last 3 weeks

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Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

For the second week running, the NZD was one of the worst performing major currencies, with weaker commodity prices doing much of the damage last week. NZX WMP dairy futures fell by 15% last week taking the cumulative fall over the past four weeks to 23%. After a rare 10-day losing streak, the NZD managed a small rise on Friday, but on a trade-weighted basis is sitting around levels not seen since October.

We expect the NZD to enter a consolidation phase from here. There's a hint of dairy prices stabilising and with the market's expectations of Fed policy now re-rated, attention will turn back towards US fiscal policy. Ongoing delays to announced fiscal plans can only mean that political realities have set in and there is plenty of room for disappointment.

It's a very busy week on the calendar ahead, including monetary policy announcements from the Fed, BoE and BoJ, a number of key economic releases, a US Budget outline and a G20 meeting.

The US FOMC Statement on Thursday morning with a new set of forecasts is the headline act. A Fed rate hike is now well-priced by the market and itself wouldn't have much implication for the currency market, with the USD recovering since Dudley gave the nod a couple of weeks ago. More crucial is the FOMC's "dot plot" which, in December, showed 3 projected rate hikes for 2017, 2018 and 2019. The market's working assumption is that this will not change. If the Fed added in another rate hike or two to the projection, then that would be USD-positive. A broadly unchanged set of projections alongside a rate hike should not see the USD make further ground. Indeed, in that case the USD could meet resistance, although the tone of Chain Yellen's press conference will be an important guide.

On the data front, US CPI, retail sales, housing market and consumer sentiment data are released. Soft retail sales and moderate core CPI data, due prior to the Fed's announcement, are unlikely to inspire an increased pace of Fed hikes.

The White House plans to release a "skinny" Budget around mid-week, ahead of a more formal Budget sometime in May. It should outline where Trump plans to boost spending and which areas will be cut. The market has been losing faith this year of the extent of any forthcoming fiscal stimulus, given the lack of detail on offer. The "skinny" Budget probably won't add much light to the subject and Trump's "phenomenal" tax package has been conspicuous by its absence, a signal that political realities have set in and Trump is still seeking buy-in from his fellow Republicans. Delays on clarity of the path of fiscal policy can only be USD-negative.

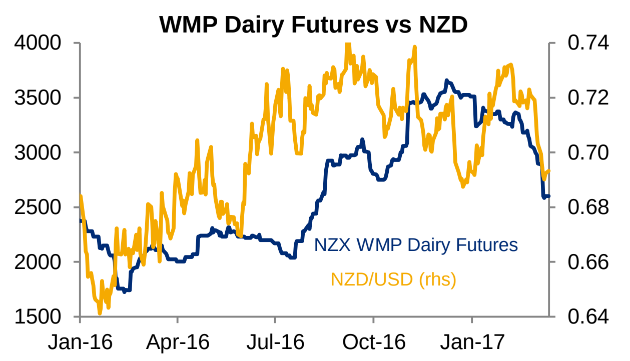
On the local calendar, we expect Q4 GDP data due Thursday to surprise on the downside relative to market and RBNZ expectations. The fact that the data are so dated could limit any possible adverse NZD reaction, but the balance of risk is for a negative NZD reaction. The other releases on the calendar including the current account, PMI and consumer confidence are not normally market moving.

The BoJ's policy announcement on Thursday should pass without market reaction. We don't think that the BoJ is about to abandon its yield curve control policy with a 0% target on the 10-year rate. But as global bond yields drift higher, the pressure will be on the BoJ to lift its yield target, albeit that is a debate for later in the year.

The BoE's asset purchase programme draws to a close and we don't expect any extension or change in policy at the BoE's policy announcement. GBP is more likely to be influenced by Brexit proceedings over coming weeks and months. Media report that PM May could trigger Brexit (article 50 of the treaty) as soon as Tuesday UK time.

In other economic news this week, Australia reports employment data on Thursday while China's data dump on retail sales, investment and industrial production is later today.

Dairy prices under pressure



Source: BNZ, Bloomberg

Cross Rates And Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.6932	0.6890 - 0.7250
NZD/AUD	0.9192	0.9150 - 0.9420
NZD/GBP	0.5696	0.5660 - 0.5830
NZD/EUR	0.6487	0.6470 - 0.6850
NZD/JPY	79.51	78.90 - 81.70

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7370	-6%
NZD/AUD	0.8990	2%

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Technicals

NZD/USD

Outlook:	Downward channel
ST Resistance:	0.7040 (ahead of 0.7150)
ST Support:	0.6890 (ahead of 0.6860)

The technical picture remains one of a slight downward channel over the past six months. A support line that cuts through lows since March last year shows a support level of 0.6930, ahead of late 2016 lows around 0.6860. That support of 0.6930 was broken last week so the low of 0.6890 becomes the new focal point. Given the sharp move down over the past couple of weeks, significant resistance levels are well north of current spot.

NZD/AUD

Outlook:	Trading range
ST Resistance:	0.9400 (ahead of 0.9500)
ST Support:	0.9150 (ahead of 0.9030)

With the currency having significantly broken through the pre-existing 9-month support line around 0.93, support levels ahead are not strong until sub-90 levels are reached. There are a couple of weak support markers around 0.9150 and 0.9030 ahead of that level.

NZ 5-year Swap Rate

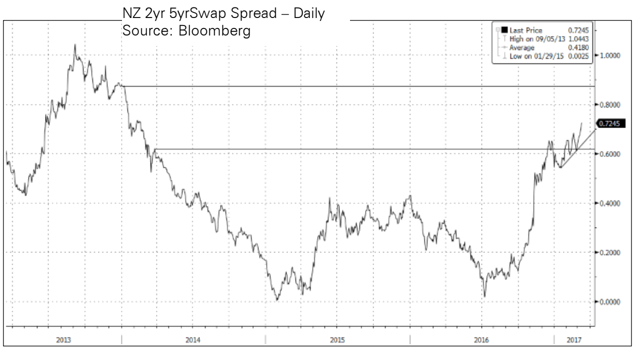
Outlook:	Higher
ST Resistance:	3.30
ST Support:	2.99

I have raised stop to 2.99 (previous resistance trendline). Still expect move to 3.30 in coming weeks.

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

Outlook:	Steeper
ST Resistance:	+88
ST Support:	+62

Steepening has been steady and expect a move to +88. Raise stop to +62.



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Key Upcoming Events

	Forecast	Median	Last
Monday 13 March			
NZ, Food Price Index, February	-0.9%		+2.8%
Jpn, Machinery Orders, January		-0.1%	+6.7%
Tuesday 14 March			
Aus, RBA's Bullock Speaks			
Aus, NAB Business Survey, February			+10
China, Fixed Assets (ex rural), Feb ytd		+8.2%	+8.1%
China, Retail Sales, Feb ytd		+10.6%	+10.9%
China, Industrial Production, Feb ytd		+6.2%	+6.0%
Euro, Industrial Production, January		+1.4%	-1.6%
Germ, ZEW Sentiment, March		+13.0	+10.4
US, NFIB Small Business Optimism, February		105.6	105.9
US, PPI ex-food/energy, February y/y			+1.6%
Wednesday 15 March			
NZ, Balance of Payments, Q4	-2.7%	-2.7%	-2.9%
Aus, Consumer Sentiment - Wpac, March			99.4
Euro, Eurozone Employment, Q4 y/y			+1.2%
UK, Unemployment Rate (ILO), January		4.8%	4.8%
US, Retail Sales, February		-0.1%	+0.4%
US, CPI ex food/energy, February y/y		+2.2%	+2.3%
US, Empire Manufacturing, March		+15.0	+18.7

	Forecast	Median	Last
Wednesday 15 March cont'd...			
US, Business Inventories, January		+0.3%	+0.4%
US, NAHB Housing Index, March		65	65
US, FOMC Policy Announcement,	1.00%	1.00%	0.75%
Thursday 16 March			
NZ, GDP, Q4	+0.4%	+0.7%	+1.1%
Aus, Unemployment Rate, February	5.6%	5.7%	5.7%
Aus, Employment, February	+25k	+16k	+13k
Jpn, BOJ Policy Announcement, Policy Rate			-0.1%
Euro, CPI, Feb y/y 2nd est		+2.0%	+2.0%P
UK, BOE Policy Announcement	0.25%	0.25%	0.25%
US, Housing Starts, February		1,260k	1,246k
US, Philly Fed Index, March		+28.0	+43.3
Friday 17 March			
NZ, BNZ PMI (Manufacturing), February			51.6
NZ, ANZ-RM Consumer Confidence, March			127.4
US, Industrial Production, February		+0.2%	-0.3%
US, Leading Indicator, February		+0.4%	+0.6%
US, Mich Cons Confidence, March 1st est		97.0	96.3
Saturday 18 March			
China, Property Prices, February			

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.50
1mth	1.84	1.85	1.85	2.50
2mth	1.9	1.93	1.94	2.53
3mth	1.96	1.99	2.03	2.56
6mth	2.02	2.04	2.07	2.56
GOVERNMENT STOCK				
12/17	1.88	1.87	1.87	2.24
03/19	2.19	2.20	2.17	2.32
04/20	2.44	2.45	2.40	2.41
05/21	2.62	2.61	2.54	2.50
04/23	2.93	2.89	2.81	2.70
04/25	3.24	3.19	3.11	0.00
04/27	3.38	3.32	3.21	3.07
04/33	3.75	3.71	3.55	3.38
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	84.9	83.03	89.89	142.75
N. AMERICA 5Y	64.60	59.82	64.48	94.42
EUROPE 5Y	71.82	69.39	74.97	92.39

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.34	2.36	2.34	2.44
3 years	2.62	2.62	2.58	2.50
5 years	3.06	3.03	2.95	2.71
10 years	3.62	3.56	3.47	3.16
FOREIGN EXCHANGE				
NZD/USD	0.6931	0.7024	0.7207	0.6797
NZD/AUD	0.9188	0.9252	0.9381	0.9162
NZD/JPY	79.52	80.000	81.805	77.397
NZD/EUR	0.649	0.6622	0.6774	0.6183
NZD/GBP	0.570	0.5718	0.5775	0.4780
NZD/CAD	0.933	0.9400	0.9430	0.9062
TWI	75.96	76.85	78.45	73.22

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