10 July 2017

Inflation Moderates Again

- Construction constraints will adversely impact manufacturers
- Tourism constraints to intensify
- Consumer confidence buoyant
- House price inflation to moderate further
- Food price jump offset by petrol price fall

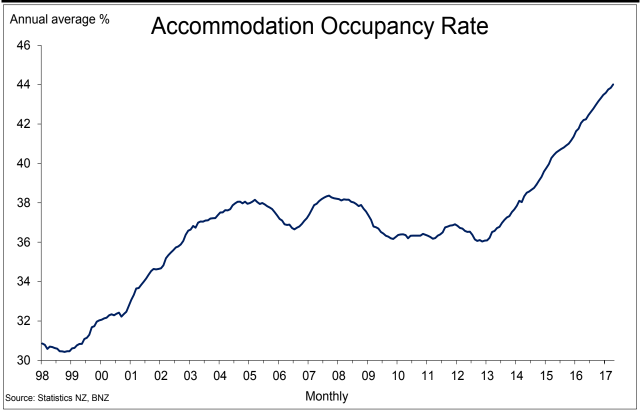
The week ahead is a relatively quiet one. There are a number of partial indicators that will help shed light on New Zealand's economic evolution but we doubt any of these will set financial markets on fire.

On the activity front, we get June's Electronic Card Transactions tomorrow. This series has been all over the place of late so there is significant uncertainty over this month's outturn. Slumping petrol prices across the month will weigh on spending as will the slowing in the housing sector. On the flip side, we know that general momentum in retail spending has been robust, the Lions rugby tour will have had a positive impact on spending, and we are looking for a bounce from May's unusually weak outcome anyway. Put all this together and we are plumping for a 0.4% increase for the month. The market is picking a greater gain, of 0.8%.

The Accommodation Survey for May is scheduled for Wednesday. This should continue to reinforce the ongoing strength in tourism inflows and reveal further increases in capacity utilisation in the hotel sector. The first Lions' game wasn't until June 3 and the first test not until June 24. So May's readings should be too early to see an impact from the tour. June data will most definitely reflect it, nonetheless.

Perhaps the key activity indicator for the week will be Friday's BNZ-Business New Zealand PMI. Globally,

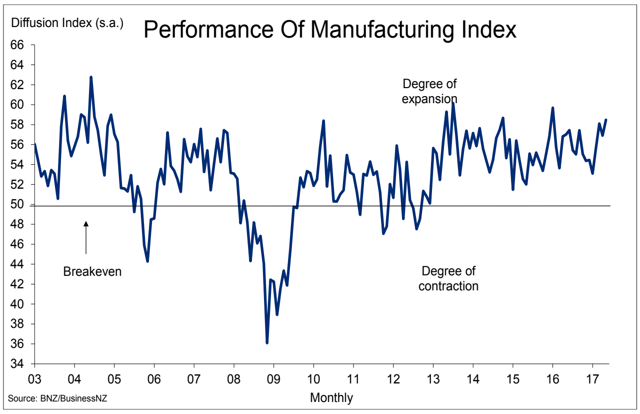
Over Full



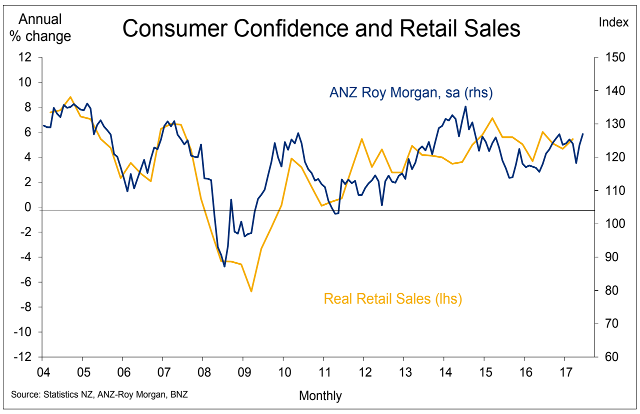
manufacturing indices have been in the ascendancy, and New Zealand has simply stayed at the forefront of this. However, our May reading of 58.5 was a 16-month high and we will be very surprised if this level can be sustained through June. This is especially given that the construction sector appears to be being constrained by a combination of heightened input costs, central bank restrictions and bank funding issues. A reading closer to 55.0 on the PMI might thus be a reasonable expectation. Even so, it would equally represent ongoing strength in the wider manufacturing sector.

Similarly, we would be surprised if the ANZ Roy Morgan consumer confidence survey, to be released Thursday, shows any increase in confidence, particularly as anecdotes on the Auckland housing market portend a potential price correction for this region. But even a modest drop from June's 126.9 reading would still be consistent with further robust growth in retail spending which, in turn, will help keep GDP growth at or above trend through the latter part of this year.

Strong



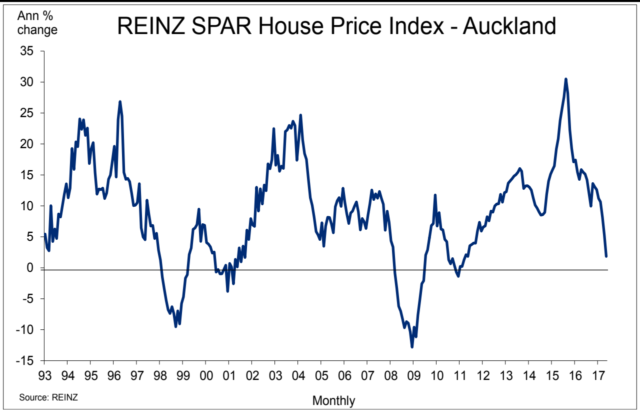
Robust



Meanwhile, we are keeping an eye out for the Real Estate Institute's residential results for June, which could well come to the public gaze by the end of this week. Recent housing market trends show prices, generally, to be going sideways in Christchurch, modestly down in Auckland and up almost everywhere else. We expect the REINZ June data to show more of the same. But with Auckland's large weighting, nationwide house price inflation is expected to fall further.

Importantly, the recent decline in Auckland house prices is now getting significant media coverage. This can be self-fulfilling to the extent that folk fearful that a market might correct are more likely to withdraw from it (buyers that is) and sellers will either delist their properties, simply not sell or, if under pressure, accept lower prices than might otherwise be the case.

Party's Over?



Certainly, there is already anecdotal evidence of speculators looking to exit the market for fear of getting burnt. All of this can lead to a sentiment-driven price correction over and above what market fundamentals might dictate.

We still think genuine excess demand will underwrite the Auckland housing market but, equally, the prospect of a reasonable correction in prices grows by the day. From a Reserve Bank perspective, housing market developments will certainly play into its lower-for-longer rates strategy.

So too will weak inflation numbers. We are forecasting next week's Consumers Price Index to rise just 0.1% over the June quarter which will result in annual inflation nudging below the magical 2.0% mark to just 1.8%. This is lower than the 0.3%/2.1% combo that the Reserve Bank had in its May Monetary Policy Statement (MPS), largely due to the recent slump in petrol prices.

While petrol prices are driving the overall CPI lower, food prices are working in quite the opposite direction, thanks to adverse weather conditions locally impacting fresh fruit and vege prices, while there is heightened inflation in global food prices too. Our Q2 CPI expectation is based on food prices rising 0.8% through the quarter. For this to be so, the June Food Price Index reading, due for release on Thursday, will have to increase about the 0.3% we anticipate. Whatever the outcome, it is unlikely to worry the RBNZ's inflation forecasts to the upside given price movements elsewhere (such as falling petrol prices) and the deflationary forces from the New Zealand dollar Trade Weighted Index which is running stronger than the Reserve Bank assumed in its May MPS.

craig_ebert@bnz.co.nz

Global Watch

- Yellen to testify, twice, and US CPI finishes the week.
- Bank of Canada to hike Wednesday.
- Quiet in Australia; Tuesday's NAB Business Survey the highlight.

Australia

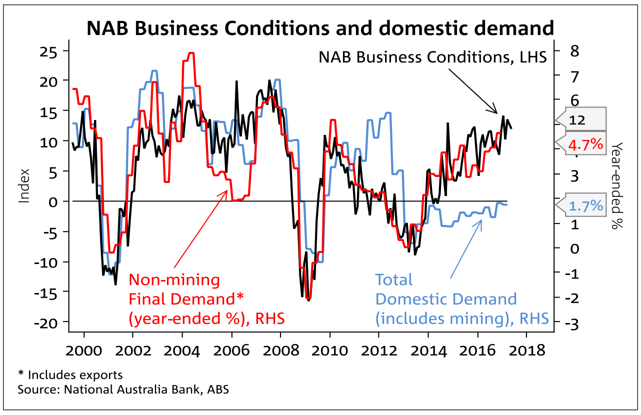
It's a quiet week ahead with only the NAB Business Survey Tuesday and Monthly Consumer Confidence Wednesday of note. Second-tier data includes Housing Finance Approvals Tuesday and Consumer Inflation Expectations Thursday. The US Fed's Williams continues his speaking tour downunder, talking again on the US economy in Sydney on Tuesday.

The focus this month will likely be on how the divergence between business and consumer confidence resolves itself – such a divergence having opened up since 2014.

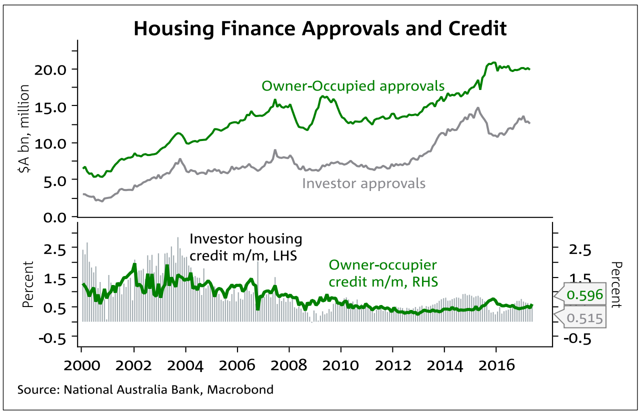
Regarding last month's NAB survey, business conditions continued at well-above average levels while business confidence tracked somewhat above its long term average. Strength in the business sector has been broad-based with all industries recording positive business conditions for only the second time since 2010 – although conditions are neutral for retail in trend terms, weighed down by the softer trends in the household sector. The moderation in business conditions in May (-1 point to +12) was largely driven by softer profitability, although employment conditions also eased slightly while trading conditions (sales) held steady at fairly elevated levels. Despite easing slightly, employment conditions (trend) are holding at solid levels which is consistent with continued improvement in employment growth reported by the ABS.

As for Housing Finance approvals Tuesday, the number of owner-occupier home loans is expected to increase 1.5% m/m; NAB is similar in expecting a 1.2% outcome.

NAB Business Survey and the Economy



The Slowing in Finance Approvals Growth



US

Yellen's House and Senate testimonies on Wednesday and Thursday will set the week's tone. There are also six other Fed speakers with Brainard Tuesday and Thursday the other one to watch. The Fed also releases its Beige Book Wednesday. Datawise, Friday's CPI and Retail Sales are the highlights: core CPI is expected to rise 0.2%/1.7% with Retail Sales tipped to have grown 0.1%, consumers benefiting from soft gas prices.

Canada

The market is priced for the Bank of Canada to hike on Wednesday (currently 85% priced), with the market looking for any signs of a follow up in the near future from the Bank's Monetary Policy Report and Poloz/Wilkins press conference. Otherwise it's quiet on the data front.

China

CPI/PPI on Monday and Trade Balance on Thursday (both for June) come ahead of the key activity reports the following week, including Q2 GDP. Money supply and lending reports due any day from Monday.

Japan

Generally second tier data releases due. BoJ Governor Kuroda's speech at Branch Managers' meeting on Monday of interest after Friday's BoJ announcement to buy an unlimited amount in fixed-rate bond operation

Eurozone

Very quiet datawise with only May Industrial Production (Wednesday) and Trade (Thursday).

UK

Wednesday's labour market report likely to be the main data interest this week. PM May presents her EU law "repeal bill" to Parliament on Monday.

david.degaris@nab.com.au

Fixed Interest Market

Reuters: BNZL, BNZM Bloomberg:BNZ

The key theme overhanging global bond markets at present is the move towards policy normalisation indicated by a growing chorus of central banks. This is driving upward pressure on bond yields, a force we think will prevail for some time yet.

In the week ahead we expect the Bank of Canada to become the second major central bank to begin a tightening cycle, raising its policy rate by 25bps to 0.75%. The OIS market prices a 95% chance of this happening. Less than a month ago such a move was seen as highly unlikely and the first tightening wasn't priced until well into next year.

Focus will also turn to US monetary policy. Key CPI and retail sales data are released at the end of the week, but ahead of that we have a series of Fed speakers on the circuit as well as Chair Yellen's testimony to Congress and the Senate on Wednesday and Thursday night respectively. We think the data and the testimony will support the prevailing Fed view that it is on a clear path towards normalisation of monetary policy. After three US (core) CPI releases in a row which have undershot expectations, we're backing a reversal of that trend, although it's hard to be confident in that call.

Last Friday's US monetary policy report didn't contain a lot new, although there was a restatement of plans to continue to tighten policy. There appeared to be an enhanced interest in financial stability concerns – citing stretched valuations in bond, equity, and commercial real estate prices– which was also one of the takeaways from the FOMC minutes last week. Yellen might choose to draw this out in her testimony, which would provide some rationale for higher rates even if the inflation backdrop wasn't as strong as desired.

The recent global bond market sell-off has been led by the euro-area, as it followed Draghi's guidance of reduced policy accommodation. The coming week is fairly quiet in the euro-area with not much on the calendar to drive markets.

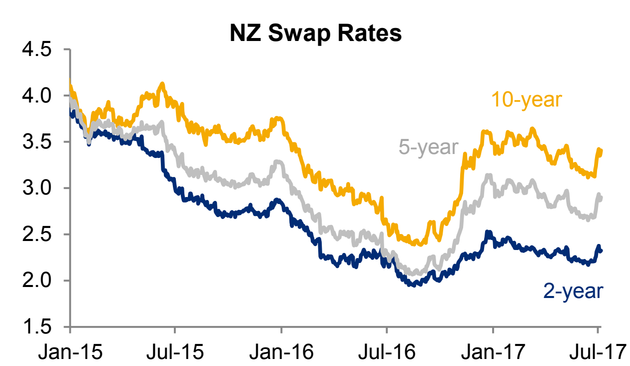
NZ only sees second-tier releases, so local data won't be a driving factor for the NZ rates market. We're aware of some views from offshore that the RBNZ will be pulled into the global central bank move towards indicating less policy accommodation. But we'd push back on that view, seeing the RBNZ (like the RBA last week) playing an even hand and maintaining a neutral bias for as long as feasible. Recent strength in the NZD and lower oil prices add downside risk to the RBNZ's prevailing CPI forecasts, supporting its view that monetary policy accommodation can remain for a considerable period.

The NZ rates curve is pricing in a 25bp hike by May 2018 and another hike by November 2018, with a chance of a third rate hike during the year. We think that is sufficient for now and would be looking to receive 2-year swap at the current rate of 2.33% and higher, on the view that the RBNZ will continue to push back on the need for higher rates.

NZ's mid to long end rates are more vulnerable in our view, given the present global forces. Of particular note, German bond rates remain far too low, with the 5-year rate still negative and the 10-year rate at 0.57%, implying a negative real yield of at least minus 100bps. The US market underprices the chance of further Fed tightening this year and beyond. Higher global rates would push up NZ rates. The 2s10s swap curve has pushed up from 92bps to 108bps over the past couple of weeks but we continue to see further curve steepening pressure.

Overall, NZ rates are near the top of recent ranges and we don't see scope for a reversal anytime soon. In our view, the risk remains for further upside pressure, more so at the long end.

Higher Rates Across the Curve Over Last 2 Weeks



Source: BNZ., Bloomberg

Current Rates/Spreads and Recent Ranges

	Current	Last 3-weeks range*
NZ 90d bank bills (%)	1.97	1.93 - 1.99
NZ 2yr swap (%)	2.33	2.20 - 2.39
NZ 5yr swap (%)	2.90	2.68 - 2.94
NZ 10yr swap (%)	3.41	3.13 - 3.43
2s10s swap curve (bps)	108	91 - 108
NZ 10yr swap-govt (bps)	39	37 - 41
NZ 10yr govt (%)	3.02	2.72 - 3.05
US 10yr govt (%)	2.39	2.12 - 2.39
NZ-US 10yr (bps)	63	58 - 74
NZ-AU 2yr swap (bps)	38	33 - 45
NZ-AU 10yr govt (bps)	29	29 - 38

*Indicative range over last 3 weeks

jason.k.wong@bnz.co.nz

Foreign Exchange Markets

Reuters pg BNZWFWDS Bloomberg pg BNZ9

It looks like the NZD is facing headwinds after the strong mid-May to mid-June recovery. The NZD has tracked sideways in a USD 0.7200-0.7350 range for the past few weeks and the TWI is showing a similar profile.

Stronger NZ terms of trade remain a supporting factor for the NZD, but a hint of risk-off sentiment has emerged, driven by the recent chorus of major central banks guiding towards less monetary policy accommodation. This has boosted global bond yields, tempered equity markets, and provided good cover for many investors to adopt a more cautious stance on the NZD. We don't see this dynamic changing anytime soon – the recent change in tone from the key central banks is something that needs to be respected and not fought against. Our near term projections reflect this bias, with end-Q3 and end-Q4 targets of USD 0.71 and USD 0.68 respectively.

When we look at correlations, the usual NZD drivers have a much lower than usual correlation with the NZD at present. One exception is US 10-year Treasury yields, which have had a greater than usual (inverse) correlation with the NZD since the beginning of the year. A path towards higher US long-term rates points to downside risk on NZD/USD.

The latest CFTC positioning data for the period to early last week showed the highest number of net long NZD speculative positions in four years, with a notional position of over $2.1bn. We are a little puzzled why more "hot money" has been attracted to the NZD, but the long positioning represents a headwind for further possible upside for the NZD. Indeed, positioning like this at an extreme level should be seen as a contrarian indicator and skews the near term risk to the downside on any negative news for the currency.

In the week ahead, the focus will turn to US monetary policy. Key CPI and retail sales data are released at the end of the week, but ahead of that we have a series of Fed speakers on the circuit as well as Chair Yellen's testimony to Congress and the Senate on Wednesday and Thursday night respectively. We think the data and the testimony will support the prevailing Fed view that it is on a clear path towards normalisation of monetary policy. After three US (core) CPI releases in a row which have undershot expectations, we're backing a reversal of that trend, although it's hard to be confident in that call.

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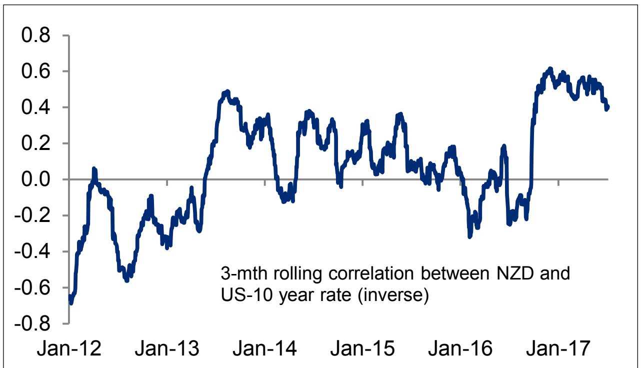
NZ only sees second-tier releases, so local data won't be a driving factor for the NZD. Focus turns to the following week's important CPI release. We're aware of some views from offshore that the RBNZ will be pulled into the global central bank move towards indicating less policy accommodation. But we'd push back on that view, seeing the RBNZ (like the RBA last week) playing an even hand and maintaining a neutral bias for as long as feasible. Recent strength in the NZD and lower oil prices add downside risk to the RBNZ's prevailing CPI forecasts, supporting its view that monetary policy accommodation can remain for a considerable period.

On the crosses, NZD/JPY is looking interesting, as it approaches key resistance around 83.5. After a 9% rally over the past few months a breather is well overdue and the cross is most vulnerable to a shock that drives risk appetite lower.

NZD More Correlated with US 10-Yr Rate This Year



Source: BNZ, Bloomberg

Cross Rates and Model Estimates

	Current	Last 3-weeks range*
NZD/USD	0.7279	0.7210 - 0.7350
NZD/AUD	0.9575	0.9480 - 0.9650
NZD/GBP	0.5650	0.5600 - 0.5760
NZD/EUR	0.6386	0.6360 - 0.6560
NZD/JPY	82.90	80.20 - 83.10

*Indicative range over last 3 weeks, rounded figures

BNZ Short-term Fair Value Models

	Model Est.	Actual/FV
NZD/USD	0.7540	-3%
NZD/AUD	0.9450	1%

jason.k.wong@bnz.co.nz

Technicals

NZD/USD

Outlook: Downward channel
ST Resistance: 0.7350 (ahead of 0.7400)
ST Support: 0.7170 (ahead of 0.7100)

The NZD looks to have met some resistance, after the strong mid-May to mid-June rally, with 0.7350 a key level to watch. Failure to move sustainably above that level would confirm that the 9-month downward channel remains in play. The first area of support is 0.7170, ahead of the 200-day moving average around 0.7100.

NZD/AUD

Outlook: Trading range
ST Resistance: 0.9650 (ahead of 0.9700)
ST Support: 0.9470 (ahead of 0.9400)

Over the past month the cross has traded within a higher trading range, within a larger trading range that has been in play for some time. It's not a particularly clear technical picture, but we'll settle for 0.9470-0.9650 as the current near-term support and resistance levels.

jason.k.wong@bnz.co.nz

NZ 5-year Swap Rate

Outlook: Neutral
ST Resistance: 2.94
ST Support: 2.68

Trade a break of 2.94. Should this occur target 3.18

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

Outlook: Steeper
ST Resistance: +72
ST Support: +45

Break of trendline signals move higher/steeper. Target +72 any pullback should be limited to +51.

pete_mason@bnz.co.nz

Key Upcoming Events

	Forecast	Median	Last
Monday 10 July			
China, CPI, June y/y		+1.6%	+1.5%
China, PPI, June y/y		+5.5%	+5.5%
Jpn, Eco Watchers Survey (outlook), June		50.3	49.6
Jpn, Machinery Orders, May		+1.7%	-3.1%
Germ, Trade Balance, May		+€18.7b	+€18.1b
Tuesday 11 July			
NZ, Electronic Card Transactions, June	+0.4%	+0.8%	-0.2%
Aus, NAB Business Survey, June			+7
Aus, Housing Finance, May	+1.2%	+1.5%	-1.9%
US, NFIB Small Business Optimism, June		104.4	104.5
US, Fed's Brainard Speaks, Monetary Policy			
US, JOLTS Job Openings, May			6,044
US, Wholesale Inventories, May 2nd est		+0.3%	+0.3%P
Wednesday 12 July			
Aus, Consumer Sentiment - Wpac, July			96.2
Jpn, Tertiary Industry Index, June		-0.6%	+1.2%
Euro, Industrial Production, May		+1.0%	+0.5%
UK, Unemployment Rate (ILO), May		4.6%	4.6%
US, Yellen Testifies, Semi-annual			
US, Beige Book			

	Forecast	Median	Last
Wednesday 12 July Cont'd...			
Can, BOC Policy Announcement		0.75%	0.50%
Thursday 13 July			
NZ, ANZ-RM Consumer Confidence, July			127.8
NZ, Food Price Index, June		+0.3%	+2.4%
China, Trade Balance, June		+¥272b	+¥282b
Germ, CPI, June y/y 2nd est		+1.6%	+1.6%P
UK, RICS Housing Survey, June		+15%	+17%
US, PPI ex-food/energy, June y/y		+2.0%	+2.1%
US, Jobless Claims, week ended 08/07		245k	248k
US, Yellen Testifies, Senate Banking			
Friday 14 July			
NZ, BNZ PMI (Manufacturing), June			58.5
Jpn, Industrial Production, May 2nd est			-3.3%
Euro, Trade Balance, May s.a.		+€20.2b	+€19.6b
US, Mich Cons Confidence, July 1st est		95.0	95.1
US, Retail Sales, June		+0.1%	-0.3%
US, Industrial Production, June		+0.3%	flat
US, CPI ex food/energy, June y/y		+1.7%	+1.7%
US, Business Inventories, May		+0.3%	-0.2%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	1.75	1.75	1.75	2.25
1mth	1.85	1.86	1.84	2.36
2mth	1.91	1.93	1.89	2.38
3mth	1.97	1.99	1.94	2.41
6mth	2.02	2.02	1.99	2.40
GOVERNMENT STOCK				
12/17	1.81	1.81	1.80	2.00
03/19	2.05	2.10	1.93	1.99
04/20	2.27	2.30	2.08	2.00
05/21	2.40	2.42	2.18	2.01
04/23	2.69	2.71	2.45	2.04
04/25	2.90	2.92	2.66	2.20
04/27	3.02	3.03	2.76	2.33
04/33	3.35	3.37	3.06	2.64
GLOBAL CREDIT INDICES (ITRXX)				
AUD 5Y	85.75	84	86	123
N. AMERICA 5Y	61.64	60	60	76
EUROPE 5Y	57.32	56	62	79

	Today	Week Ago	Month Ago	Year Ago
SWAP RATES				
2 years	2.33	2.37	2.21	2.19
3 years	2.55	2.59	2.40	2.19
5 years	2.90	2.92	2.71	2.28
10 years	3.41	3.42	3.20	2.60
FOREIGN EXCHANGE				
NZD/USD	0.7276	0.7343	0.7134	0.7176
NZD/AUD	0.9574	0.9550	0.9530	0.9610
NZD/JPY	82.95	82.49	78.81	73.60
NZD/EUR	0.6382	0.6429	0.6337	0.6443
NZD/GBP	0.5646	0.5643	0.5528	0.5400
NZD/CAD	0.9373	0.9527	0.9615	0.9262
TWI	78.46	78.76	77.00	76.77

Contact Details

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Senior Economist
+(64 4) 474 6923

Jason Wong
Senior Market Strategist
+(64 4) 924 7652

Main Offices

Wellington
42-52 Willis Street
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 473 3791
FI: 0800 283 269

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
111 Cashel Street
Christchurch 8011
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Global Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Ray Attrill
Global Co-Head of FX Strategy
+(61 2) 9237 1848

Skye Masters
Head of Interest Rate Strategy
+(61 2) 9295 1196

Wellington

Foreign Exchange	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+(61 2) 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+(44 20) 7796 3091
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 212 916 9631
Fixed Income/Derivatives	+1 212 916 9677

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(85 2) 2526 5891