ANZ RESEARCH

NEW ZEALAND ECONOMICS
MARKET FOCUS

19 December 2016

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This is our last *Market Focus* for the year. Our first edition for 2017 will be on Monday 16 January. We would like to wish our readers a safe and enjoyable festive season.

A HAPPY ENDING

ECONOMIC OVERVIEW

September quarter data this week should provide a nice snapshot on the state of the economy, which we believe is solid: decent GDP growth with a contained current account deficit. That goes to the heart of our latest economic forecasts, which show that while activity growth is likely to moderate over the course of 2017 as natural headwinds build, we are not talking a full-blown downturn. The global scene remains a key risk but the economy does not have the internal imbalances (excesses) we've seen before at this stage of the cycle that can demand the piper is paid. In other data, dairy prices may rise further, while trade figures are expected to show a small monthly deficit. Net migration figures will undoubtedly remain strong, while credit growth and new mortgage lending will likely cool further.

DATA PREVIEW – Q3 GDP & BALANCE OF PAYMENTS

The Q3 GDP and balance of payments data will provide a decent summary of the state of the economy. Growth momentum should be strong (with annual growth accelerating towards 4%), but importantly, not contribute to a meaningful deterioration in external imbalances.

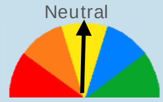
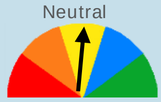
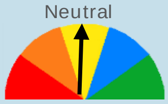
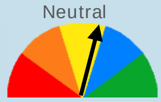
INTEREST RATE STRATEGY

Short-end rates continue to drift higher, despite being well above what we would consider to be reasonable levels. As such we expect rates to drift lower into the holidays. The US bond market has interpreted the Fed's message as hawkish, and US Treasury bond yields have gone even higher. The reaction thus far seems broadly appropriate and looking ahead we expect yields to continue gradually moving up. This will add ongoing pressure to steepen the NZGS yield curve. Inflation-linked bond breakevens look set to continue to rise. Expect NZ/US spreads to compress.

CURRENCY STRATEGY

The USD remains in the driver's seat with the NZD along for the ride. This week's data dump should be NZD supportive but that looks set to be usurped by a USD that is yet to peak. We expect the NZD to hold better ground against the other crosses and the TWI to hold at elevated levels. NZD/AUD is on track for new highs.

THE ANZ HEATMAP

Variable	View	Comment	Risk profile (change to view)
GDP	3.4% y/y for 2017 Q2	The economy is recording decent momentum, and we expect that to generally continue at least over the first part of 2017. Downside risk mainly stems from offshore.	Neutral Negative  Positive
Unemployment rate	4.7% for 2017 Q2	The unemployment rate should continue to trend lower. Wage inflation is contained, in part due to strong labour supply growth.	Neutral Negative  Positive
OCR	1.75% by Jun 2017	With strong growth, capacity pressures emerging and inflation past its lows, further OCR cuts would now be hard to justify.	Neutral Down  Up
CPI	1.4% y/y for 2017 Q2	Headline inflation is past its lows, with base effects seeing it return to the target mid-point shortly. Domestic and core inflation should also gradually lift.	Neutral Negative  Positive

ECONOMIC OVERVIEW

SUMMARY

September quarter data this week should provide a nice snapshot on the state of the economy, which we believe is solid: decent GDP growth with a contained current account deficit. That goes to the heart of our latest economic forecasts, which show that while activity growth is likely to moderate over the course of 2017 as natural headwinds build, we are not talking a full-blown downturn. The global scene remains a key risk but the economy does not have the internal imbalances (excesses) we've seen before at this stage of the cycle that can demand the piper is paid. In other data, dairy prices may rise further, while trade figures are expected to show a small monthly deficit. Net migration figures will undoubtedly remain strong, while credit growth and new mortgage lending will likely cool further.

FORTHCOMING EVENTS

ANZ Business Outlook – December (1:00pm, Monday, 19 December).

Food Price Index – November (10:45am, Tuesday, 20 December). Further seasonal weakness in fruit and vegetable prices should drive the overall index lower.

GlobalDairyTrade Auction (early am, Wednesday, 21 December). Competing themes make calling this one tricky. If auction prices can hold steady then a milk price around the mid-$6/kg MS beckons

International Travel & Migration – November (10:45am, Wednesday, 21 December). While the next month or two may see a near-term hit from the earthquake, these figures should remain strong.

Overseas Merchandise Trade – November (10:45am, Wednesday, 21 December). We have pencilled in a monthly unadjusted deficit of ~ $500m.

RBNZ New Residential Mortgage Lending – November (3:00pm, Wednesday 21 December). The slowing trend experienced over the past few months is likely to have continued.

GDP – Q3 (10:45am, Thursday, 22 December). We expect growth of 1.0% q/q, which would lift annual growth to near 4%. Manufacturing and services sector activity leads the way.

Balance of Payments – Q3 (10:45am, Thursday, 22 December). The current account deficit looks set to remain well below its historical average at around 3% of GDP.

RBNZ Credit Aggregates – November (3:00pm, Thursday, 22 December). Credit growth is past its peak, and is expected to continue to soften over the months ahead.

WHAT'S THE VIEW?

Last week we released our latest *Economic Outlook* publication. Below is a quick summary of some of the key points.

As we look towards 2017, the economy is growing briskly. We estimate the economy grew around 3½% over 2016 and forward indicators such as our own confidence composite and financial conditions gauges suggest that a similar pace of annualised growth (if not a little stronger) is on track for at least the first half of 2017.

The drivers of this growth are reasonably familiar, and we expect them to generally persist. Strong population growth on the back of record net migrant inflows is boosting demand. The construction sector pipeline remains large (with the damage resulting from the latest earthquakes creating another source of impetus), even if capacity and capital are becoming increasingly constraining factors. The strengthening labour market is supporting household confidence and consumption, as are historically low borrowing costs. The tourism sector is booming. Prospects in the dairy sector have improved as prices have recovered and non-dairy agriculture sectors continue to perform strongly. The terms of trade looks to be at, or near, its cyclical low, with the outlook now one of modest improvement, supporting national incomes (and income growth).

While we can identify some worrying signs that would typically foreshadow a downturn (excessive credit growth, overvalued house prices, deteriorating household saving, poor productivity growth etc), **we believe the economy is more internally balanced this time around.** This is because external imbalances are contained, a housing boom has not turned into a consumption boom, domestic inflation pressures remain low, meaning the RBNZ is not actively trying to slow the economy yet, the regulatory framework has been tightening (LVR restrictions), and financial institutions are actively leaning against the top of the cycle given funding pressures.

That won't stop growth from slowing (in fact we see it easing from 3½%-4% towards 3% over 2017). **But we are talking about moderation (a gallop to a canter) as opposed to a full-blown downturn.** Growth is forecast to moderate on the back of capacity constraints (finding skilled labour is now the biggest problem facing firms), a turn in the credit cycle as credit growth eases to a more sustainable pace, tighter financial conditions and a cooler housing market. It is therefore a moderation that we see as natural and healthy in order to avoid

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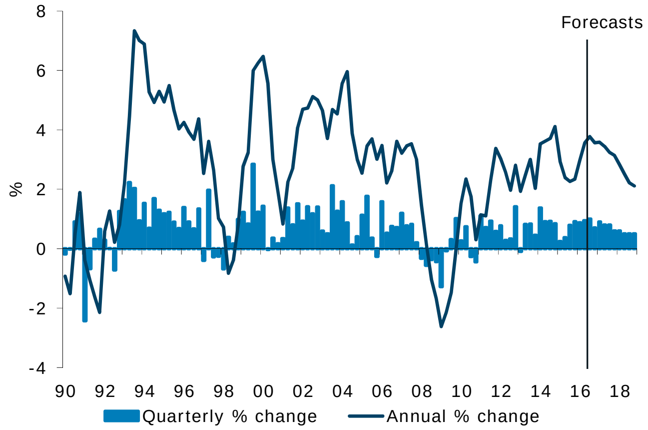
the widespread excesses that typically emerge at this point in the cycle.

FIGURE 1: REAL GDP GROWTH



Source: ANZ, Statistics NZ

The inflation cycle is turning upwards. Base effects from a stabilisation in oil prices alone are expected to see headline inflation return to the RBNZ's target band in Q4 for the first time in over two years. But more fundamentally, inflation pressures are building (and are expected to continue to build) as the economy increasingly butts up against capacity headwinds. While deflationary pressures remain (elevated NZD, global excess capacity, leverage, technology), we think traditional demand-pull forces are re-exerting themselves. After returning to the target band in Q4, headline inflation is forecast to reach 2% by early 2018. Non-tradable inflation is forecast to have risen above 3% over the same period.

We expect the RBNZ to start gradually removing stimulus by mid-2018. We forecast 50bps of OCR hikes over 2018, lifting the cash rate to 2.25%. However, we currently see the risk skewed towards earlier action and would not completely rule out RBNZ hikes in the second half of 2017.

Global growth and inflation are forecast to gradually trend higher, with the baton shifting from ultra-stimulatory monetary policy to fiscal policy and signs of reflation appearing across the commodity complex. However, uncertainty is high and we expect a volatile few years. The world is awash with numerous risks and challenges: politics (courtesy of the 'anger' vote), mispriced risk, excessive leverage amidst rising interest rates, demographics (which are slowing growth), poor productivity growth and overvalued asset prices.

With regard to the primary sector outlook, the cyclical upturn in international soft commodities has strengthened, with further momentum expected into the New Year. Supply dynamics and renewed Chinese demand for certain products are the main drivers. Dairy revenue is lifting, with gains in international prices offsetting lower production. Meat and fibre production is also lower, which, combined with other sector-specific dynamics, is expected to support prices. Forestry is experiencing a good run, which is expected to extend. Horticulture prices look fairly robust, but crop sizes currently look set to be more variable in 2017.

On interest and exchange rates we note, **US Treasury bond yields have broken higher, bringing an end to a 35-year bull run.** It is natural for markets to expect yields to rise as global policy tilts from central bank stimulus (bond buying) to expansionary fiscal policy (bond selling), but we do not expect this to give way to a full-blown bear market. Rather, we expect bond yields to rise gradually, taking New Zealand long-term rates with them. With the OCR on hold, anchoring the short end, steeper yield curves beckon. In currency markets, we expect the NZD to decline gradually, with USD strength driving the NZD/USD lower more rapidly than NZD/AUD and the other major NZD crosses.

Turning to the week ahead, the delayed GDP and Balance of Payments data for Q3 are the main focal points and should once again paint a decent picture of the current health of the economy. Our full preview of the data is on page 6, but we again expect them to show solid activity growth but with a contained current account deficit – a somewhat unusual combination for New Zealand historically. Typically, strong growth has been accompanied by a sharply wider current account deficit, so the fact that it is not this time goes to the heart of why our outlook for growth (discussed above) is one of the moderation and not a sharp downturn.

We expect GDP growth of 1.0% q/q, which would represent the fifth consecutive quarter around that pace. It would lift annual growth to near 4%, and so would certainly be consistent with the strong signal provided by the likes of our Confidence Composite gauge. While growth in primary production looks as though it has been modest over the quarter, strong growth looks to have been recorded by the likes of manufacturing and services-based activity (which in many ways reflects strong population growth).

The current account deficit is expected to remain below 3% of GDP. We see both the seasonally adjusted balance and the annual balance remaining broadly unchanged at their Q2 levels (of $1.9bn and 2.9% of GDP respectively). That should

ECONOMIC OVERVIEW

help to keep external balance sheet metrics contained as well.

There are a number of competing themes in the dairy market at the moment making it difficult to judge whether price gains will extend further, or whether there will be some moderation. Accordingly, NZX futures market suggest little change for WMP and a slight gain for GDT-TWI (largely courtesy of an 11% lift for SMP).

On the positive side of the ledger **Chinese domestic raw milk supply reportedly remains tight** with farm-gate prices rising in some regions and spot WMP trading into the USD4000/t plus. This, combined with stronger Middle-East/Africa participation at the last auction suggests price gains could extend into Q1 2017. Supply of WMP also remains tight out of New Zealand, but it has some valuation challenges against the SMP/milkfat stream and European product.

On the other side it is unclear whether earlier-bought product arriving in China from now on (for FTA window) and a seasonal lift in domestic raw milk supply will reduce internal pressures, impacting spot market dynamics. **The robustness of Middle East/African demand if prices push even higher is also uncertain.** The strength of the Algerian tender in January and how oil markets fare will offer clues. The other factors are an anticipated general improvement in milk supply conditions with higher farm-gate returns across the globe, and USD strength.

Fonterra obviously see this valuation gap (between WMP and SMP/milkfat) persisting in the short term and tactically have added extra WMP over coming GDT auctions (+5000 t) to take advantage of current market conditions. However, with New Zealand milk supply remaining tight they have reduced the SMP/milkfat stream (-9130 t). **We doubt New Zealand's milk supply will remain as tight as suggested** (Fonterra forecast -7%, implies an 8% fall over the remainder of the season), **but with overall inventory levels tight extra product is unlikely to be added to the GDT platform before the autumn.**

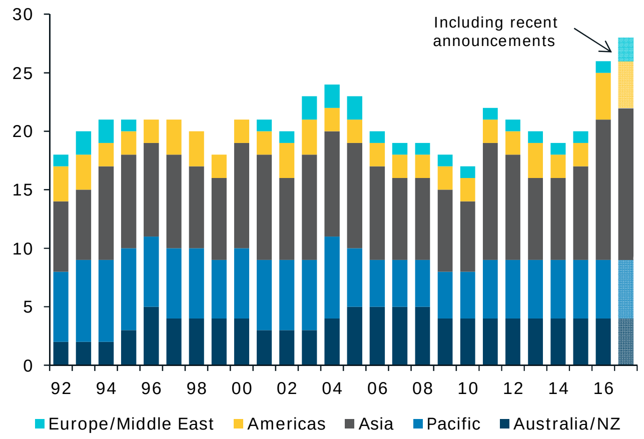
The reduction in SMP supply is expected to support prices (NZX futures +11%); however, globally there remains an oversupply and New Zealand product is trading at a premium (due to shortage and contractual relationships). With reduced GDT supply this week's auction will provide a good guide as to how much further stretch there could be for those who prefer Oceania supply. If SMP prices do hit the levels implied by the futures market (WMP equivalent USD3,400/t) the chances of WMP prices being able to hold or extend will look better.

All up if auction prices can hold steady then a milk price around the mid-$6/kg MS beckons in 2016/17. If they extend further then there could be additional upside toward $6.75/kg MS. Watch for an early Christmas present from Fonterra in the form of a milk price upgrade.

The International Travel & Migration figures for November are unlikely to throw up many surprises; they should be strong. The net inflow of 6,240 migrants (seasonally adjusted) in October was the second-largest net inflow on record, following the largest net inflow in September, and we wouldn't be surprised to see a number around this level. While it is possible that the latest earthquake dents inflows a touch over the months ahead, we doubt that impact will last long. And the reality is that with ongoing economic outperformance and political shenanigans offshore, we expect New Zealand will remain a popular destination for migrants (and New Zealanders).

It should be the same for visitor arrivals. The earthquakes may have some impact over the months ahead, but we expect the underlying trend to remain strong (capacity constraints notwithstanding), particularly when you consider that next year 29 different international airlines (ex-cargo) will be flying to New Zealand, up from just 19 in 2014.

FIGURE 2. INTERNATIONAL AIRLINES FLYING TO NEW ZEALAND (EX CARGO)



Source: ANZ, Ministry of Transport

Overseas trade figures for November are expected to show a small monthly deficit. We have pencilled in a deficit of close to $500 million, which would not be too far from the average November deficit experienced over the past five years. However, within the figures we are expecting to see further gradual signs of improvement after the

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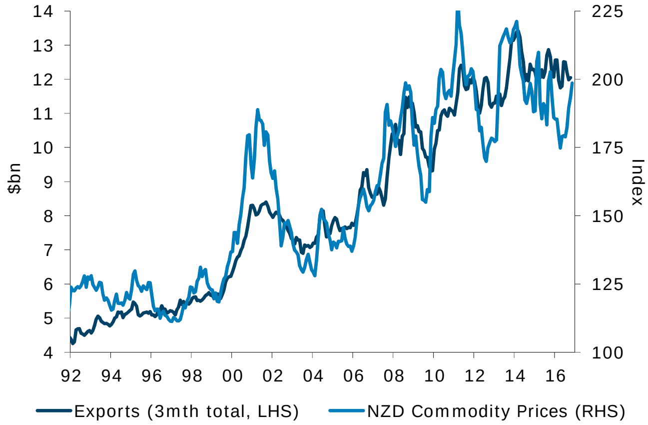
deficit narrowed from close to $600m to $300m in seasonally adjusted terms in October. Certainly, there are a number of moving parts to consider (weather, NZD, primary sector inventories, import prices, trading partner performance etc), but we do believe that the improvement in export commodity prices will see the trade accounts show some modest improvement over the months ahead.

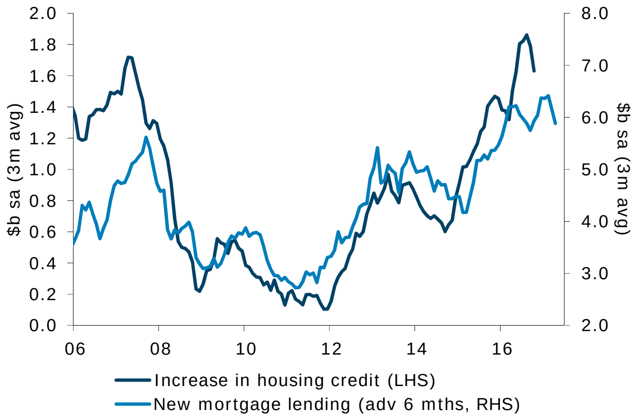
FIGURE 3: NZ EXPORTS AND COMMODITY PRICES



Source: ANZ, Statistics NZ

Figures on both new residential mortgage lending and the overall stock of housing credit should show a continued cooling. On the back of LVR restrictions and increased bank credit rationing new residential mortgage lending has been slowing over the past few months. In October, total new lending was down 8.3% on 12 months prior, with investor lending – unsurprisingly – slowing particularly sharply (down from a share of 37% in July to 27% in October). That slowing in new lending is also now feeding through into slower growth in the overall stock of housing credit, which rose just 0.6% m/m in October – the softest growth in seven months. Both trends are expected to continue over the months ahead and into 2017.

FIGURE 4: NEW MORTGAGE LENDING AND HOUSING CREDIT GROWTH



Source: ANZ, RBNZ

LOCAL DATA

ANZ Economic Survey of Manufacturing – Q3. Total sales volumes rose 2.1% q/q, with ‘core’ sales increasing 2.3% q/q.

BNZ-BusinessNZ PMI – November. The index eased 0.7pts to 54.4.

Building Work Put In Place – Q3. The volume of building work rose 1.4% q/q, led by a 2.4% q/q increase in residential work.

ANZ-Roy Morgan Consumer Confidence – December. Headline confidence fell from 127.2 to 124.5.

BNZ-BusinessNZ PSI – November. The Performance of Services Index lifted from an upwardly revised 56.6 to 57.9.

Building Consent Issuance – October. Total dwelling consent issuance rose 2.6% m/m. The trend in housing consents is softening more than for multi-dwelling units.

DATA PREVIEW

SUMMARY

The Q3 GDP and balance of payments data will provide a decent summary of the state of the economy. Growth momentum should be strong (with annual growth accelerating towards 4%), but importantly, not contribute to a meaningful deterioration in external imbalances.

CURRENT ACCOUNT – 2016Q3

(Thursday 22 December, 10.45am)

Current Account	ANZ	Market
Quarter (nsa)	**-$4,830m**	-$4,894m
Quarter (sa)	**-$1,940m**	--
Annual	**-7.4bn**	
% of GDP	**-2.9%**	-3.0%

In line with the typical seasonal pattern, the unadjusted current account will widen sharply in Q3. We expect a deficit of slightly over $4.8bn, which is on par with the figure recorded 12 months prior. As such, we see the annual deficit holding at 2.9% of GDP, well below its historical average (3.7%).

In seasonally adjusted terms, we expect the deficit to widen a touch, with some offsetting movements at the component level. The goods deficit is expected to widen modestly as export values ease on lower prices and modest volume growth, while the services balance is expected to largely unwind Q2's deterioration to sit at a similar level as in Q1 (on a bounce-back in tourist spending). The income deficit is expected to narrow modestly on weaker bank profitability and also as the secondary income balance 'mean-reverts' (although there is plenty of uncertainty around the latter).

This contained current account balance reinforces the economy's structural health. The fact the economy is growing strongly (set to be confirmed by subsequent GDP figures) and yet the current account deficit sits below historical averages highlights a far less vulnerable economic picture than has been evident in the past. Despite housing and debt exuberance in some parts, this hasn't broadened into an economy-wide free-for-all, which has often been the tendency. This better structural picture should also be reinforced by key balance sheet ratios such as external debt to GDP sitting at broadly similar levels to Q2.

And we don't see much in the way of deterioration from here. The factors contributing to this picture (higher national saving, household spending restraint, altered bank behaviours etc) are assumed to persist, with the current account deficit holding around 3% of GDP for the foreseeable future.

GROSS DOMESTIC PRODUCT – 2016Q3

(Thursday 22 December, 10.45am)

GDP	ANZ	RBNZ	Market
Quarterly %	**1.0%**	0.9%	0.8%
Annual %	**3.8%**	3.7%	3.6%
Ann. Ave. %	**3.2%**	3.1%	

We expect production-based GDP growth of 1.0% q/q, which would be the fifth consecutive quarter of growth around this pace, lifting annual growth to 3.8%. It is also the second consecutive quarter where we expect primary goods, and services sector activity to all contribute positively to quarterly growth (although only modestly so in the case of primary production).

Led by manufacturing, goods production is expected to have risen by 1.5% q/q. The Economic Survey of Manufacturing showed the largest lift in "core" sales volumes since 2002, offsetting an expected small fall in primary food manufacturing. The construction sector is also expected to post its fourth consecutive positive growth contribution (although at a more modest rate than the prior three quarters).

Services sector activity is expected to expand 1.0% q/q, making a 0.6%pt contribution. Although housing market activity has softened, strong population growth is still a key factor underpinning services sector activity. Professional, administrative and support services activity is expected to be especially strong, joined by decent gains from public administration, and arts and recreation. Although accommodation and food services growth is expected to be broadly similar to the prior two (solid) quarters, retail trade is forecast to be a touch softer.

The expenditure GDP picture is expected to be a little mixed. Private consumption should see a decent step-down from Q2's strong 1.9% q/q growth, but remain positive. Positive contributions are also expected from residential and other fixed asset investment. Inventories are estimated to make a 0.5%pt contribution to growth, largely offsetting an estimated 0.6%pt drag from net exports.

MARKET IMPLICATIONS

Unless there is a decent downside surprise (like Australia saw with its equivalent Q3 figures), we doubt the figures will cause much in the way of market ripples. Strong domestic economic credentials (which these numbers will just reinforce) are reasonably well appreciated by the market now and are a key reason why we see the NZD continuing to hold up on a TWI basis.

INTEREST RATE STRATEGY

SUMMARY

Short-end rates continue to drift higher, despite being well above what we would consider to be reasonable levels given the monetary policy outlook and the tighter state of financial conditions. While the degree of capitulation has surprised us, we do believe it is just that – capitulation – and as such we expect rates to drift lower into the holidays. The US bond market has interpreted the Fed's message as hawkish, and US Treasury bond yields have gone even higher. The reaction thus far seems broadly appropriate and looking ahead we expect yields to continue gradually moving up. This will add ongoing pressure to steepen the NZGS yield curve. Inflation-linked bond breakevens continue to rise, and we expect the trend to continue. With the next NZGS tender a month away, offshore holdings stable, short-end rates toppy, and US yields the main driving force for higher yields, expect NZ/US spreads to compress.

THEMES

- Short-end rates have moved even higher as global rates have increased, despite TWI elevation and higher retail interest rates. We doubt this will continue beyond this week as the allure of carry takes hold.
- The Fed has hiked rates and delivered upgraded forward projections. The market has read this as hawkish, but our interpretation is that it was as expected. We do see US bond yields moving higher, but only gradually from here.
- Offshore holdings of NZGS continue to hold up remarkably well, and there are no real signs of significant shifts in allocations along the curve. This apparent comfort should keep a lid on yields.
- Curve steepening remains a key theme, and will be supercharged if we see short-end rates correct lower, as we expect.
- Inflation-linked breakevens continue to perform, in line with moves seen offshore.

MONETARY POLICY AND SHORT END

We remain of the view that short-end rates are too high in relation to the macroeconomic outlook and the state of financial conditions. Granted, the most recent spike higher did surprise us, leaving us somewhat coy about maintaining our view. However, when we consider how elevated the TWI still is (77.6), and recent rises in retail interest rates, the conclusion is that financial conditions are tightening, not loosening. Against a backdrop of early signs of a cooling housing market, **these are hardly reasons to believe the OCR is going up any time soon though 4% GDP growth is starting to demand it.**

We also note that it was primarily upward moves in US rates that drove the short end higher. While not unusual, such drivers are typically temporary, and can only go against domestic factors for a limited time. All of that leaves us fairly comfortable that we will see a reversal as domestic factors and carry considerations come to the fore over the holidays.

GLOBAL MARKETS AND LONG END

Confirmation of a Fed rate hike and an additional 25bp hike in the Fed's dot-plot projections have seen US yields move to fresh highs. This has, in turn, driven long-end rates higher here too. While there is still a gap between market pricing and the Fed's dot plots, uncertainty remains high. We expect further increases to be more gradual from here. This is due to a cautious Fed as tighter overall financial conditions work in tandem with Fed policy.

That still means NZ long-end rates are headed higher and the curve will steepen too. However, we note that ongoing strong levels of offshore support (with non-resident holdings down only $130m in November, and still close to a record high) and a lack of fresh supply should keep a lid on spreads, especially if we do see a correction at the short end.

STRATEGY

Investors: No change – our preference for being **short duration** remains in place. Curve steepening is expected, driven by the short end, where we prefer to be overweight. We also prefer linkers to nominals.

Borrowers: We are more confident now than we were a few months ago that the lows for yields are in. We see merit in adding to hedges. But with BKBM biased lower, some caution is required.

KEY VIEWS		
SECTOR	**DIRECTION**	**COMMENT**
Short end	Neutral/bullish	2yr capitulation exhausted. We got bullish too soon, but even so, levels incompatible with OCR outlook.
Long end	Neutral/ bearish	Will continue grinding higher as the Fed steps up the pace of tightening (from 1 hike in each of 2015 and 2016 to 3 hikes in 2017), but don't forget about easy ECB and BoJ policy. Less bearish now than before.
Yield Curve	Biased steeper	Short end and long end heading in different directions, steepening the curve.
Geographic spreads	Neutral/ narrower	Divergent policy settings should help support NZ on a spread, as will seasonal reduction in nominal NZGS supply. However, likely to be offset to an extent by flows emanating from defensive duration shortening.
Swap spreads	Neutral/wider	NZGS demand so-so; real risks lie in potential corporate flow. Pay flow slow so far, but will pick up on dips.
NZD/TWI	Holding up	NZD/USD neutral but TWI to remain elevated with NZD strong vs. AUD/EUR/Asia, keeping a lid on the OCR.

CURRENCY STRATEGY

SUMMARY

The USD remains in the driver's seat with the NZD along for the ride. This week's data dump should be NZD supportive but that looks set to be usurped by a USD that is yet to peak. We expect the NZD to hold better ground against the other crosses and the TWI to hold at elevated levels. The AUD looks vulnerable amidst speculation of a credit downgrade (though a margin of excellence tweak).

TABLE 1: KEY VIEWS			
CROSS	GUIDE	MONTH	YEAR
NZD/USD	↔/↓	Yield gap closing; USD in control	Firmer USD bias ultimately wins
NZD/AUD	↔	Settled up here	Elevation to remain
NZD/EUR	↔/↑	Politics not euro supportive	Divided outlooks
NZD/GBP	↔/↓	Pound back in vogue	GBP stabilising
NZD/JPY	↔	Neutral	USD dictating USD/JPY higher

THEMES AND RISKS

- A more optimistic Fed / dot plot upgrade equals USD strength.
- Equities continue to hit new highs as the 'good news' side of lifting rates (it's all about the economy) dominates the threat to valuations.
- Global growth momentum continues to look better.
- Jury still out on whether diminishing liquidity will challenge the hunt for yield (and thus NZ assets).

ASSESSMENT

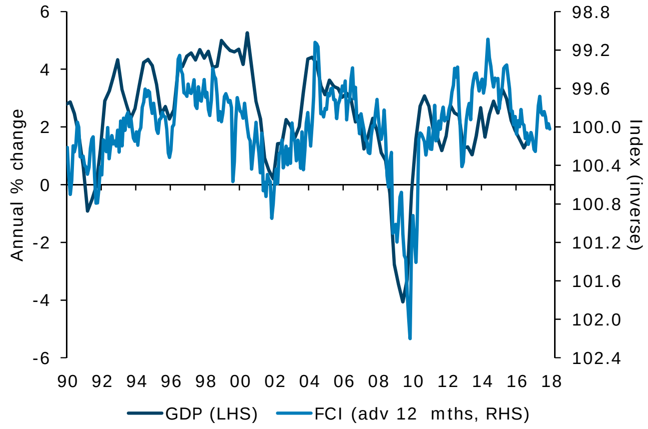
The USD remains in the driver's seat dominating all and sundry. Throw together an upgrade to the Fed's dot plots and longer-term yields brushing through 2.5% with ease and you get USD strength.

This rally looks like it has further to run. For one, there are not too many viable alternatives. Perception towards the EUR continues to be weighed down by the potential for political fragmentation as the anger vote manifests. The ECB and BOJ are still easing. The US rates market has 57bps of hikes pencilled in for 2017, which remains shy of the 75 implied by the Fed.

Expect attention to turn to financial conditions and what the back-up in yields and stronger USD imply for growth over 2017. We've seen somewhat of a tightening but not yet of sufficient magnitude to derail the economic story.

However, we note that NZ has experienced a far more aggressive tightening in financial conditions relative to the US, a sign the strength in the NZD and rising yields have moved too far. In that environment, topside pushes will be sold into and the bias is lower for the NZD.

FIGURE 1. US FINANCIAL CONDITIONS VS GDP



Source: ANZ, Bloomberg

This week's data dump should be NZD supportive. We're anticipating a GDP outturn at the strong end of expectations (1% q/q). However, we'll be paying equal attention to the signals from the more timely series over Q4. The economic pulse remains strong and it's no coincidence that the rates market is now starting to err towards the RBNZ being in play in 2017.

While we still back NZ's credentials, the USD story will usurp it for now, leaving us with a mild downside bias for the NZD/USD. The NZD is expected to hold at elevated ranges against the EUR, GBP, JPY and AUD.

TABLE 2: NZD VS AUD: MONTHLY GAUGES		
GAUGE	GUIDE	COMMENT
Fair value	↔/↓	Fair value is 0.93. Soft AU GDP surprise.
Yield	↔	Market starting to think RBNZ could be in play in 2017.
Commodities	↔/↓	AU commodities doing much better.
Data	↔/↑	Data pulse stronger in NZ.
Techs	↔	Looks to have found a zone.
Sentiment	↔	Swinging to and fro.
Other	↔/↑	Australia's fiscal numbers and triple A rating under the spotlight.
On balance	↔	**Elevation to continue.**

TABLE 3: NZD VS USD: MONTHLY GAUGES		
GAUGE	GUIDE	COMMENT
Fair value	↔/↑	Below fair value estimate of ~0.75.
Yield	↔/↓	US yields now hard to ignore.
Commodities	↔/↑	ToT have based, a key leg of support.
Risk aversion	↔	Still a potential Achilles' heel.
Data	↔/↓	NZ data flow positive and improving in the US.
Techs	↔	Break of 0.70 significant.
Other	↓	USD sentiment in control.
On balance	↔/↓	**Door opened for further moves lower.**

DATA EVENT CALENDAR

DATE	COUNTRY	DATA / EVENT	MKT.	LAST	NZ TIME
19-Dec	NZ	ANZ Activity Outlook - Dec	--	37.6	13:00
	NZ	ANZ Business Confidence - Dec	--	20.5	13:00
	GE	IFO Business Climate - Dec	110.6	110.4	22:00
	GE	IFO Current Assessment - Dec	115.9	115.6	22:00
	GE	IFO Expectations - Dec	105.6	105.5	22:00
	EC	Construction Output MoM - Oct	--	-0.9%	23:00
	EC	Construction Output YoY - Oct	--	1.8%	23:00
	EC	Labour Costs YoY - Q3	--	1.0%	23:00
20-Dec	US	Markit Services PMI - Dec P	55.2	54.6	03:45
	US	Markit Composite PMI - Dec P	--	54.9	03:45
	NZ	Food Prices MoM - Nov	--	-0.8%	10:45
	AU	RBA Dec. Meeting Minutes	--	--	13:30
	GE	PPI MoM - Nov	0.1%	0.7%	20:00
	GE	PPI YoY - Nov	-0.2%	-0.4%	20:00
	EC	ECB Current Account SA - Oct	--	€25.3B	22:00
	EC	Current Account NSA - Oct	--	€29.8B	22:00
	JN	BOJ Monetary Policy Statement	--	--	UNSPECIFIED
	JN	BOJ Policy Rate - Dec	-0.10%	-0.10%	UNSPECIFIED
21-Dec	UK	CBI Retailing Reported Sales - Dec	20	26	00:00
	UK	CBI Total Dist. Reported Sales - Dec	--	34	00:00
	NZ	Net Migration SA - Nov	--	6240	10:45
	NZ	Trade Balance NZD - Nov	-500M	-846M	10:45
	NZ	Exports NZD - Nov	4.00B	3.90B	10:45
	NZ	Imports NZD - Nov	4.50B	4.74B	10:45
	NZ	Trade Balance 12 Mth YTD NZD - Nov	-2951M	-3297M	10:45
	AU	Westpac Leading Index MoM - Nov	--	0.06%	12:30
	AU	Skilled Vacancies MoM - Nov	--	-0.4%	13:00
	NZ	Credit Card Spending MoM - Nov	--	2.8%	15:00
	NZ	Credit Card Spending YoY - Nov	--	10.2%	15:00
	UK	Public Finances (PSNCR) - Nov	--	-£3.4B	22:30
	UK	Central Government NCR - Nov	--	-£4.0B	22:30
	UK	Public Sector Net Borrowing - Nov	£11.6B	£4.3B	22:30
	UK	PSNB ex Banking Groups - Nov	£12.2B	£4.8B	22:30
22-Dec	US	MBA Mortgage Applications - 16-Dec	--	-4.0%	01:00
	EC	Consumer Confidence - Dec A	-6.0	-6.1	04:00
	US	Existing Home Sales - Nov	5.50M	5.60M	04:00
	US	Existing Home Sales MoM - Nov	-1.8%	2.0%	04:00
	NZ	GDP SA QoQ - Q3	0.8%	0.9%	10:45
	NZ	GDP YoY - Q3	3.6%	3.6%	10:45
	NZ	BoP Current Account Balance NZD - Q3	-4.894B	-0.945B	10:45
	NZ	Current Account GDP Ratio YTD - Q3	-3.0%	-2.9%	10:45
	UK	GfK Consumer Confidence - Dec	-8	-8	13:01
	NZ	Money Supply M3 YoY - Nov	--	7.1%	15:00
	GE	Import Price Index MoM - Nov	0.2%	0.9%	20:00
	GE	Import Price Index YoY - Nov	-0.2%	-0.6%	20:00
23-Dec	US	Chicago Fed Nat Activity Index - Nov	-0.15	-0.08	02:30
	US	GDP Annualized QoQ - Q3 T	3.3%	3.2%	02:30
	US	GDP Price Index - Q3 T	1.4%	1.4%	02:30

Continued on following page

DATA EVENT CALENDAR

DATE	COUNTRY	DATA/EVENT	MKT.	LAST	NZ TIME
23-Dec	US	Personal Consumption - Q3 T	2.8%	2.8%	02:30
	US	Core PCE QoQ - Q3 T	1.7%	1.7%	02:30
	US	Durable Goods Orders - Nov P	-4.5%	4.6%	02:30
	US	Durables Ex Transportation - Nov P	0.2%	0.8%	02:30
	US	Cap Goods Orders Nondef Ex Air - Nov P	0.5%	0.2%	02:30
	US	Cap Goods Ship Nondef Ex Air - Nov P	--	-0.1%	02:30
	US	Initial Jobless Claims - 17-Dec	259k	254k	02:30
	US	Continuing Claims - 10-Dec	2010k	2018k	02:30
	US	FHFA House Price Index MoM - Oct	0.4%	0.6%	03:00
	US	Personal Income - Nov	0.3%	0.6%	04:00
	US	Personal Spending - Nov	0.3%	0.3%	04:00
	US	Real Personal Spending - Nov	0.2%	0.1%	04:00
	US	PCE Deflator MoM - Nov	0.2%	0.2%	04:00
	US	PCE Deflator YoY - Nov	1.5%	1.4%	04:00
	US	PCE Core MoM - Nov	0.1%	0.1%	04:00
	US	PCE Core YoY - Nov	1.7%	1.7%	04:00
	US	Leading Index - Nov	0.2%	0.1%	04:00
	US	Kansas City Fed Manf. Activity - Dec	1	1	05:00
	GE	GfK Consumer Confidence - Jan	9.9	9.8	20:00
	UK	GDP QoQ - Q3 F	0.5%	0.5%	22:30
	UK	GDP YoY - Q3 F	2.3%	2.3%	22:30
	UK	Current Account Balance - Q3	-£28.2B	-£28.7B	22:30
	UK	Index of Services MoM - Oct	0.2%	0.2%	22:30
	UK	Index of Services 3M/3M - Oct	0.8%	0.8%	22:30
	UK	Total Business Investment QoQ - Q3 F	0.9%	0.9%	22:30
	UK	Total Business Investment YoY - Q3 F	-1.6%	-1.6%	22:30
24-Dec	US	New Home Sales - Nov	575k	563k	04:00
	US	New Home Sales MoM - Nov	2.1%	-1.9%	04:00
	US	U. of Mich. Sentiment - Dec F	98.0	98.0	04:00

Key: AU: Australia, EC: Eurozone, GE: Germany, JN: Japan, NZ: New Zealand, UK: United Kingdom, US: United States, CH: China.
Source: Dow Jones, Reuters, Bloomberg, ANZ Bank New Zealand Limited. All $ values in local currency.
Note: All surveys are preliminary and subject to change

LOCAL DATA WATCH

Domestic economic momentum is solid, with downside risks mainly stemming from offshore. With inflation showing signs of tentatively lifting, the OCR now looks to be on hold at 1.75% for a considerable period.

DATE	DATA/EVENT	ECONOMIC SIGNAL	COMMENT
Mon 19 Dec (1:00pm)	ANZ Business Outlook – Dec	--	--
Tue 20 Dec (10:45am)	Food Price Index – Nov	Seasonal falls	Further seasonal weakness in fruit and vegetable prices should drive the overall index lower.
Wed 21 Dec (early am)	GlobalDairyTrade Auction	Supply-driven	A considerable supply adjustment is underway globally, which should lend further support to prices.
Wed 21 Dec (10:45am)	International Travel & Migration – Nov	Strong	There may be a near-term hit from the earthquakes over the next month or two, but we expect net inflows to remain strong overall.
Wed 21 Dec (10:45am)	Overseas Merchandise Trade – Nov	On the mend	With commodity prices recovering, we believe the deterioration in the trade deficit will start to gradually reverse.
Wed 21 Dec (3:00pm)	RBNZ New Mortgage Lending – Nov	Slowing	The slowing trend experienced over the past few months should have continued.
Thu 22 Dec (10:45am)	Balance of Payments – Q3	Contained	The current account deficit looks set to remain well below its historical average at around 3% of GDP.
Thu 22 Dec (10:45am)	GDP – Q3	1.0% q/q	Manufacturing and services-based activity are expected to drive another decent lift in overall activity growth, with annual growth approaching 4%.
Thu 22 Dec (3:00pm)	RBNZ Credit Aggregates – Nov	Past the top	Credit growth is past its peak, and is expected to continue to soften over the months ahead.
10-17 Jan	REINZ Housing Market Statistics	Losing steam	Within the context of an ongoing shortage, macro-prudential restrictions, higher mortgage rates and slowing credit growth should see the rate of price growth continue to slow.
Wed 11 Jan (10:00am)	ANZ Job Ads – Dec	--	--
Thu 12 Jan (10:00am)	ANZ Truckometer – Dec	--	--
Thu 12 Jan (1:00pm)	ANZ Commodity Price Index – Dec	--	--
Fri 13 Jan (10:45am)	Electronic Card Transactions – Dec	Bounce back	We view the drop in retail spending in November as more of a one-off than a trend, and see spending growth rebounding.
Mon 16 Jan (10:45am)	Food Price Index – Dec	Flat	We are looking for a flat result, although pressures do appear to be building for some larger future monthly gains.
Thu 19 Jan (10:30am)	BNZ-BusinessNZ PMI – Dec	Solid	While the index is off its highs, it is still pointing to a strong pace of growth, which we expect to persist.
Thu 19 Jan (10:45am)	CPI – Q4	+0.2% q/q	The stabilisation in petrol prices should see headline inflation return to the RBNZ's target band. Of more importance will be core and underlying measures and we suspect there will be more signs of a lift off lows.
Fri 20 Jan (1:00pm)	ANZ-Roy Morgan Consumer Confidence – Jan	--	--
On balance		**Data watch**	**Momentum is decent at present, albeit with risks. Inflation remains low, but looks to be rising.**

KEY FORECASTS AND RATES

	Jun-16	Sep-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18	Sep-18
GDP (% qoq)	0.9	**1.0**	**0.7**	**0.9**	**0.8**	**0.8**	**0.6**	**0.6**	**0.5**	**0.5**
GDP (% yoy)	3.6	**3.8**	**3.6**	**3.6**	**3.4**	**3.2**	**3.1**	**2.8**	**2.5**	**2.2**
CPI (% qoq)	0.4	0.3	**0.2**	**0.5**	**0.4**	**0.6**	**0.2**	**0.9**	**0.5**	**0.6**
CPI (% yoy)	0.4	0.4	**1.1**	**1.4**	**1.4**	**1.7**	**1.7**	**2.1**	**2.2**	**2.2**
Employment (% qoq)	2.4	1.4	**0.7**	**0.6**	**0.5**	**0.4**	**0.4**	**0.4**	**0.4**	**0.3**
Employment (% yoy)	4.5	6.1	**5.9**	**5.2**	**3.3**	**2.2**	**1.9**	**1.7**	**1.6**	**1.5**
Unemployment Rate (% sa)	5.0	4.9	**4.8**	**4.8**	**4.7**	**4.6**	**4.6**	**4.5**	**4.4**	**4.4**
Current Account (% GDP)	-2.9	**-3.0**	**-3.0**	**-3.1**	**-3.2**	**-3.2**	**-3.1**	**-3.1**	**-3.1**	**-3.1**
Terms of Trade (% qoq)	-2.5	-1.8	**0.7**	**0.8**	**1.0**	**0.7**	**0.6**	**0.3**	**0.4**	**0.1**
Terms of Trade (% yoy)	-4.3	-2.3	**0.4**	**-2.9**	**0.6**	**3.2**	**3.1**	**2.6**	**2.0**	**1.4**

	Mar-16	Apr-16	May-16	Jun-16	Jul-16	Aug-16	Sep-16	Oct-16	Nov-16	Dec-16
Retail ECT (% mom)	0.1	0.9	-0.2	1.2	0.2	-1.2	2.0	0.5	-0.1	--
Retail ECT (% yoy)	6.2	7.8	3.3	6.8	5.8	3.2	6.1	4.2	5.1	--
Credit Card Billings (% mom)	-0.9	2.1	0.2	-0.9	2.6	-1.1	3.2	2.8	--	--
Credit Card Billings (% yoy)	5.0	9.0	6.1	4.1	5.7	2.2	8.5	10.2	--	--
Car Registrations (% mom)	-3.8	6.2	-3.6	-0.9	-0.1	2.8	-3.1	11.7	2.9	--
Car Registrations (% yoy)	-0.2	8.7	4.2	-1.2	-1.9	2.6	-0.8	13.1	18.4	--
Building Consents (% mom)	-9.8	8.0	-0.7	20.4	-8.7	-1.5	0.2	2.6	--	--
Building Consents (% yoy)	0.4	13.7	10.1	39.9	7.8	11.8	14.5	14.2	--	--
REINZ House Price Index (% yoy)	13.3	14.5	14.7	14.2	16.3	11.7	9.7	14.4	14.9	--
Household Lending Growth (% mom)	0.6	0.8	0.7	0.8	0.8	0.8	0.7	0.6	--	--
Household Lending Growth (% yoy)	7.7	7.9	8.1	8.3	8.6	8.7	8.8	8.7	--	--
ANZ Roy Morgan Consumer Conf.	118.0	120.0	116.2	118.9	118.2	117.7	121.0	122.9	127.2	124.5
ANZ Business Confidence	3.2	6.2	11.3	20.2	16.0	15.5	27.9	24.5	20.5	--
ANZ Own Activity Outlook	29.4	32.1	30.4	35.1	31.4	33.7	42.4	38.4	37.6	--
Trade Balance ($m)	189	350	343	107	-351	-1235	-1394	-846	--	--
Trade Bal ($m ann)	52599	52626	52854	52660	52078	51900	51942	51968	--	--
ANZ World Commodity Price Index (% mom)	-1.3	-0.8	1.0	3.5	2.1	3.2	5.1	0.7	2.7	--
ANZ World Comm. Price Index (% yoy)	-22.4	-16.8	-11.7	-5.6	1.9	11.1	10.6	4.0	13.1	--
Net Migration (sa)	5360	5490	5590	5720	5650	5670	6350	6240	--	--
Net Migration (ann)	67619	68110	68432	69090	69015	69119	69954	70282	--	--
ANZ Heavy Traffic Index (% mom)	3.4	-2.4	-2.4	5.1	-6.3	7.0	-2.2	-0.4	4.0	--
ANZ Light Traffic Index (% mom)	0.9	0.3	-1.4	2.7	-0.6	-1.6	0.1	-2.0	1.7	--

Figures in bold are forecasts. mom: Month-on-Month; qoq: Quarter-on-Quarter; yoy: Year-on-Year

KEY FORECASTS AND RATES

	ACTUAL			FORECAST (END MONTH)						
FX RATES	Oct-16	Nov-16	Today	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
NZD/USD	0.715	0.714	0.697	0.71	0.69	0.67	0.65	0.64	0.64	0.65
NZD/AUD	0.941	0.957	0.957	0.93	0.93	0.93	0.93	0.94	0.97	0.98
NZD/EUR	0.653	0.671	0.667	0.68	0.67	0.66	0.64	0.64	0.64	0.62
NZD/JPY	75.07	80.72	82.11	78.1	79.4	77.1	74.8	73.6	73.6	74.8
NZD/GBP	0.588	0.574	0.558	0.58	0.57	0.55	0.54	0.54	0.52	0.52
NZ$ TWI	75.6	77.1	77.8	76.6	75.6	74.1	72.5	72.1	72.4	72.5
INTEREST RATES	Oct-16	Nov-16	Today	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17	Mar-18	Jun-18
NZ OCR	2.00	1.75	1.75	1.75	1.75	1.75	1.75	1.75	1.75	2.00
NZ 90 day bill	2.14	2.04	2.02	2.10	2.00	2.00	2.00	2.00	2.20	2.30
NZ 10-yr bond	2.71	3.13	3.42	3.40	3.60	3.70	3.80	3.90	4.00	4.10
US Fed funds	0.50	0.50	0.75	0.75	0.75	1.00	1.00	1.25	1.25	1.50
US 3-mth	0.88	0.93	1.00	1.05	1.13	1.20	1.33	1.45	1.60	1.75
AU Cash Rate	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50	1.50
AU 3-mth	1.75	1.77	1.78	1.70	1.80	1.80	1.80	1.80	1.80	1.80

	16 Nov	12 Dec	13 Dec	14 Dec	15 Dec	16 Dec
Official Cash Rate	1.75	1.75	1.75	1.75	1.75	1.75
90 day bank bill	2.07	2.04	2.04	2.04	2.03	2.04
NZGB 03/19	2.11	2.19	2.18	2.17	2.24	2.24
NZGB 05/21	2.46	2.56	2.55	2.54	2.63	2.64
NZGB 04/23	2.73	2.87	2.85	2.84	2.92	2.95
NZGB 04/27	3.08	3.31	3.29	3.28	3.38	3.41
2 year swap	2.26	2.32	2.31	2.32	2.39	2.41
5 year swap	2.76	2.91	2.90	2.91	3.01	3.04
RBNZ TWI	77.36	78.60	79.16	79.18	78.50	78.50
NZD/USD	0.7062	0.7162	0.7188	0.7217	0.7071	0.6963
NZD/AUD	0.9427	0.9584	0.9604	0.9619	0.9570	0.9533
NZD/JPY	77.43	82.96	82.95	83.02	83.69	82.11
NZD/GBP	0.5674	0.5689	0.5659	0.5703	0.5641	0.5572
NZD/EUR	0.6593	0.6752	0.6772	0.6782	0.6750	0.6663
AUD/USD	0.7491	0.7473	0.7484	0.7503	0.7389	0.7304
EUR/USD	1.0711	1.0607	1.0615	1.0641	1.0476	1.0451
USD/JPY	109.64	115.83	115.40	115.04	118.35	117.93
GBP/USD	1.2446	1.2589	1.2703	1.2655	1.2534	1.2496
Oil (US$/bbl)	45.86	51.51	52.74	52.99	51.01	50.90
Gold (US$/oz)	1230.70	1158.50	1162.35	1160.60	1143.75	1130.45
Electricity (Haywards)	3.12	3.37	4.30	3.82	3.83	3.31
Baltic Dry Freight Index	1145	1069	1052	1003	966	946
NZX WMP Futures (US$/t)	3480	3600	3620	3580	3580	3570

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