

Unjustifiably or understandably, it's a matter of perspective

- The RBNZ's concern about the level of the NZD has escalated to the point where a decline is "needed".
- However, the level of the NZD is understandable given the current fundamentals which are supporting it.
- Nevertheless, the high NZD makes the RBNZ's job harder. But we don't expect an OCR cut just yet at this week's OCR Review.

The RBNZ is concerned about the level of the NZD. Going back through previous Official Cash Rate (OCR) Reviews and Monetary Policy Statements (MPS), the RBNZ has been **very conscious of the high NZD for over a year and a half**. In July, and again in August, the RBNZ's urgency around the level of the NZD (and in particular the Trade-Weighted Index) increased dramatically. The RBNZ **stated that "a decline in the exchange rate is needed" in the August MPS, language it rarely uses**. On top of "a decline ... is needed", the RBNZ has **often used the phrase "unjustifiable"** in order to describe the NZD. However, we are driven to question just **how unjustifiable the currency actually is when you take into account current fundamentals**.

Firstly, as we have mentioned before, are the **high Terms of Trade (ToT)**. While off recent highs, the ToT remain elevated and are **set to lift further, particularly if dairy prices continue recovering. This is supporting the NZD**. Secondly, is our reasonable rate of **economic growth**. Indeed, last week's [Q2 GDP result](#) saw annual GDP growth lift to 3.6%. This is one of the **highest growth rates in the OECD, which supports foreign investment in New Zealand and, therefore, the NZD**.

Thirdly, as has been bandied around a lot recently, is the **relative strength of New Zealand's interest rates**. Not only have many **central banks** implemented unprecedented monetary policy easing by introducing **negative interest rates**, but **over US\$10 trillion in bonds around the world currently have negative yields**. In comparison, NZ is looking pretty good. **A 5-year term deposit currently gives you around a 3.6% return and the 10-year NZ generic government bond is 2.56%**. This compares to 10-year government bonds yielding 1.69% in USA, 0.87% in the UK and 0.004% in Germany.

Taking these factors into consideration, **the ongoing strength in the NZD seems almost understandable**. However, this **merely makes the RBNZ's job even harder as the high NZD is severely impacting inflation rates in New Zealand**. [At the OCR review](#) on Thursday, we will get a glimpse into the RBNZ's most current thoughts around the NZD and inflation. **We expect that the RBNZ will continue to stress that the NZD remains too high**. However, with no key pieces of inflation-related data out between August and September, we believe the RBNZ will wait until November before cutting the OCR by 25bp to 1.75%. **The RBNZ's stated preference for moving at a MPS over an OCR review also makes us confident that there will be no change this week**.

A similar on-hold result is expected for the US Federal Reserve's rate announcement on Thursday morning. **Thursday also brings Fonterra's annual results**, where a change in the milk payout could be announced. However, this is not widely expected to the case. **Milk prices do have a chance to take another leg higher before the announcement**, with a GlobalDairyTrade auction scheduled for Tuesday night. **Futures are pointing to an 8 – 10% lift in key whole milk powder prices**.

Foreign Exchange

- The Trade-Weighted Index remained largely unchanged last week.

Interest Rates

- NZ rates continued to lift across the curve over the past week.

Week Ahead

- GDT auction, RBNZ OCR review, travel and migration data for August.

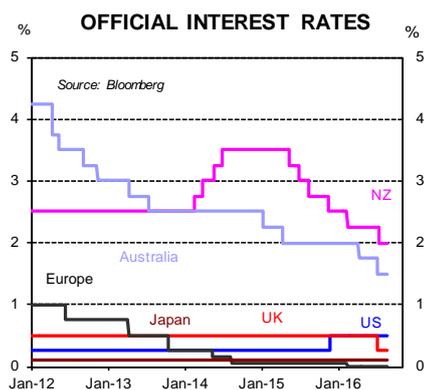
Week in Review

- Annual GDP growth outperformed the RBNZ's expectations, the current account deficit narrowed.

Global Calendars

- US Federal Reserve and Bank of Japan rate announcements.

Chart of the Week: Relative interest rates supporting demand for the NZD



As mentioned above, NZ interest rates are one of the key reasons that the NZD remains high. Despite the fact that the RBNZ has been cutting interest rates since June 2015, interest rates in New Zealand remain some of the highest in developed nations.

Many central banks have kept interest rates low since the Global Financial Crisis. The European Central Bank and Bank of Japan have gone as far as introducing negative interest rates on certain deposits in order to stimulate their lagging economies.

This has made it hard for the RBNZ to boost inflation because offshore demand for the NZD (in order to buy NZD-denominated securities) has remained so strong. The RBNZ has been eagerly awaiting the US Federal Reserve to start raising US interest rates and, by doing so, lessen the relative strength of NZ interest rates. However, this process has proven to be much slower than originally anticipated.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7260	0.7317	0.7269	0.6762	0.6365	FLAT/DOWN	0.7120	0.7420
NZD/AUD	0.9708	0.9707	0.9508	0.8914	0.8845	FLAT	0.9580	0.9850
NZD/JPY	74.16	75.01	72.92	75.31	76.25	DOWN	73.20	75.40
NZD/EUR	0.6510	0.6508	0.6411	0.5997	0.5580	FLAT	0.6420	0.6610
NZD/GBP	0.5585	0.5514	0.5530	0.4680	0.4087	FLAT	0.5500	0.5670
TWI	77.9	77.9	76.9	71.8	68.6	FLAT/DOWN	76.00	79.75

^Weekly support and resistance levels * Current is as at 9.30 am Monday; week ago as at Monday 5pm.

The **Trade Weighted NZD remained broadly unchanged across the week**, with falls against the USD and JPY offset by a lift against the GBP. Looking ahead, we expect another strong lift in dairy prices at this week's Global Dairy Trade auction, which could lend support to the NZD. However, on Thursday, while the RBNZ is expected to leave the OCR unchanged, it's possible the RBNZ delivers a very dovish statement targeting the recent strength in the NZD.

We expect the **USD to remain weighed this week** as the Fed is likely to leave the Fed Funds range on hold this Thursday morning. Downward revisions to the FOMC's growth forecasts are likely to limit any upward revision to US interest rate expectations.

JPY volatility will be high when the Bank of Japan meets on Wednesday. In what will be a close call, we expect the Bank of Japan (BoJ) to leave policy unchanged. No monetary policy change from the BoJ will push JPY higher versus USD, NZD and AUD. But if the BoJ undertakes more aggressive easing (like increasing the pace of its asset purchases or deeper policy rate cuts), JPY will have a kneejerk downside reaction. We still expect the BoJ to ease monetary policy on 1 November when it updates its economic forecasts.

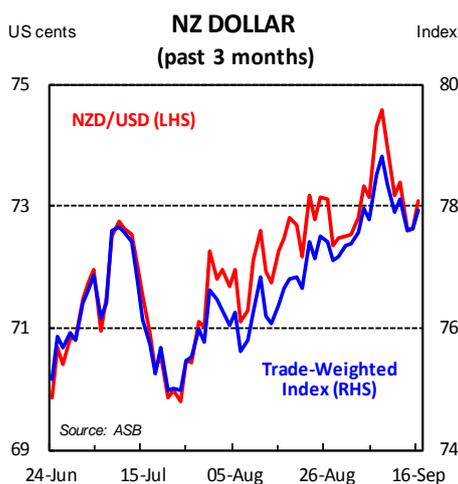
Short-term outlook:

Key data

Date

Time (NZT)

Market



RBA Meeting Minutes

20/9

1.30 pm

-

Global Dairy Trade Auction

20/9

Overnight

-

BoJ Rate Announcement

21/9

-

-0.1%

FOMC Rate Announcement

22/9

6.00 am

0.25%

RBNZ Rate Announcement

22/9

9.00 am

2%

Key events: **NZD:** Global Dairy Trade Auction (Wed); RBNZ OCR Review (Thurs). **USD:** Aug housing starts, building permits (Tue); FOMC meeting & Summary of Economic Projections (Thu). **AUD:** RBA Sep meeting minutes (Tue). **JPY:** BoJ meeting (Wed). **EUR:** Jul balance of payments (Mon); ECB economic bulletin (Thu); Sep PMIs (Fri).

Speakers: **FOMC:** Yellen (Thu); non-voters Lockhart & Harker (Fri); voter Mester (Fri). **RBA:** Lowe (Thu). **BoJ:** Kuroda (Wed). **ECB:** Draghi (Thu). **BoE:** Cunliffe (Thu); Forbes and Carney (Fri).

Medium-term outlook:

Last Quarterly Economic Forecasts

We amended the **GBP, EUR and JPY outlook in late June after the Brexit vote**. The UK's decision to exit the EU at the June 23 referendum saw us cut our near-term GBP/USD estimate in response to likely recession and uncertainty. The exit vote provoked the buying of safe-haven currencies, strengthening the Yen in particular.

Meanwhile, the **NZD remains supported by relatively high Terms of Trade, relatively high interest rates, increased offshore investor demand and a structural improvement in the current account deficit**. The NZD/USD risks remaining above our forecast range of 0.67-0.68. However, we expect the RBNZ to cut interest rates once more in 2016, in November. While this will potentially weigh on the NZD/USD, a lowered chance of Fed interest rate hikes will limit NZD/USD downside. Over 2017, we see the NZD/USD remaining elevated in a range of 0.70-0.73.

We still expect the **RBNZ to cut the OCR to 1.75%, but the RBA is likely to move its cash rate to 1.25%**. The RBA's May/August rate cuts and prospect for more means we have firmed our NZD/AUD medium-term forecast to 0.95. Although our forecasts had NZD/AUD remaining around 0.93 over the near term, that pair is likely to trade around 0.94-0.97 until the RBNZ cuts the OCR further.

There is a firm chance the NZD now remains more elevated against the EUR than had previously thought. Following the UK's June 23 vote to leave the EU, there is now a higher chance that the ECB provides more stimulus to the European economy. However, the Eurozone's current account surplus will continue to help support the EUR, limiting downside. **In the near term we continue to see NZD/JPY hold above 70**. Further out, the prospect for more BOJ easing should weaken the JPY, pushing NZD/JPY above 85 in 2017.

The **GBP fell sharply in response to the UK's decision to leave the EU**. Our base case had been that the UK would remain in the EU. Given this unexpected turn of events, the GBP is now likely to remain lower than expected and the NZD/GBP higher as a result.

Interest Rate Market

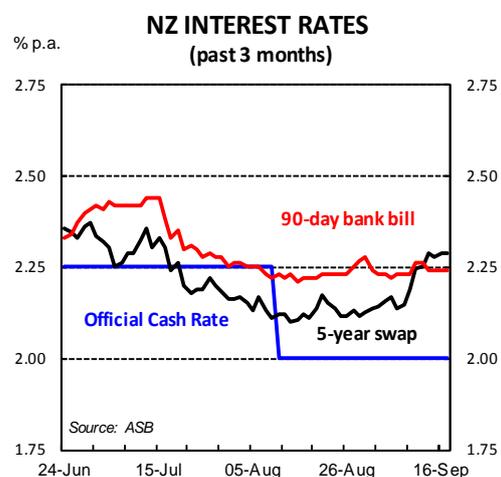
Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.00	2.00	2.00	2.25	2.75	FLAT
90-day bank bill	2.24	2.26	2.22	2.34	2.84	FLAT
2-year swap	2.11	2.09	2.01	2.27	2.77	DOWN
5-year swap	2.29	2.25	2.14	2.57	3.14	DOWN
5-year benchmark gov't stock	2.08	1.99	1.77	2.36	2.69	DOWN
NZSX 50	7251	7280	7392	6642	5714	FLAT

^Weekly support and resistance levels * Current is as at 9.30am Monday; week ago as at Monday 5pm.

NZ rates continue to lift across the curve over the past week. The 2-year swap rate moved 3 basis points higher over the week, while the 5-year swap lifted 4 basis points. **Strong NZ economic data**, including a recovery in dairy prices and robust GDP growth, have helped contribute to a gradual unwinding of OCR expectations. It's also likely that end-of-financial-year positioning for a number of major market participants could be contributing to the lift in OCR expectations.

The **US OIS LIBOR spread** continues to widen ahead of the October 14th money market reforms. The impact of this has also spilled over into NZ markets, with the spread between the 90-day rate and OIS expectations remaining elevated.

Short-term outlook:



Key data

	Date	Time (NZT)	Market
RBA Meeting Minutes	20/9	1.30 pm	-
Global Dairy Trade Auction	20/9	Overnight	-
BoJ Rate Announcement	21/9	-	-0.1%
FOMC Rate Announcement	22/9	6.00 am	0.25%
RBNZ Rate Announcement	22/9	9.00 am	2%

Comment: Thursday is a big day for NZ interest rate markets. The **FOMC statement at 6am is likely to set the tone**, and be particularly **important for moves in the longer-end of the NZ interest rate curve**. **Short-term interest rate moves will depend on the tone of the RBNZ's OCR review**. It's possible the RBNZ could be very frustrated by recent moves in market OCR expectations, considering the RBNZ felt it delivered a very dovish outlook in August. At this week's OCR assessment, the RBNZ is likely to discuss the stronger economic data. However, the RBNZ could also direct market focus towards the higher TWI and its August MPS alternative scenario if it wanted to encourage market pricing to move lower.

Medium-term outlook:

Last Quarterly Economic Forecasts

The RBNZ cut the OCR by 25bps, as widely expected, on August 11. It lowered also its 90-day bank bill outlook to a low of 1.8% by mid-2017 (implying an OCR of 1.75% if not slightly lower). In addition, **the RBNZ retained a firm easing bias** of "our current projections and assumptions indicate that further policy easing will be required" Financial markets had been salivating for an indication of an even greater degree of easing, and were left underwhelmed initially.

Although the RBNZ is still concerned about housing risks, it is also now more concerned about the downside inflation risks, particularly if inflation expectations were to fall further. The NZD Trade Weighted Index assumes the NZD will gently depreciate from around 76 beyond year-end, and there is a risk that the RBNZ will have to ease to a greater extent if the NZD doesn't follow that path. As in the preceding Economic Assessment, the NZD was called out as making it difficult for the RBNZ to meet its inflation objective and in need of depreciation.

We continue to expect the RBNZ to cut once further, in November, when the RBNZ has received the next set of key economic data, including key long-term inflation expectations, and has comprehensively redone its forecasts. Weaker- than-expected data or persistent NZD strength could conceivably bring the easing forward to September. **In addition, the risks remain skewed to a lower OCR than 1.75%, particularly if the NZD persists above the RBNZ's (new) assumed level or inflation expectations weaken.**

Key international data for the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
Reserve Bank of Australia, meeting minutes	20/09	1:30pm	-	-	-
Bank of Japan, Interest Rate Announcement, %	21/09	-	-0.1	-0.1	-
US FOMC Interest Rate Announcement, %	22/09	6:00am	0.25	0.25	-
Eurozone Composite PMI, September, Index	23/09	8:00pm	52.9	52.8	-

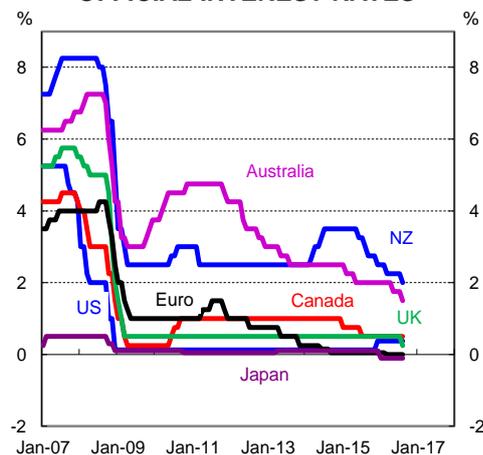
The Reserve Bank of Australia left the cash rate unchanged at its record low of 1.5% in September. The statement accompanying the decision omitted the line "... the likelihood of lower interest rates exacerbating risks in the housing market has diminished." We will be looking to see whether the RBA expresses any concerns about the current state of the housing market.

In what will be a close call, we **expect the Bank of Japan to leave policy unchanged** in September and ease in November. The Board may decide to ease monetary policy on 1 November when the Board updates its economic forecasts. We note that since Kuroda became governor in 2013, the BoJ has eased monetary policy only at monetary policy meetings when it has updated its economic forecasts.

Recent comments from various US Federal Open Market Committee participants have strongly hinted at a rate hike this year. An increase in the Funds rate in September is possible but less likely in our view. Recent disappointing US economic data suggest a December hike is more likely than a September hike. In our judgement, the Fed leadership is very cautious and will prefer to wait if faced with some soft economic data or rising risks.

The **Eurozone composite PMI** has been range bound over 2016. While the PMI remains indicative of positive growth continuing, momentum is not as strong as it was in 2015. The geopolitical uncertainty across parts of the region is being offset by the support provided by the ECB easing measures. As such, the PMIs should remain near recent levels in September.

OFFICIAL INTEREST RATES



NZ Data Preview: a look at the week ahead

Data	Date	Time (NZT)	Previous	Market expects	ASB expects
GlobalDairyTrade auction, whole milk powder, % change	20/09	Overnight	3.7	-	+8 to +10
Net migration, August	21/09	10:45am	5,600	-	5,450
RBNZ OCR decision	22/09	9:00am	2.00%	2.00%	2.00%
Fonterra annual results	22/09	8:00-9:00am	-	-	-

Overnight Tuesday, the latest **GlobalDairyTrade** auction takes place. **We expect a fourth strong result on top of the price surge over the past three auctions.** Current futures pricing suggests a whole milk powder price rise in the 8% to 10% range. We expect global dairy prices to maintain or lift modestly further over the remainder of 2016, reflecting the tightening in global dairy supply.

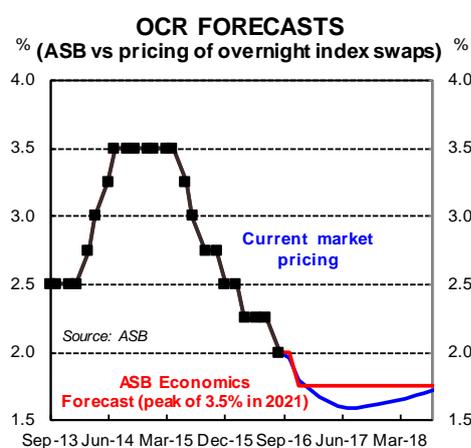
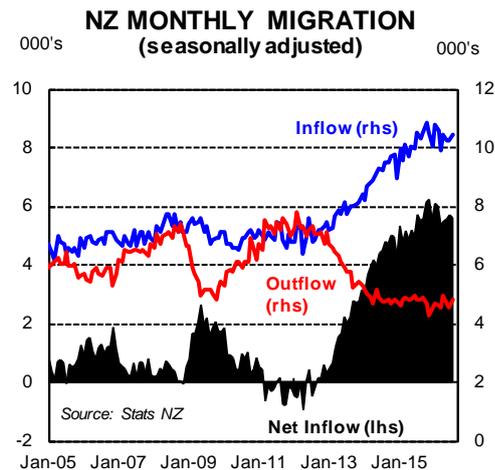
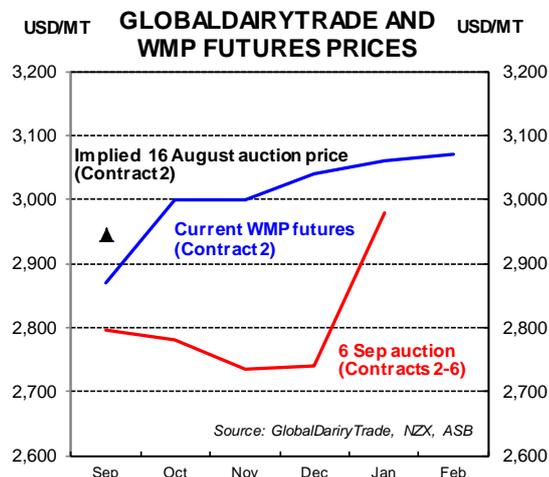
Annual net migration came off its record high in July, but could mark another record in August, if the monthly read comes in above 5,600, i.e. matches last month's inflow. There have been some signs net migration is starting to peak, with the pace of annual growth slowing. However, even if migration does start to slow, we only expect a very gradual drop-off, with students still a major source of arrivals. We look for annual migration to slow to around 66,000 by the end of the year from the current 69,000. The risks are mainly around expected departures, with many of those arriving on student visas already staying on after graduation; this has potential to creep higher.

We expect the RBNZ to hold the OCR steady at 2.00% at the September OCR review and maintain the easing bias in the accompanying statement. The RBNZ has reiterated a number of times this year its preference for moving at Monetary Policy Statements (MPS) over OCR reviews. As a result, we think the RBNZ will use September as a chance to take stock.

We continue to expect the RBNZ will cut the OCR to 1.75% in November. Furthermore, the risks remain skewed to an even lower OCR in early 2017. Inflation risks are still skewed to the downside. The NZD has continued to appreciate since the August MPS and remains above the Bank's TWI assumed levels, despite these being significantly revised upwards. Wage growth is still muted. Pricing intentions in business surveys remain weak and petrol prices remain soft, all of which are likely to drive headline annual inflation down to around 0.2% in Q3. But strong economic growth in the first half of 2016 and a nascent rebound in dairy prices are positives.

Even though we expect the OCR to remain at 2% in September, we look for the RBNZ's policy assessment to again reiterate that "further easing may be required". The language of the statement will again be examined in minute detail. In particular, comments on the NZD will be in focus, given the emphasis the RBNZ has placed on the currency's resilience to recent OCR cuts.

Fonterra announces its annual results on Thursday. We expect Fonterra to confirm the 2015/16 season milk price at \$3.90 per kg. Fonterra last revised its 2016/17 season milk price forecast on August 25. There is an opportunity for Fonterra to discuss recent developments and possibly revise its forecast higher. However, given the proximity to its recent revision, Fonterra may be content to leave it at \$4.75 for the time being. We still expect, over time, Fonterra will revise this forecast higher and we still expect a \$6 milk price to be achieved by season end.



Data Recap: weekly recap

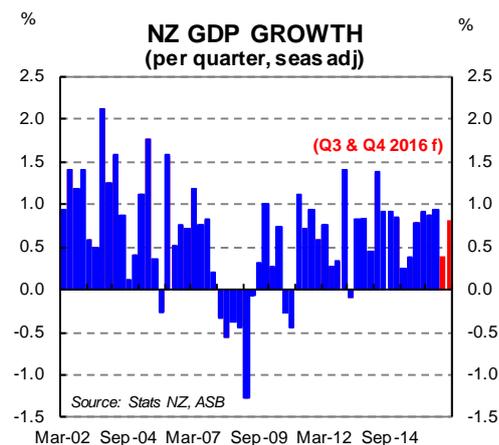
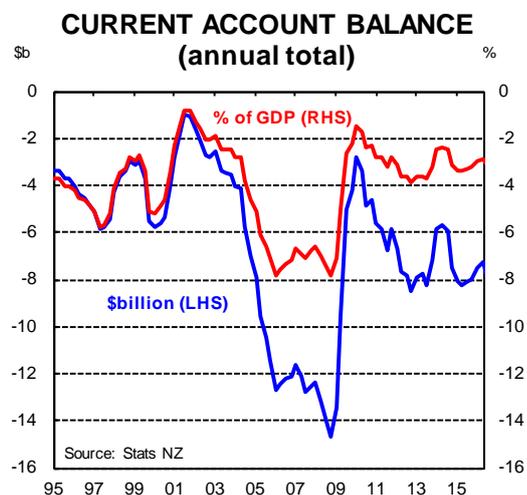
Data	Date	Actual	Market forecast	ASB Forecast
Current Account, Q2, %GDP	14/09	-2.9	-2.6	-2.9%
GDP, Q2, %qoq	15/09	0.9	1.1	1.2%
ANZ Consumer Confidence, September, Index	16/09	121	-	-
Westpac Consumer Confidence, Q3, Index	19/09	108	-	-

The annual current account deficit narrowed to 2.9% of GDP in Q2 from a revised 3.1% in Q1, slightly wider than the market's expectations but matching the ASB forecast. However, the seasonally-adjusted current account deficit widened to \$1,826m in Q2 from \$1,639m in Q1. **Much of the widening in the seasonally-adjusted deficit is owed to increased spending by New Zealanders abroad.** Looking at the goods balance, both imports and exports increased but the overall deficit narrowed a touch. From here, we expect little major movement in the annual current account balance. We expect the services balance to remain strong on the back of continued tourism strength. Dairy prices have also begun to recover. On the other side of the ledger, strengthening domestic demand and rebounding oil prices will lift import expenditure.

Headline Q2 GDP growth was weaker than we expected and slightly softer than the market expected. However, the previous quarter was revised up by 0.2 percentage points. All up, annual growth is materially higher than the RBNZ believed at the August MPS. We continue to expect the RBNZ will cut the OCR to 1.75% in November. In light of continued weak inflation, and despite strong growth, we **continue see a high chance of a further cut next year** should inflation indicators continue to print on the weak side.

Consumer confidence continued its recent upbeat trend in September in the ANZ Roy Morgan survey. Headline consumer confidence bounced back in September, rising to 121.0 from 117.7, tantalising shy of the 2016 high of 121.4, set in January. The index is now above 5 and 10-year average levels. On a seasonally-adjusted basis, confidence extended its recent winning run to 4 months, climbing to 124.5 from 121.8. That's a high since April 2015 and is well clear of recent averages.

Westpac consumer confidence for Q3 showed a similar trend to the recent ANZ results. Consumer confidence is lifting, but at a slow and steady pace. Confidence lifted 2 points between Q2 and Q3, from 106 to 108. While there are a number of factors at play supporting confidence (low interest rates, employment growth and growing housing and construction sectors) people remain nervous about the outlook, especially those in rural areas.



Global Data Calendars

Calendar - Australasia, Japan and China

Date	Time (NZT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 19 Sep	11:23	NZ	WBC consumer confidence	Q3	Index	106.0	~	~
Tue 20 Sep	11:30	AU	ANZ Roy Morgan Weekly Consumer Confidence	Sep	Index	118.1	~	~
	13:30	AU	RBA September Meeting Minutes					
	13:30	AU	House price index	Q2	q%ch	-0.2	~	4.0
Wed 21 Sep	~	JN	BOJ Annual Rise in Monetary Base	Sep	¥tn	80.0	80.0	~80.0
	~	JN	BOJ policy rate	Sep	%	-0.1	-0.1	-0.1
	10:45	NZ	Net migration	Aug	~	5,600	~	5,450
	11:50	JN	Trade balance	Aug	¥bn	317.6	491.0	~
	12:30	AU	WBC leading index	Aug	m%ch	0.1	~	~
	14:00	AU	RBA's Heath gives speech at CEDA Conference					
	15:00	NZ	Credit card spending	Aug	m%ch	2.3	~	~
	18:30	JN	BOJ Governor Press Conference					
Thu 22 Sep	01:00	CH	Conference Board China August Leading Economic Index					
	09:00	NZ	RBNZ official cash rate	Sep	%	2.0	2.0	2.0
Fri 23 Sep	12:30	JN	Nikkei Japan PMI manufacturing					
	13:45	CH	MNI September business indicator	Sep P	Index	49.5	~	~
	16:30	JN	All industry activity index	Jul	m%ch	1.0	~	~

*P = Preliminary

Calendar - North America & Europe

Date	Time (UKT)	Eco	Event	Period	Unit	Last	Forecast	
							Market	ASB
Mon 19 Sep	09:00	EC	Current account	Jul	€bn	37.6	~	~
	10:00	EC	Construction output	Jul	m%ch	0.0	~	~
	15:00	US	NAHB housing market index	Sep	Index	60.0	60.0	~
Tue 20 Sep	13:30	US	Housing starts	Aug	000	1,211	1,192	~
	13:30	US	Building permits	Aug	000	1,144	1,170	~
Wed 21 Sep	19:00	US	FOMC rate decision (lower bound)	Sep	%	0.25	0.25	0.25
	09:00	EC	ECB Publishes Economic Bulletin					
Thu 22 Sep	14:00	EC	ECB President Draghi speaks at ESRB Conference in Frankfurt					
	15:00	EC	Consumer confidence	Sep	Index	-8.5	~	~
	15:00	US	Existing home sales	Aug	\$mn	5.4	5.5	~
Fri 23 Sep	09:00	EC	Markit Eurozone services PMI	Sep P	Index	51.7	~	~
	14:45	US	Markit US manufacturing PMI	Sep P	Index	52.0	52.0	~
	17:00	US	Fed's Harker, Mester, Lockhart on Panel at Philly Fed Conference					

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