REDWARD ASSOCIATES

Asia-Pacific TODAY

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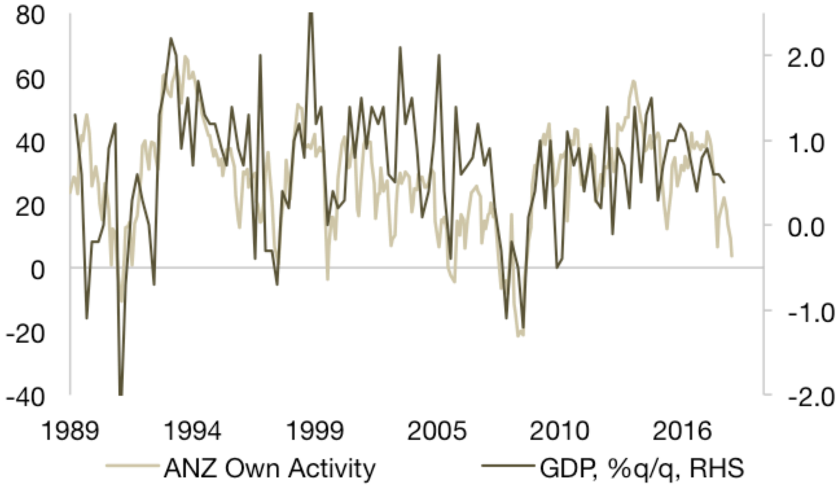
IN THIS ISSUE

- With activity indicators pointing to weakness and core CPI inflation below the mid-point of the inflation target and showing no sign of increasing, we see scope for the RBNZ to become more dovish.
- We remain comfortable received November OIS and short NZD.
- We expect little change to the RBA Statement today opening the door for the AUD to test the bottom of its recent AUD/0.7310-0.7485 range.

Chart of the day: ANZ Own Activity Confidence & NZ GDP, %y/y



Source: Bloomberg, Redward Associates

RBNZ to maintain dovish bias.

We see scope for more explicitly dovish forward guidance.

The Reserve Bank of New Zealand holds its August Monetary Policy Statement on Thursday (09:00 NZST). At present, the OIS market and analysts, ourselves included, expect no change to the Official Cash Rate, currently 1.75%. However, while analyst expectations appear to be skewed towards a Statement and forward guidance that is largely unchanged from the May Statement and June OCR Review, we see scope for the Reserve Bank to provide a more explicitly dovish bias to policy.

In recent months indicators of domestic activity have softened. On 31 July the ANZ Business Outlook reported a slide in business confidence to net -44.9 while business own activity expectations fell to just 3.8. Weakness was observed across all business categories with business reporting slowing investment and employment intentions amid deteriorating profit expectations and tightening credit availability. Weakness in the ANZ survey was backed up by weakness in both the manufacturing and services PMI's with both falling to 52.8 in July. Meanwhile, the Q2 HLFS reported a 0.5%q/q rise in employment but the labour force increased by 0.6%q/q with the unemployment rate rising 0.1pp, to 4.5%. While some of the weakness in headline confidence may reflect a negative political risk-premium - business confidence has typically been lower under a centre-left government - the recent slump in business assessment of their own outlook augers badly for growth (see Figure 1).

In their May Statement, the Reserve Bank projected real GDP growth of 0.7% in Q2 rising to 0.8%q/q in Q3 and 0.9%q/q in Q3. We see little prospect of this occurring with activity just 0.5%q/q in Q1 and likely weaker in the second quarter. This suggests to us scope for the Reserve Bank to significantly downgrade near-term GDP growth expectations - perhaps as much as 0.5-0.8pp with a corollary effect on their estimate of the output gap.

Meanwhile, inflationary pressures remain in abeyance with headline CPI increasing 0.4%q/q (1.5%y/y) but excluding tobacco and automotive fuels, inflation was just 0.8%y/y. While some commentators highlighted the rise in the Reserve Bank's sector factor model as an indication of a rise in core CPI inflationary pressures, with inflation rising 0.1pp to 1.7%y/y in Q2, we believe that this filter approach to measuring core CPI inflation is capturing in part the lift in petrol prices. We believe the Reserve Bank will look through the effect of administered price changes - including to wages - and external price shocks and conclude that core inflationary pressure remains weak. Indeed, our assessment suggests that CPI ex-petrol prices is closely tracking its 5-year average with no sign of a pick-up in trend.

With inflation below target and showing little sign of picking up, the Reserve Bank needs activity to continue to expand at, or above, trend. As this is not occurring, we expect the Reserve Bank to alter its forward guidance, lowering their OCR forecast path and signalling a more explicitly dovish stance. While the Reserve Bank may retain the statement that policy may be adjusted *"in either direction - up or down - as necessary"* they may decide to state explicitly that if activity continues to disappoint, more stimulus may be required, weighing on the OIS curve - which continues to price hikes in 2019 - and the NZD.

- We expect the RBNZ to lower their forward guidance and indicate that if activity remains subdued, more monetary stimulus may be needed.

- We find it inconceivable that the RBA can signal a more hawkish outlook while house prices are sliding and the housing market stress is rising.

RBA to remain neutral today.

While the RBA is likely to remain cautiously upbeat, they are also likely to be cognisant of risks.

The Reserve Bank of Australia hold their regular Monetary Board meeting today (14:30 AEST). At present, the OIS market and analysts, ourselves included, expect no change in the Official Cash Rate, currently 1.5%.

While the OCR is likely to remain unchanged, it is unclear how the Reserve Bank will interpret recent events with today's meeting likely to be influenced by the Reserve Bank's forecast revisions to be published on Friday in their Statement on Monetary Policy (SoMP).

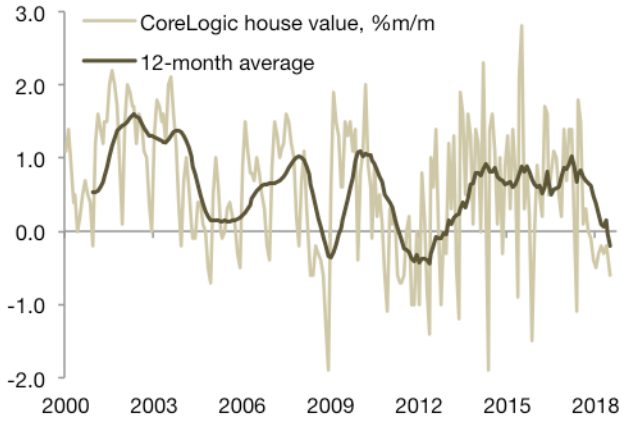
We expect the Reserve Bank to maintain its upbeat assessment of economic activity, noting the recent rebound in employment growth after a period of weakness. While the RBA will be cognisant of a recent softening in the NAB business survey and a sharp correction in both the manufacturing and services PMI's they are likely to maintain their view that activity is running slightly ahead of potential, leading to tightening capacity conditions which will support *"a gradual pick-up in inflation."* We remain unconvinced.

While activity appears to be expanding roughly around potential, its spill-over to capacity pressures and core inflation appears weak. Moreover, our projections suggest that headline CPI inflation is likely to slow to around 1.5%y/y this year - with 0.8pp driven by tobacco and automotive fuels - and we question the ability of the Reserve Bank to maintain their central forecast *"for CPI inflation to be a bit above 2 per cent in 2018."*

We will also be paying close attention to the Reserve Bank's risk assessment, notably on house prices. In our opinion, it is inconceivable for the Reserve Bank signal a shift towards a more hawkish stance with CoreLogic house prices down 2.9% in 9-months and indicators such as household credit and auction clearances suggesting weakness is intensifying (see Figure 2).

We expect the Reserve Bank to maintain its final paragraph policy statement more-or-less unchanged, arguing that progress towards achievement of its goals will be quite gradual and that policy accommodation remains necessary to achieve the inflation target. Should our view come to pass, we anticipate that the AUD will slip towards the bottom of its recent AUD/0.7310-0.7485 trading range.

Figure 2: CoreLogic house prices, %m/m



Source: Bloomberg, Redward Associates

Foreign exchange portfolio

- Medium. **Short AUD 1M** at AUD/0.7424 (USD 300k) target AUD/0.7175, stop AUD/0.7525. P&L 0k.
- Medium. **Short IDR 1M** at 13,876/USD (USD 200k) target 14,650/USD, stop 14,265/USD. P&L 3.7k.
- Strong. **Short JPY 1M** at 110.39/USD (USD 300k) target 117.85/USD, stop 110.35/USD. P&L 2.4k.
- Strong. **Short NZD** at NZD/0.7003 (USD 300k) target NZD/0.6475, stop NZD/0.6885. P&L 11.9k.
- Medium. **Short PHP** at 53.54/USD (USD 500k) target 56/USD, stop 52.85/USD. P&L -5.7k.
- Medium. **Short SGD** at 1.3630/USD (USD 200k) target 1.3870/USD, stop 1.3485/USD. P&L 0.5k.
- Strong. **Short XAU** at 1,214.90/oz (159.3oz) target USD 1,175/oz, stop USD 1,228/oz. P&L 0k.

Notional capital = USD 1mio
Current leverage ratio is 2:1
Level of conviction: Strong, Medium, or Weak

Fixed income portfolio

- Strong. **Paid USD 2y1y IRS** at 2.19% (0.4k DV01) targeting 3.70%, stop 2.78%. P&L 34k.
- Strong. **Received NZD November OIS** at 1.7675% (0.3k DV01) targeting 1.50%, stop 1.92. P&L 0.6k.
- Medium. **Paid AUD May OIS** at 1.57% (0.3k DV01) targeting 1.75%, stop 1.47%. P&L 0.1k.
- Strong. **Paid USD 2y1y IRS vs. NZD 2y1y IRS** at -24bp (0.3k DV01) targeting -140bp, stop -10bp. P&L 8.7k.

REDWARD ASSOCIATES

Peter Redward
m: +64 27 510 8820
p: +64 9 379 8831
e: peter@redwardassociates.com
w: www.redwardassociates.com

Physical address:
Level 12 Augusta House
19 Victoria Street West
Auckland 1010
New Zealand

Postal address:
PO Box 5091
Wellesley Street
Auckland 1141
New Zealand