China is a boon for NZD a bane for AUD

Energy sector weakness takes its toll on AUD and CAD. Despite softer US data, EUR remains heavy with its rates sliding further to new lows. The Japanese press highlight the difficult choice the BoJ face this weekend, somewhat raising the odds they act. Low Australian inflation raises the odds the RBA cut next week. The RBNZ is likely to keep rates on hold and attempt to jawbone its currency lower. However, the stronger performance of milk and meat in recent months highlights that the rotation in China from industrial to services and consumer led demand is a boon for NZD and a bane for AUD.

EUR likely to remain heavy

The weakness in energy markets spilled over to a weaker CAD on Tuesday. Oil prices slipped below lows in late-September, although at least did not accelerate lower, managing a partial recovery in American trading.

The US economic reports were generally weaker than expected and are likely to dampen expectations of policy tightening later this year. However, the jury will remain out with the labour and housing market still tightening. The chance of policy action by the Fed this week is virtually nil, and most anticipate that the Fed will prefer to keep its options open and attempt to release a balanced statement.

The EUR is likely to struggle with its rates market still pushing lower and further into record lows at the front end in the wake of the ECB meeting last week. Eurozone credit data today lost some momentum and with lower oil prices, the ECB is likely to forge ahead with plans to enhance its policy easing strategy, including lowering its deposit rate (the effective floor rate) from -0.20%.

Will Kuroda stick to his mandate?

Expectations of BoJ policy easing were fading this week, but have been given a boost by an Asian Nikkei Review article citing unofficial sources suggesting a policy easing is on the table, although one might be held back at this time. As I discussed earlier this week (BoJ may be charging up the defibrillator) the market may be under estimating the resolve of Kuroda to stick to his inflation targeting mantra. The greater downside risks to not achieving his target may embolden him to shock the market. A rate cut is not expected, but should not be ruled out of the question (in my view). The ANR article suggests that the government may not prefer further easing at this time (consistent with remarks made by FM Aso late last week). However, now that PM Abe has unleashed the beast (Kuroda), he may not be able to put him back in his cage. The mandate Kuroda agreed to was to generate sustainable inflation and he may see this as paramount over political expediency.

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RBNZ to stick to easing bias

RBNZ Rate cut expectations have come off the boil a bit since the RBNZ delivered a third 25bp cut in a row at its last meeting on 10-Sep taking rates to 2.75%. At the time many thought there was likely to be at least one more at either the meeting tomorrow and/or the final meeting for the year in December. Now the market is wavering from expecting a further cut, with one not fully discounted until mid-2016.

Since the Sep meeting milk prices have recovered significantly, export growth reported yesterday recovered in Q3, driven by strong sales to China. Overall economic activity appears to have improved significant from a slow-down in the first half of the year to a bit below trend.

The performance of services index rose to an 8-year high from 58.5 in Aug to 59.3 in Sep, indicative of strength in demand from tourism and rapid immigration that is yet to abate.

The housing market showed extraordinary strength in Auckland, spreading out to surrounding areas in September, and housing sales continued their strong recovery from last year, rising 38.3%y/y in Sep. Median house prices in Auckland rose 25.4%y/y in Sep and 15.4%y/y nationally.

In its previous 10 Sep statement the RBNZ said, “At this stage, some further easing in the OCR seems likely.” In a speech on 14 October, RBNZ governor Wheeler dampened rate cut expectations, but still concluded a cut “seems likely”.

He said, “Recent economic indicators have been more encouraging. Some further easing in the OCR seems likely but this will continue to depend on the emerging flow of economic data. At the same time however, we remain conscious of the impact that low interest rates can have on housing demand and its potential to feed into higher price inflation. It is important also to consider whether borrowing costs are constraining investment, and the need to have sufficient capacity to cut interest rates if the global economy slows significantly.”

As such, it will be crucial for the RBNZ to keep that cut “seems likely” view point in the statement, otherwise it will be a positive surprise for the NZD, and the currency has appreciated significantly in recent months, something the RBNZ would probably like to see reversed.

The NZD TWI is up by around 7% from around 68 at the time of the last meeting to around 73. In September, the RBNZ forecast that the currency would fall further to 65 by mid-2016, and this was desired to help generate higher inflation that has consistently run below target in recent years, dragging down longer term inflation expectations.

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The RBNZ has become more focussed on raising inflation this year, worried like many central banks by the effects of prolonged low inflation and weak global inflationary impulses. The higher currency and lower oil prices are likely to see a substantial downward revision in the RBNZ's inflation outlook. As such, the RBNZ is likely to persist with its assessment that a further rate cut is likely.

Furthermore it is likely to re-engage in talking its currency lower. In September, it said that "further depreciation is appropriate, given the sharpness of the decline in New Zealand's export commodity prices." Since then, commodity prices have recovered significantly. The CBA NZ commodity price index is up over 10% from its lows, led by a 33% rise in its dairy index. As such, this can account for much of the recovery in the NZD. However, the dampening impact on New Zealand's already low and below target inflation is likely to raise concerns over the strength in the NZD.

In arguing that a cut is still likely the RBNZ can of course point to global turmoil and weaker emerging market growth. It can also argue that fresh macro-prudential measures to cool investor demand in Auckland may begin to take effect after they are implemented on 1 November. It might also caution over the risks of drought.

China rotation a boon for NZD a bane for AUD

However, the NZD may well continue to hold firmer than the AUD. Its agricultural commodities are proving more resilient than energy or metals. In China, the down-turn in industrial production and fixed asset investment are dragging on Australian commodities. But stronger consumer demand in China is likely to under-pin demand for milk. The New Zealand Finance minister English made this point last week, saying he was "Relatively positive" on the part of China's FDP that matters to New Zealand.

This is emphasised by the Chinese Industrial profits data reported yesterday. In year-to-date/year-on-year terms, mining sector profits (including energy) fell 55.7% in Sep. Iron smelting fell 60.5% in Sep. However, profits from agricultural food processing rose 12.7% in Sep, suggesting that indeed food demand is rising.

AUD to be weighed down by renewed rate cut talk

The AUD was languishing ahead of the CPI release today, with weaker commodity trends returning as an issue for the currency. The significantly lower CPI today, moving to the lower side of the RBA target band is likely to rekindle rate cut expectations as soon as next week. The evidence is that prudential measures to cool the housing market are starting to take effect and the mining sector down-turn remains entrenched and deepening. Government finances are likely to be undermined by renewed weakness in commodity prices. The RBA may aim to use lower rates to keep a lid on the currency.

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In the news

- Apple's earnings report beats analysts' expectations, supporting technology shares moderately in after-hours trading.
- The Asian Nikkei Review rekindle dwindling BoJ policy easing expectations reporting that the BoJ "face a tough choice" poised to "push back the estimate for reaching 2% inflation", saying, "attention turns to whether it will back up its commitment to the target with action at a policy board meeting this week.". It says that the BoJ has limited ammunition left and "must carefully weigh the need for and timing of such a move to ensure maximum effect." In particular it notes limitations to raising the size of monthly purchases currently aimed at raising the money base by JPY80 tn per month, quoting a "senior official" as saying, "we can't afford to waste shots." It argues that the BoJ may prefer to hold easing in reserve in case the JPY strengthens on a lengthy delay in the Fed raising rates. It also argues that the BoJ worries that easing now may weaken the JPY, undermining consumer and small business confidence at a time "when neither the government nor industry much wants it." (Kuroda and Co. face tough choice on more QE – Asia.nikkei.com)

Economic news

- Australia trimmed mean core inflation slowed from 2.2%y/y to 2.1%y/y in Q3, below 2.4% expected. The weighted median core measure also fell from 2.4%y/y to 2.2%y/y, below 2.5% expected. The headline measure was unchanged at 1.5%, below 1.7% expected. The data are likely to give rate cut expectations in November a boost.
- Japan Retail sales fell 0.2%y/y in Sep, weaker that +0.4% expected, down from +0.8%y/y in august, continuing tepid momentum in the last year and a half since the 2014 consumption tax hike.
- USA Durable goods orders fell 1.2%m/m in Sep and were revised down from -2.0%m/m to -3.0%m/m in August. With revisions, below an expected fall of -1.5%m/m in Sep. Core capital goods orders, excluding defense and aircraft, fell 0.3%m/m in Sep, below an expected rise of 0.2%, and were revised down from -0.2%m/m to -1.6%m/m in Aug. The fall in total orders in Aug/Sep reverses most of the rise in the previous two months Jun/Jul, leaving the trend flat this year. The fall in core capital goods orders in the last two months, reverses about a third of the rise in the previous two months of Jun/Jul, consistent with some renewed drag from the energy sector and global markets turmoil in Aug/Sep. The peak in core orders was Aug/Sep a year ago, they are down around 7.0% since then, up slightly from the lows around from around Feb to May by around 1.3%.
- USA Markit PMI services flash index fell from 55.1 to 54.4 in October, below 55.5 expected. It has fallen for the last two months to a low since January. It is roughly the same as the Eurozone services PMI released on Friday at 54.2 in October, up from 53.7 in Sep, higher than 53.5 expect5ed.
- USA Conference Board Consumer Confidence index fell to 97.6 in October from 102.6 in Sep, revised down from 103.0. This fall comes after surprising gains in the previous two months and leaves confidence in a flat trend this year around its

highs since 2007, at a relatively neutral level, overall showing some resilience to global turmoil, but being held back.

- USA Richmond Fed Manufacturing index was -1 in October, up from -5 in Sep, above -3 expected. Still down from its recent high of +7 in July, off the low for the year, around the same level as its low in April. Consistent with the pattern of other manufacturing indices bobbing along this year, weaker than a year ago.
- The Case Shiller house price index inflation rose from 4.6%y/y in July to 4.7%y/y in Aug, below a rise of 4.8% expected.
- The Eurozone credit impulse index, capturing the change in the flow of credit to the private sector fell from 4.48 in august to 3.70 in Sep, reversing gains over the previous two months, although still well up on -0.44 a year ago. Lending growth to the private sector slowed from +1.0%y/y in August to +0.7%y/y in Sep. The slowing was apparent in lower business lending, down from +0.4%y/y to +0.1%y/y in Sep, while household lending rose further from +0.9%y/y to +1.1%y/y in Sep, a high rate since 2012.
- UK GDP growth slowed from 2.4%y/y in Q2 to 2.3%y/y in Q3, below 2.4% expected. In the quarter it rose 0.5%q/q, less than 0.6% expected Eurozone Money supply and credit growth
- UK index of services was flat m/m in August, less than +0.2% expected. It rose 0.9% 3m/3m, less than 1.0% expected.
- Taiwan Monitor Indicator was unchanged at 14 in Sep, remaining at its low since 2012.
- China's government leading index was 88.51 in Sep, little changed from 98.53 in august, up slightly from its low in July of 98.41, the low since 2009.
- China Industrial profits improved from a fall of 8.8%y/y in Aug to a fall of 0.1%y/y in Sep. However, the growth trend is flat below zero since August last year. In year-to-date/year-on-year terms, mining sector profits (including energy) fell 55.7% in Sep, up from a fall of 57.3% in Aug, Manufacturing profits (which account for 85% of profits) rose 4.1% in Sep, down from 4.5% in Aug. Within manufacturing, Iron smelting fell 60.5% in Sep, down from -51.6 in Aug, Electrical equipment and Machinery rose 12.7% in Sep, up from 12.1% in Aug, Agricultural food processing rose 12.7% up from 11.7%.
- Japan PPI services prices inflation fell to 0.6%y/y in Sep as expected from 0.8%y/y in Aug (revised up from 0.7%).
- Philippines imports slowed to +4.1%y/y in Sep from +23.0%y/y in Aug, (revised up from 16.9%). Its trade deficit narrowed from -$1519m to -$954m in Sep, narrower than -1333m expected.

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