2017 OUTLOOK

THE KEY VIEWS OF NAB AND BNZ'S ECONOMISTS AND STRATEGISTS.

Inflation returns

KEY THEMES

1) GLOBAL REFLATION IN 2017
2) HOW HIGH FOR THE USD?
3) RBA BELOW THE FED AND $A ASSETS
4) STEEPER YIELD CURVES
5) BOND & FX VOLATILITY UP
6) CREDIT MARKET – SECTOR PICKS

CONTENT

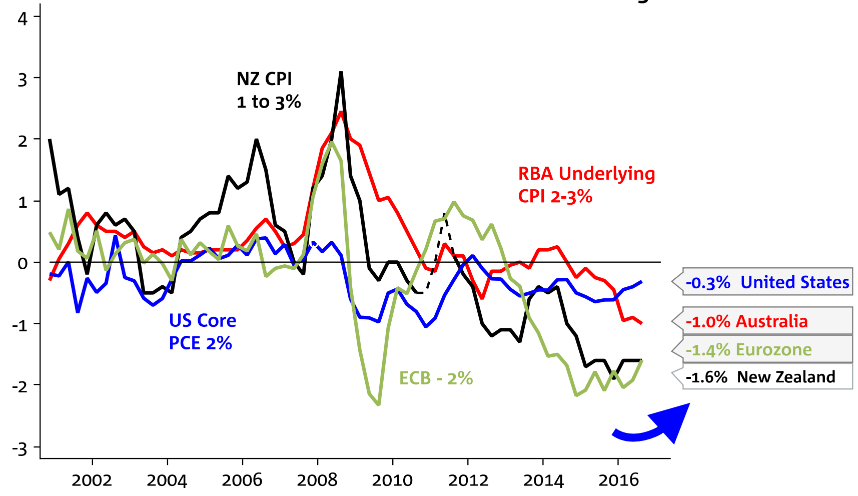
21 December 2016 |

KEY THEMES FOR 2017

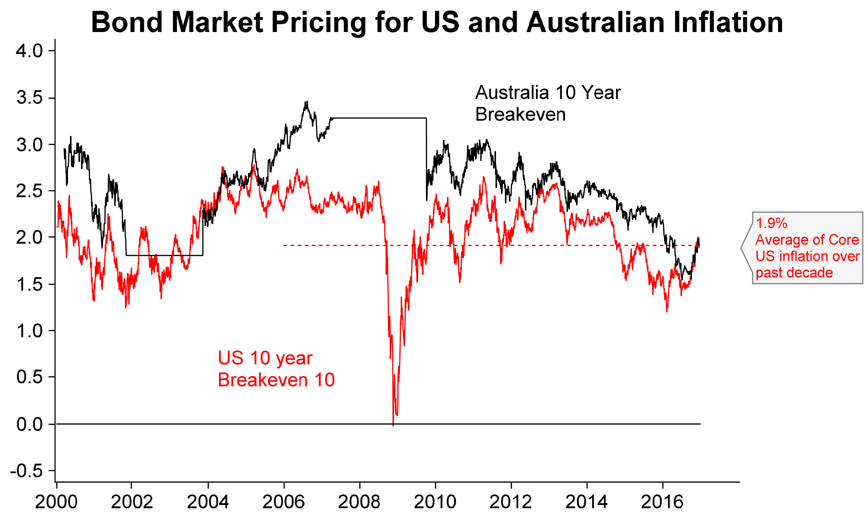
#1 Global reflation in 2017

Peter Jolly

- Inflation has been too low. The IMF says "cyclical unemployment and weaker import (commodity) prices can account for the bulk of the deviation of inflation from (central bank) targets .....but other unexplained factors have been playing an increasingly larger role". RBA Governor Lowe said these unexplained factors likely include globalisation, improved price transparency, and increased competition.[1]
- During 2017 at least two of these factors will partially unwind. Higher commodity prices will lift all advanced countries' inflation rates and with that some prices/wages that are linked to the CPI. Economic slack is forecast to reduce in most advanced countries during 2017 – although notably not in Australia – meanwhile the United States economy is already at full employment and both wages and core inflation are rising.
- Our inflation forecasts take no account of any lift in trade barriers that may be associated with a Trump Presidency.
- The markets' pricing for inflation has lifted but has room to rise further. The US 10 year break-even inflation rate is now 1.9%, merely the average US inflation rate over the past decade – a decade that included the GFC. Even without a Trump effect, the case can be made for US inflation being higher in the next decade than the last. We'd expect the US BEI to trade 2-2½% in 2017.
- The high correlation between countries BEI's – see chart 2 - means Australian and NZ BEI's also have an upward bias in 2017.



Source: National Australia Bank, Macrobond. Note that NZ is adjusted for GST increase in 2010.



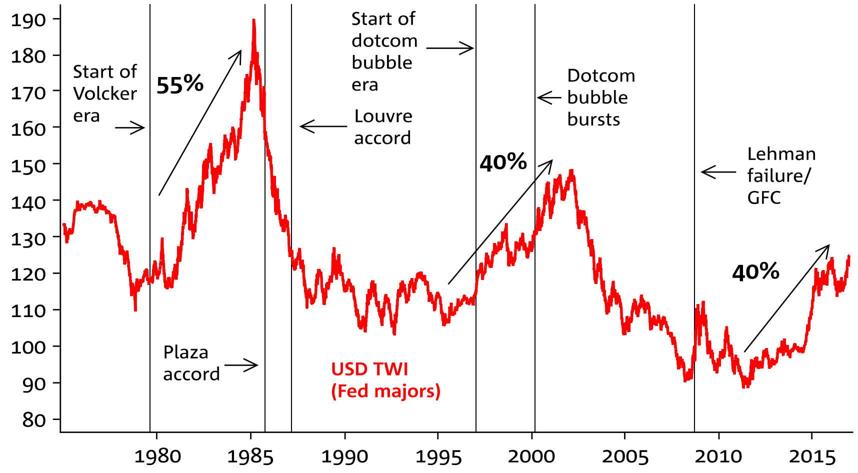
Source: National Australia Bank, Macrobond

1. http://www.imf.org/external/pubs/ft/weo/2016/02/pdf/c3.pdf for IMF and http://www.rba.gov.au/speeches/2016/sp-gov-2016-10-18.html for Phil Lowe

#2 How high for the USD? (and low for the AUD and NZD?)

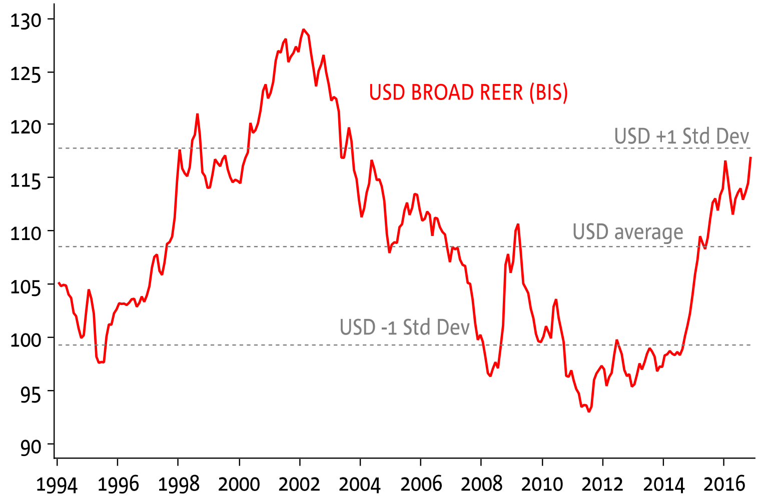
- The case for the USD moving higher in 2017 is compelling, but we don't expect to see double-digit gains.
- Monetary policy divergence is set to be more pronounced in 2017 with Fed tightening while BoJ, ECB and BoE further expand their balance sheets. FOMC risk is skewed to the Fed doing more not less than the ~60bps of tightening currently priced.
- Yields spreads should attract more capital into the USD, yet:
  1. USD fully reflects the shift in US yields and yields spreads since Trump's victory and now the Dec FOMC narrative.
  2. We aren't expecting 10yr US yields to make a sustained move above 2.75% in 2017. This is more consistent with a 3-5% rise in the USD than ~10%.
  3. In broad (real) terms, the USD is starting to become stretched albeit still below the early 2000s highs, while in narrow terms, the 2011-2016 USD rise already matches the scale of 1995-2002 appreciation (~40%).
  4. A more pronounced US yield spike and USD appreciation in H1 2016 risks upsetting equity markets and will trigger Fed concerns over too-tight financial conditions including dollar strength. A familiar playbook that should repeat during 2017.
- Corporate tax reform encompassing a tax holiday on profits accumulated overseas can play with the grain of fundamentally driven capital inflows into the USD (so upside risks).
- USD strength is the key ingredient in our forecasts for AUD down to 0.70 in 2017 (then to the mid/high 0.60s) and NZD to ~0.67 (see #17)

Narrow $ index well below prior cycle highs....



Source: National Australia Bank, Macrobond

...but broad $ index starting to become stretched

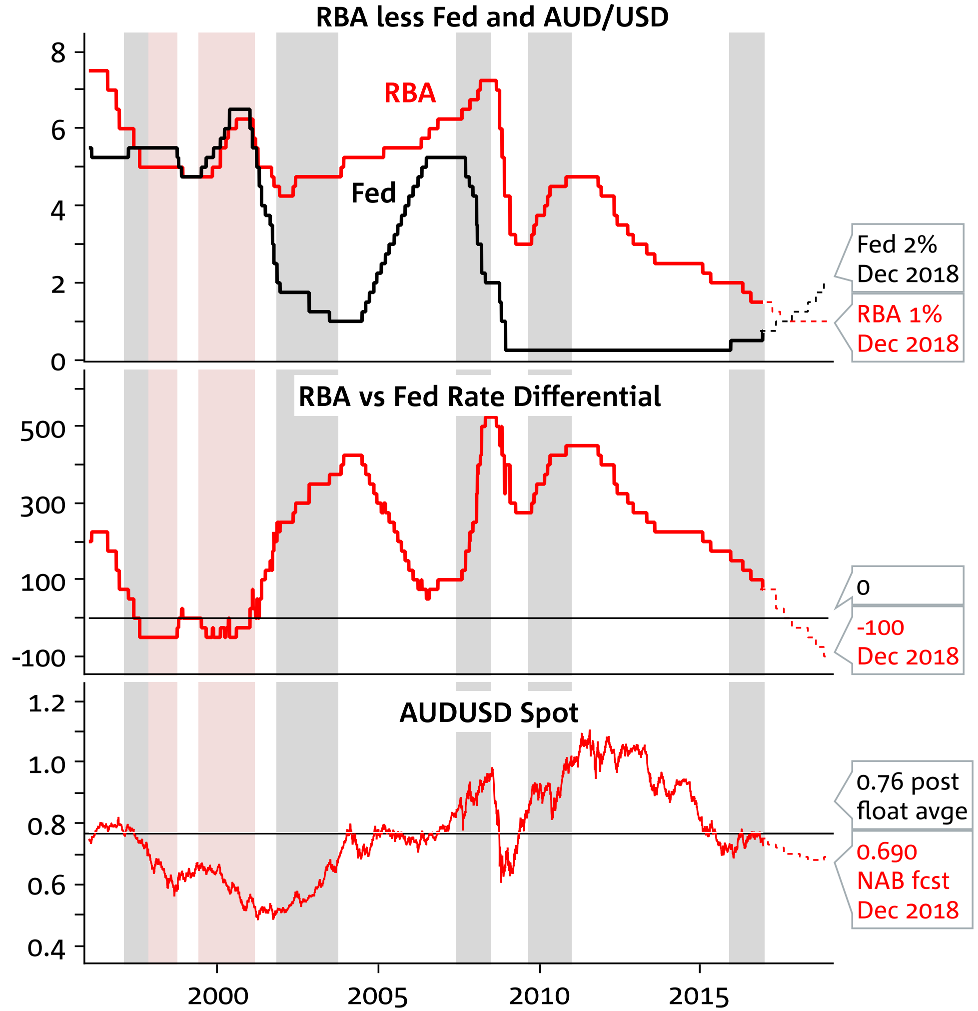


Source: National Australia Bank, Macrobond

#3 RBA below Fed poses downside risk for $A assets

Peter Jolly and Ivan Colhoun

- NAB Economists forecast the RBA cutting the cash rate during 2017 as the Fed continues to hike. The forecast has the RBA going from 75bps over the Fed to 25bps under by end of 2017, and 100bps under by end of 2018.
- The RBA and the Fed being on divergent policy paths is common. The current divergence is the fifth over the past two decades.
- More unusual is RBA cash being under Fed funds – although not unprecedented as this was the state of affairs for much of the period between mid 1997 and late 2000.
- The RBA being below the Fed is challenging for a current account deficit country like Australia that needs to attract substantial amounts of foreign capital each year. If the interest rate gap is no longer supportive, Australian assets may need to “cheapen” to attract foreign capital - either via a lower $A or wider Aus-US bond spread.
- When the RBA was below the Fed in the 1997-2000 period, Australian assets “cheapened” mostly via a lower $A - then AUD/USD traded between 0.50-0.75. Bonds also cheapened, as while the Aus-US cash rate spread was negative for long periods the 10 year bond spread rarely was.
- During 2017 we don’t expect $A to weaken anything like it did during the 1997-200 period – for one the terms of trade are higher now. Even so, a weaker AUD/USD is the clear bias and our forecast has it sub 70 cents. We again see relative weakness for Aussie bonds, with the already narrow Aus-US bond differential unlikely to narrow much even as the cash rate differential goes negative.



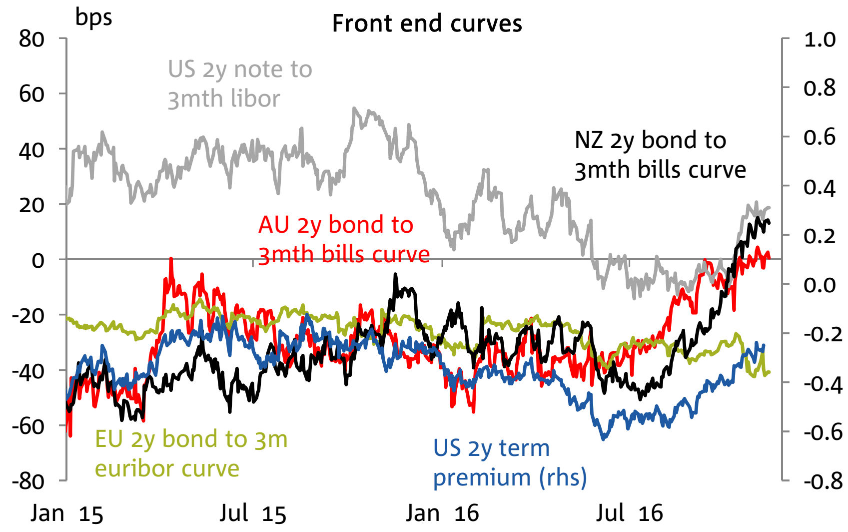
Source: National Australia Bank, Macrobond

Grey periods are where RBA and Fed on divergent paths and Pink is when RBA cash is below Fed Funds

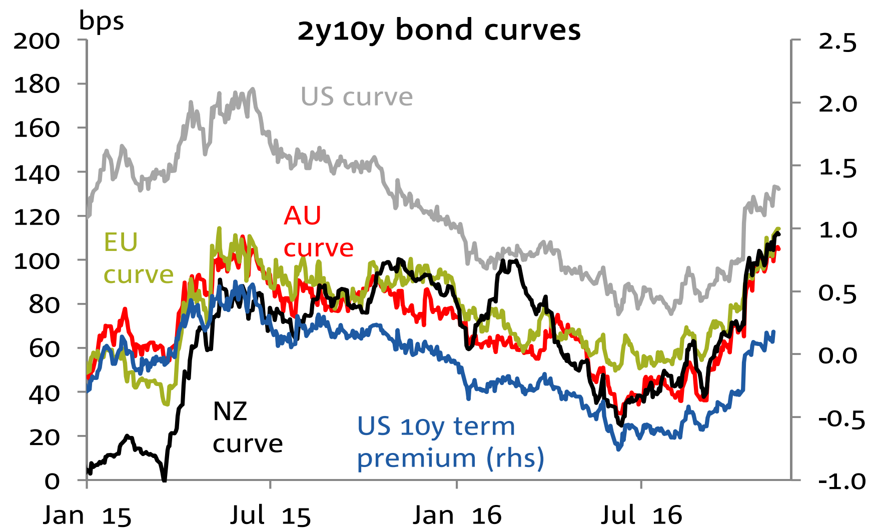
#4 Steeper yield curves

Skye Masters, Alex Stanley, and Kymberly Martin

- An improved growth outlook, shifting focus from monetary policy to fiscal policy (risk of increased sovereign bond supply), tapering by the ECB and ultimately re-pricing of the term premium has seen yield curves steepen since the post Brexit lows (in yields).
- There remains scope for further re-pricing in the term premium and so the bias for steeper curves will persist into 2017.
- The degree of steepening may vary across regions dependent on central bank action.
- Given the backdrop of higher yields in 2017 and NAB's view on the RBA (two rate cuts in 2017) curve steepening should be more pronounced in the AU curve. Across the AU curve, steepening pressure should be more pronounced in the broader curve vs the front end.
- For the NZ curve, steepening pressure will dominate in the early part of 2017, with flattening by the later part as the front of the curve increasingly prices the start of an RBNZ hiking cycle.
- As for the US curve, steepening will persist if the market deems the Fed is behind the curve but otherwise curve flattening should evolve as the front end reacts to the higher Fed funds rate and the longer end of the curve out-performs in any further push higher in yields.



source: NAB, Bloomberg

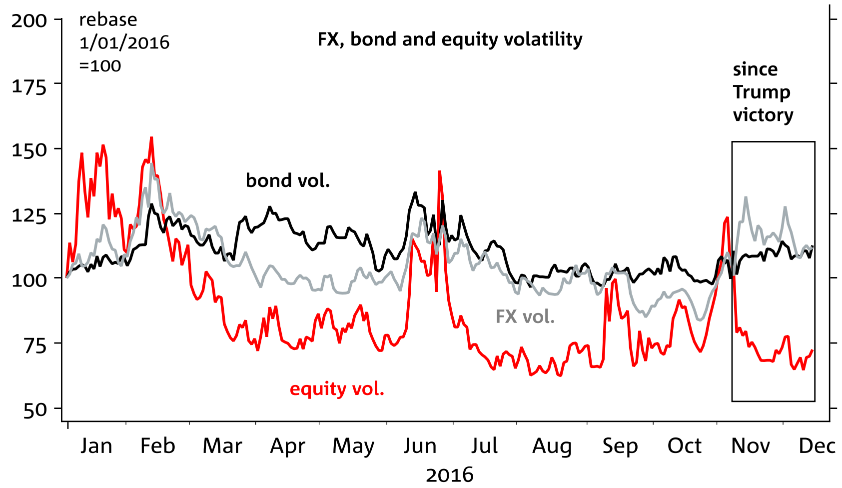


source: NAB, Bloomberg

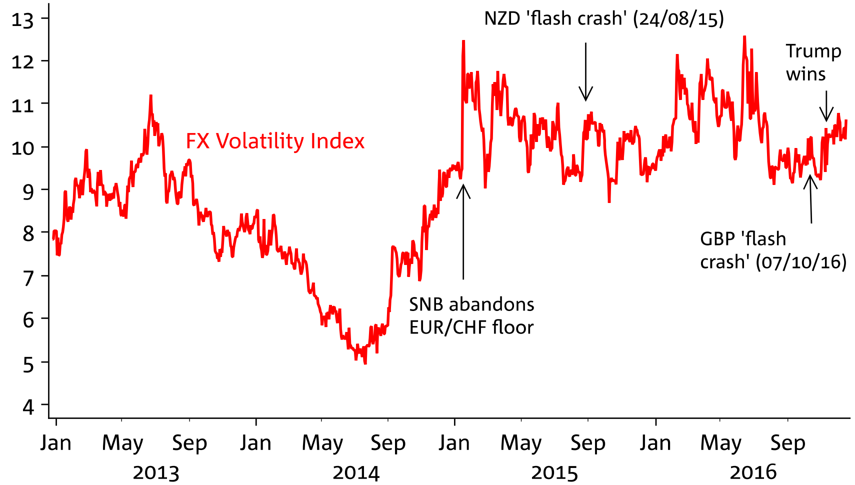
#5 Bond & FX Volatility up

Ray Attrill , Skye Masters and Alex Stanley

- Since Trump's election win, bond and FX vol. have risen while equity vol. has fallen. This divergence reflects a repricing for anticipated fiscal policy stimulus and higher inflation risk.
- This regime is likely to persist in 2017. A higher US inflation risk premium will drive higher bond vol. and higher bond vol. begets higher FX vol. with US yields set to remain the key USD FX driver in 2017.
- Some realignment between equity, bond and FX vol. is possible if a large enough sell-off in rates undermines stocks. Or, more likely, political risks drive periodic bouts of risk aversion that benefit bonds and safe haven currencies at the expense of stocks and higher yielding currencies (as in early 2016).
- FX volatility is on average 30% higher in the two years since the Jan 2015 SNB shock than the two years prior, since when there have been several other 'flash crashes'.
- These appear to partly reflect structural features of the FX market. The BIS, for one, notes that changes in the participation and behaviour of both sell-side and buy-side FX market participants appears to have implications for the functioning of the market, particularly during times of stress.
- To the extent these structural changes are permanent, one implication is that higher-yielding currencies should be weaker than otherwise in a structurally higher volatility environment.
- Fears of a US-initiated trade war may have contributed something to the rise in EM FX vol. If this fear becomes reality, it would add further to EM FX vol. with contagion to AUD and NZD vol.



Source: National Australia Bank, Macrobond

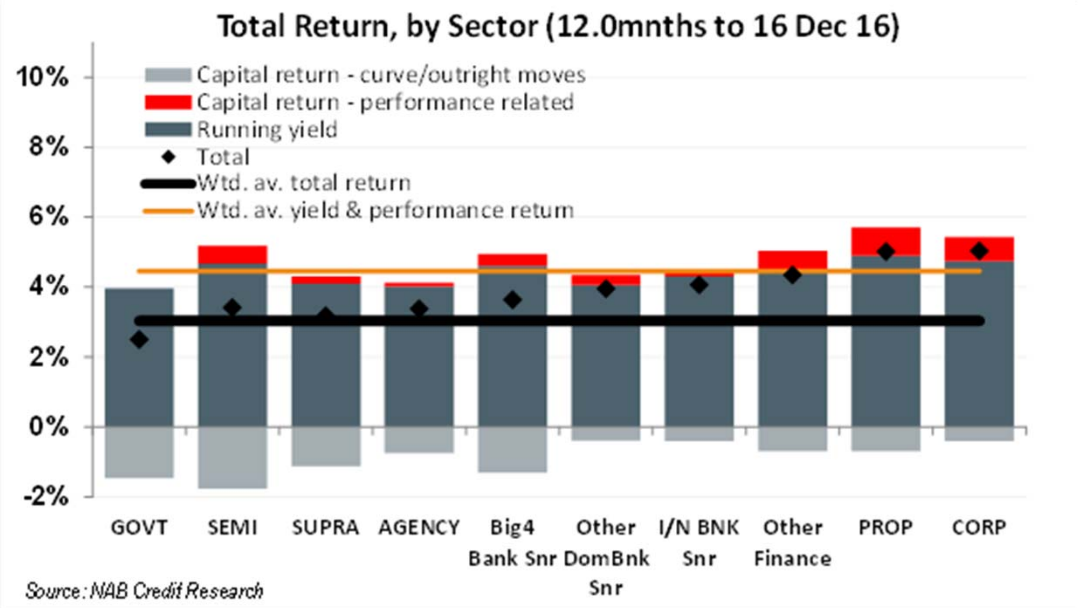


Source: National Australia Bank, Macrobond

#6 Credit market – sector picks

Michael Bush, Simon Fletcher, and Andrew Jones

- A higher running yield & shorter average duration, combined with positive capital returns, resulted in the non-FI corporate bond sector generating the best Australian fixed income returns in 2016.
- The same factors are expected to drive that sector's outperformance again in 2017 – but with rising idiosyncratic risks posing challenges.
  - **Overweight non-FI Corporates.** Limited supply & sound balance sheets – together with lesser direct exposure to some of the idiosyncratic risk events - will continue to place a tightening bias to Australian corporate spreads. Recovering credit fundamentals & credit rating upside will provide further potential upside for the Resources sector.

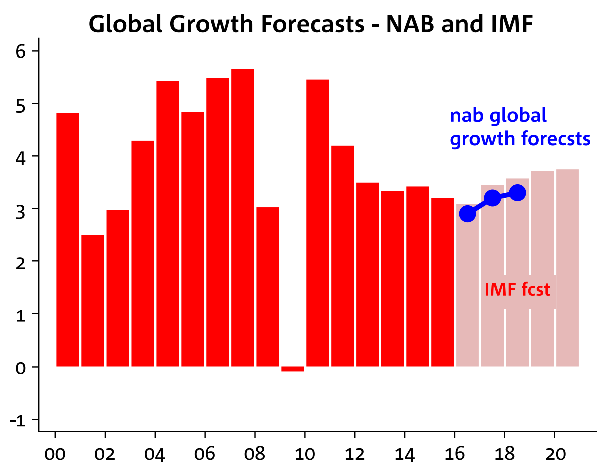


  - **Neutral Australian banks.** Australian banks still face credit ratings pressure – including from TLAC, a potential sovereign rating downgrade and/or a deteriorating stand-alone credit. But risks are not all one way. Positively, the major Australian banks are more pre-funded than is usual & supply may be lower than expected given modest asset price growth – this means that should general credit spreads widen the banks are in a solid position.
  - **Neutral US banks; underweight US corporates.** US banks face an uncertain 2017. A wind-back of regulation may be well received by equity holders, but may not be so positive for banks' credit profiles. The likelihood of rising rates, whilst offering some benefits to bank earnings, may also see rising stress on already stretched corporate balance sheets, resulting in rising default rates & deteriorating bank asset quality. A higher US$ will place added pressure on corporate earnings.
  - **Underweight European banks.** European banks (& SSAs) are facing an uncertain political landscape which threatens to impact investor appetite. European banks also face additional regulatory & balance sheet scrutiny. Those negatives though will be balanced by the extension of the ECB's QE programme, albeit with bond purchases at a reduced rate.

GLOBAL ECONOMY *Brighter growth signs and modest reflation*

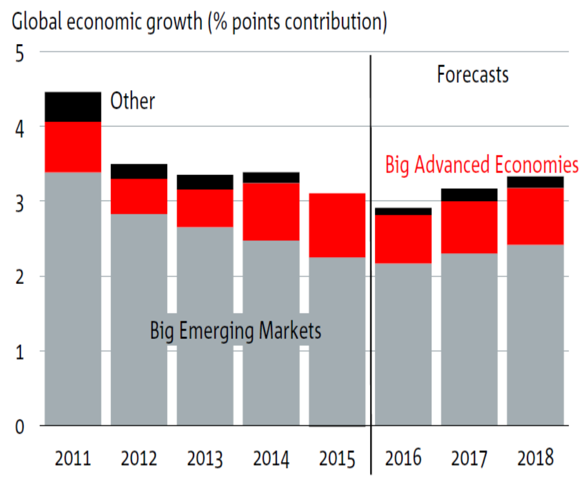
- The global economy has proved resilient. Growth has been declining since 2010 but we expect 2016 will be the low-point and look for a moderate growth recovery from 2017. Growth is likely to be concentrated in the US, China, and India.
- The problem of low inflation in advanced countries should ease and we expect inflation to rise modestly in 2017 as labour markets tighten in the likes of the US/Japan and commodity prices rise.
- The main risks to the forecast are 1) the high burdens of debt overhanging the big advanced and emerging market economies and 2) ongoing political uncertainty that could trigger more changes in economic policies – particularly in Europe during 2017.

GROWTH TO PICK UP



Source: National Australia Bank, IMF, Macrobond

CONTRIBUTIONS TO GROWTH



GLOBAL FORECASTS

Dec year	2014	2015	2016	2017	2018	20 Yr Avge
GDP						
Australia	2.7	2.4	2.3	2.4	2.5	3.4
New Zealand	3.8	2.5	3.4	3.2	2.4	3.0
US	2.4	2.6	1.6	2.1	2.4	2.6
Eurozone	1.1	1.9	1.6	1.5	1.6	1.5
UK	3.1	2.2	2.0	1.3	1.6	2.4
Japan	-0.1	0.6	1.0	0.8	0.6	0.8
China	7.3	6.9	6.6	6.5	6.3	9.2
India	7.0	7.2	7.4	7.5	7.5	6.6
World	3.3	3.0	2.9	3.2	3.3	3.5
Inflation						
Aus - Underlying	2.2	2.1	1.5	1.8	1.9	
NZ - CPI	0.8	0.1	1.4	1.7	1.9	
US - core pce	1.6	1.4	1.8	1.8	2.2	
Eurozone	0.4	0.0	0.3	1.1		
UK	1.5	0.1	0.7	2.5		
Japan	2.8	0.8	-0.2	0.5	IMF fcst	
China	2.0	1.4	2.1	2.3		
India	5.9	4.9	5.5	5.2		
Policy Interest Rates						
Australia	2.50	2.00	1.50	1.00	1.00	
New Zealand	3.50	2.50	1.75	1.75	2.50	
US	0.25	0.50	0.75	1.25	2.00	
Eurozone	-0.20	-0.30	-0.40	-0.40	-0.40	
UK	0.50	0.50	0.25	0.25	0.25	
Japan	0.00	0.00	-0.10	-0.10	-0.10	
China	5.51	4.30	4.35	4.10		

Source: NAB forecasts except for some inflation rates which are IMF's

See more detail of NAB's global forecasts see http://business.nab.com.au/the-forward-view-global-december-2016-19904/

Christy Tan, Julian Wee, and Group Economics

GLOBAL ECONOMY *China/EM growth a bit slower, inflation higher*

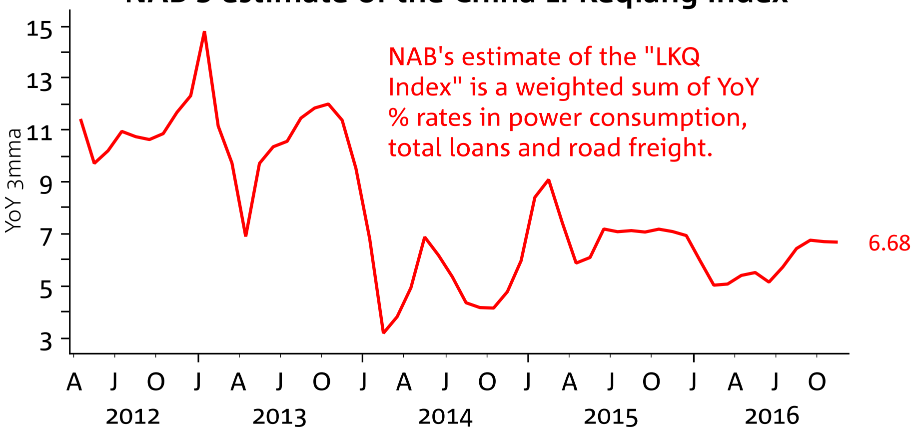
CHINA

- GDP growth looks on track for 6.7% this year and 6.5% in 2017, largely due to increased fiscal spending.
- A key question is whether the authorities are able to continue to limit their stimulus to “new economy” areas.
- Capacity reduction in steel and coal sectors must continue.
- Authorities to keep RMB stable against the CFETS basket, while allowing weakness against a strengthening USD.

EMERGING ASIA

- Our expectations are for inflation to accelerate but growth is still seen decelerating in 2017.
- China, India and the Philippines are expected to fare best with growth rates around 6%-7%.
- US-China trade relations will be key for both China and the region.
- South Korea and Thailand could see destabilising elections with Malaysia also possibly calling elections.

NAB'S estimate of the China Li-Keqiang Index



Source: National Australia Bank, Macrobond

Market sees inflation accelerating and growth slowing in 2017

Source: National Australia Bank, Bloomberg

Nick Parsons, Gavin Friend, and Group Economics,

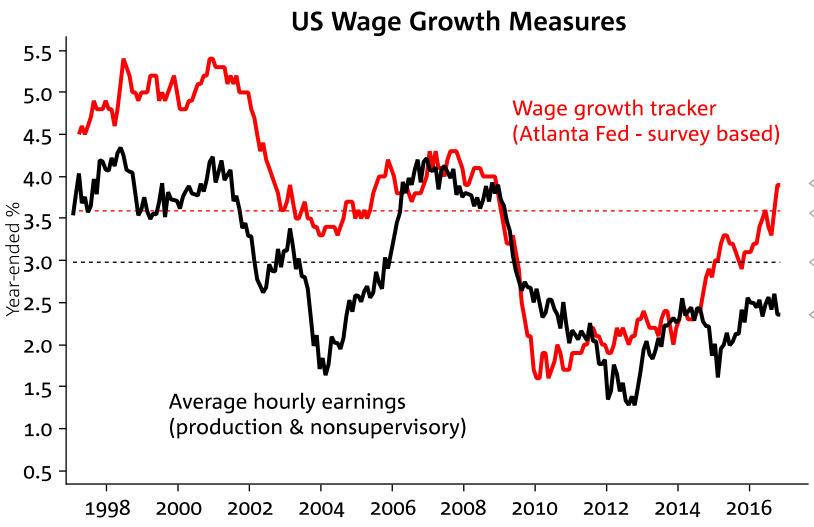
GLOBAL ECONOMY *making America great again as Europe lags*

UNITED STATES

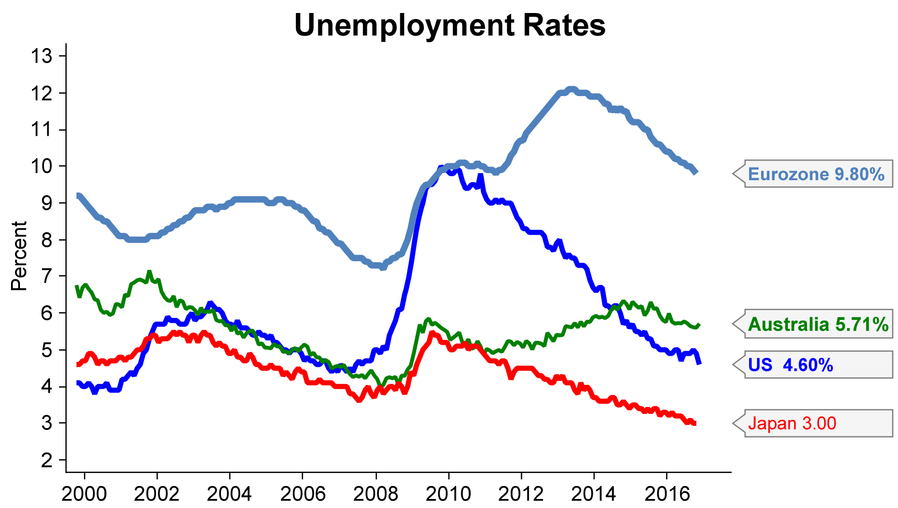
- The US economy remains on a solid footing. We now assume additional fiscal stimulus starting in the 2nd half of 2017 and have lifted our 2018 GDP growth forecast.
- Compared to the latest FOMC projections, NAB is more optimistic on the unemployment rate and a bit softer on inflation in 2017 but see it higher in 2018.
- The pace of Fed hikes in 2017 will depend on the weight the Fed places on having missed their inflation target for many years relative to concerns about 'getting behind the curve'.
- NAB looks for two Fed hikes in 2017. The FOMC consensus is now for three.

EUROPE

- The eurozone economy hasn't grown above 2% in any year since the GFC. The IMF, OECD and ECB all look for growth around 1.6% in both 2017 and 2018.
- CPI remains well below 2% target, so ECB will continue QE throughout 2017 and beyond.
- Political risk will be a major theme in 2017 with key elections in France, Germany, Netherlands and Italy.
- Risk of EU fragmentation remains elevated.



Source: National Australia Bank, Macrobond

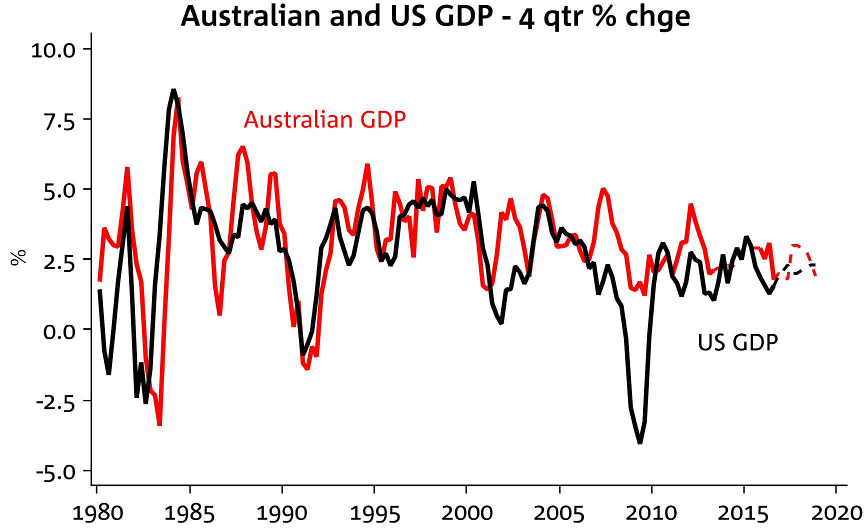


Source: National Australia Bank, Macrobond

AUSTRALIA *Managing transitions*

Ivan Colhoun, Tapas Strickland, and Group Economics,

- The Australian economy and the RBA and/or $A may run counter to the improving global tide in 2017 as the RBA needs to manage the transition associated with further falls in mining investment and a slowing in non mining activity. For 2018 that task gets more complicated as the construction cycle reverses and LNG exports flatten out.
- NAB expects the RBA to cut rates twice in 2017 as a result, even as the US continues to tighten.
- The recent jump in major Australian commodity prices is expected to partially reverse.

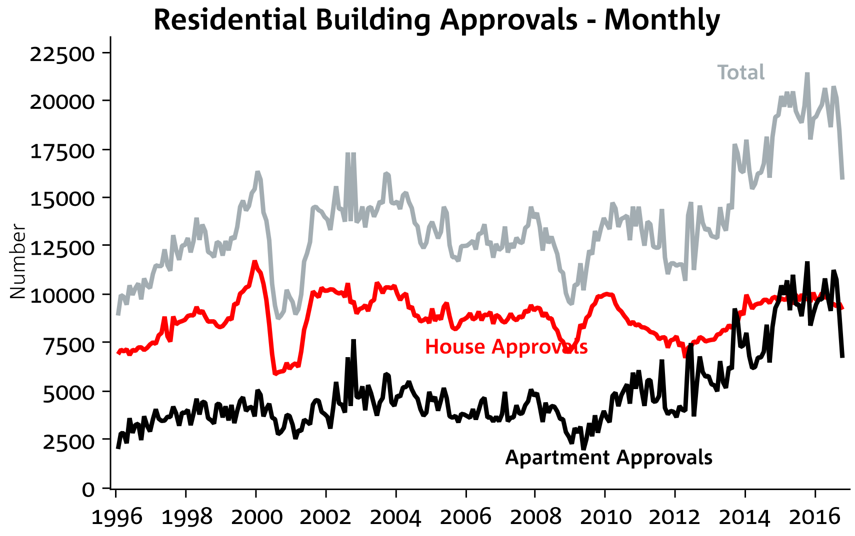


Source: National Australia Bank, Macrobond

ECONOMIC FORECASTS

yoy Dec % unless otherwise stated	2014	2015	2016	2017	2018
Household Consumption	2.6	2.9	2.4	2.3	2.0
Underlying Business Investment	-6.4	-12.4	-11.7	0.7	6.2
Residential Construction	8.3	9.5	7.7	2.1	-3.5
Underlying Public Spending	-1.2	4.0	3.5	2.6	2.7
Exports	7.4	5.5	7.2	9.8	4.5
Imports	-0.8	2.2	3.2	5.3	5.2
GDP total	2.4	2.6	2.0	3.0	1.9
CPI headline - ann %	1.7	1.7	1.7	2.4	2.3
CPI underlying - ann %	2.2	2.0	1.5	1.9	2.0
Unemployment Rate - %[2]	6.2	6.0	5.7	5.6	5.6
Terms of trade - ann%[2]	-10.9	-12.5	13.4	-4.2	-7.0
Current Account - % GDP[2]	-2.9	-4.8	-2.8	-0.3	-2.2
Fiscal Balance - % GDP[1]	-3.1	-2.4	-2.4	-2.2	-1.4
RBA Cash Rate - end year %	2.5%	2.0%	1.5%	1.0%	1.0%

1. June Qtr
2. Dec Qtr

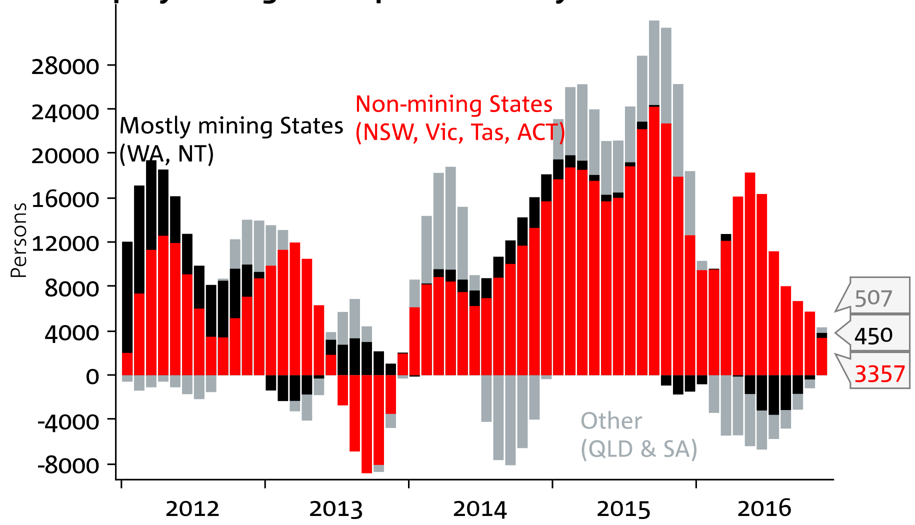


Source: National Australia Bank, Macrobond

AUSTRALIA *Focus on housing and labour market trends in 2017*

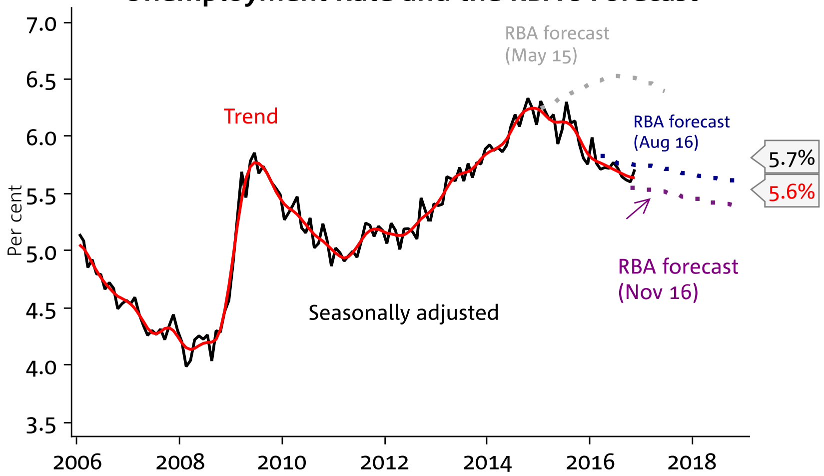
- The loss of momentum in non-mining is evident in employment growth.
- The trend for jobs growth in the non-mining states has slowed to just over 3,000 jobs per month, even as the loss in jobs in the mining states appears to have stabilised. If sustained, job creation of this magnitude would see the unemployment rate begin to rise quite soon.
- NAB's forecasts anticipate that the RBA will cut rates twice in 2017 to prevent unemployment rising in 2018 as housing construction slows. The housing cycle downturn that underpins this forecast is quite moderate. Apartment settlement failures – a risk factor that we are monitoring - could accelerate or deepen this development. Brisbane and Melbourne are the areas seen to be most exposed to this development.
- The path of the unemployment rate should be monitored closely to see that this forecast remains on track. To date, the unemployment rate has continued to trend slightly lower, recently due to a declining participation rate. Any rise in the unemployment rate would likely see the market quickly switch to the view that still easier financial conditions are required in Australia, even as the US raises rates. NAB's forecast sees this occurring via a combination of lower official rates and a lower $A.

Employment growth per month by state - trend terms



Source: National Australia Bank, ABS

Unemployment Rate and the RBA's Forecast

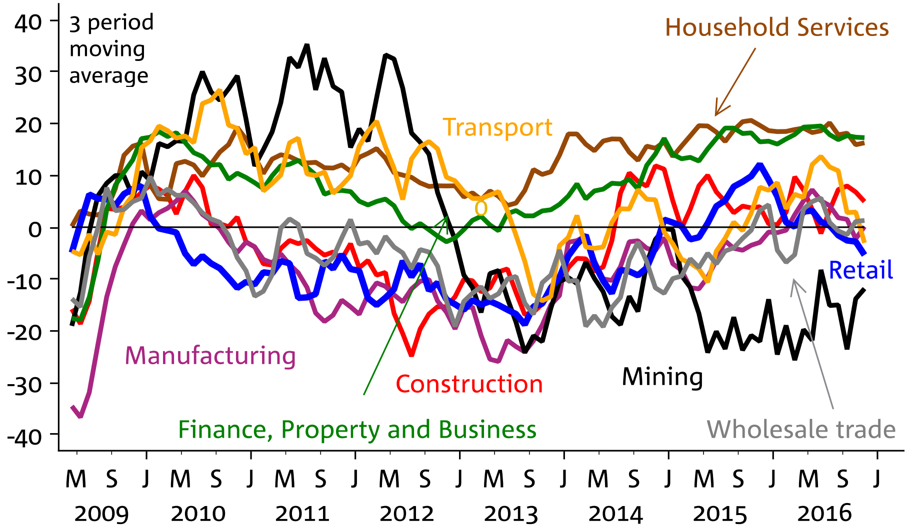


Source: National Australia Bank, ABS, RBA

AUSTRALIA *Recently, some loss in momentum in non-mining*

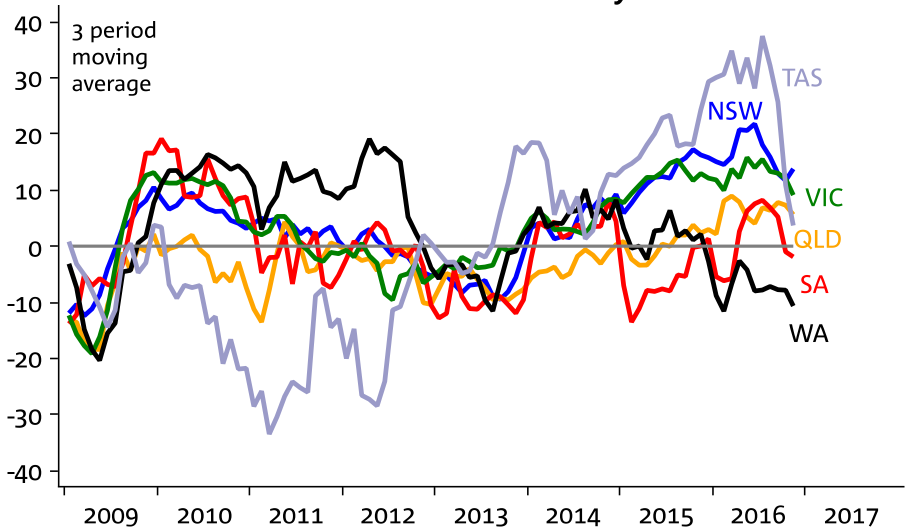
- More immediately, the non-mining economy has lost some momentum in recent months, even as prospects for the end of the mining downturn have strengthened due to sharply higher commodity prices. The latter are not expected to be sustained.
- Retail business conditions have been slowing since late 2015, while business conditions have slowed since around mid-year in Transport and Manufacturing and have eased slightly in Household Services and Finance, Property and Business.
- By state, business conditions remain weak in WA, and more importantly, have eased since mid-year in the larger non-mining states.
- The reasons for these slowing trends are not entirely clear. The moderation in retail is likely associated both with the weakness in WA and mining and recent slower growth in wages. The more recent slowing trends in a number of sectors and the non-mining states likely reflect a combination of political/geopolitical uncertainties (Brexit followed by the Australian and US elections), the lagged effects of lower commodity prices, slower US growth in late 2015 and the first half of 2016 and tighter credit conditions imposed by APRA and the banks on real estate investors and property developers.

NAB Business Conditions



Source: National Australia Bank, Macrobond

NAB Business Conditions by state



Source: National Australia Bank, Macrobond

NEW ZEALAND *Strength fosters inflation*

Stephen Toplis, Craig Ebert, and Doug Steel

- It seems almost inevitable that New Zealand's growth rate will slow.
- The question is what will drive that slowdown? Will it be because domestic demand softens or because capacity constraints become binding - or a combination of both?
- If the former, then inflationary pressures will moderate, the RBNZ will be very tardy in raising rates and the expansion will probably roll on for longer than would otherwise be the case.
- If the latter, then inflationary pressures may rise more quickly than generally expected resulting in the RBNZ being forced into raising rates more aggressively than many expect and growth eventually slowing faster.
- While our current view sees the cash rate on hold through 2017, and then rising fairly aggressively thereafter, we caution strongly that the higher growth, higher inflation and higher interest rate scenario is starting to look increasingly likely.

ECONOMIC FORECASTS

Dec yoy % unless otherwise stated	2014	2015	2016	2017	2018
Household Consumption	2.7	2.3	3.5	2.6	2.1
Government Consumption	2.7	2	1.4	1.4	1.2
Business Investment - ex intangibles	9.6	2.7	3.9	5.9	2.9
Residential Construction	14.6	5.9	15.4	12.8	9.2
Exports	3.1	6.8	3.3	3.2	3.4
Imports	7.9	3.6	3.4	4.6	3.8
GDP total	3.8	2.5	3.4	3.2	2.4
CPI headline - ann%	0.8	0.1	1.4	1.7	1.9
Unemployment Rate - %[2]	5.5	5	4.9	5.1	5.4
Terms of Trade - ann%[2]	-5.0	-3.2	4.5	3.7	-2.2
Current Account - % GDP[2]	-3.2	-3.4	-2.9	-2.3	-3.2
Fiscal - OBEGAL - % GDP[1]	-1.2	0.2	0.7	0.3	0.9
RBNZ Cash Rate - end year %	3.5	2.5	1.75	1.75	2.5

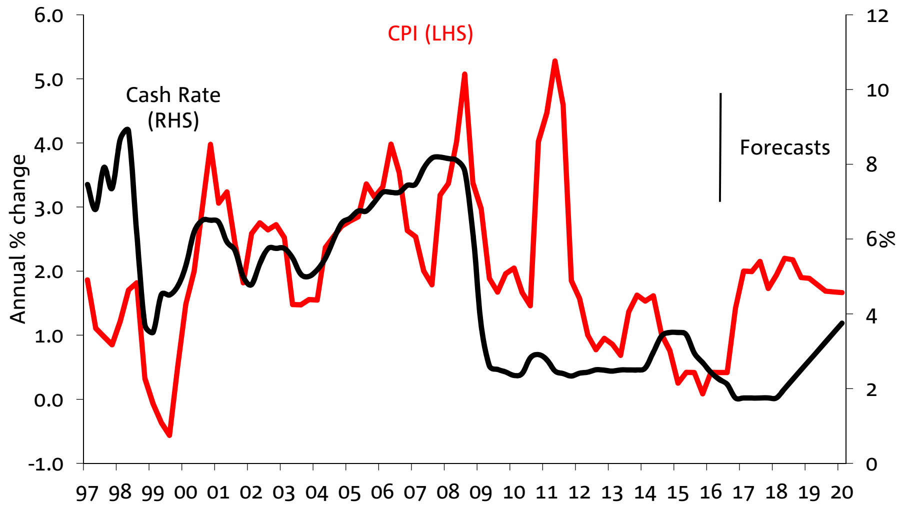
1. June Qtr

2. Dec Qtr

NEW ZEALAND *Strength fosters inflation*

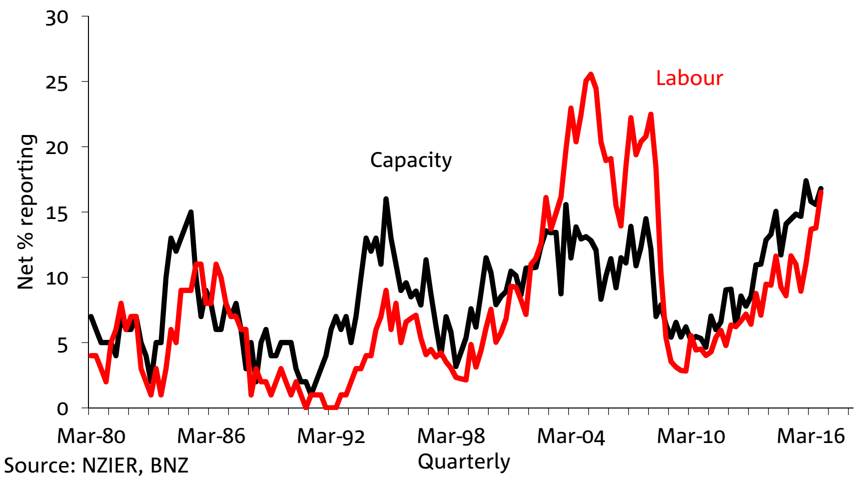
- The economic expansion is being driven by: very strong migration-driven population growth; soaring tourism exports; and, in turn, double-digit residential construction activity and solid private consumption growth.
- The expectation is that net migration moderates but this has been the case for some time and it's simply not doing so. Migration strength is putting a significant cap on wage growth but continues to exacerbate the excess demand for housing.
- Construction (including infrastructure) will be further bolstered by activity following the Kaikoura\Seddon earthquakes. The timing of the extra pressure on the construction sector couldn't be worse.
- Further bolstering activity will be the income gains accruing to the dairy sector as the payout looks set to rise even further.
- For the first time in a long time politics may play a role in the economic outlook as political uncertainty rises in the run up to what is expected to be a late-year General Election.

Consumers Price Index and the Cash Rate



Source: Statistics NZ, BNZ

Capacity Constraints to Higher Production



Source: NZIER, BNZ

FOREIGN EXCHANGE OUTLOOK *USD still the big daddy in 2017*

- Expectations of further yield spread widening (US vs majors) in 2017 support our view of a stronger USD. But the maturity of the USD cycle and the extent of the expected US yield back-up suggests double digit gains are unlikely (see slide 4).
- “Trump-onomics” – in its early phases at least – tilts the balance of US growth and inflation risks to the upside and with that risks that the Fed responds more aggressively to rising inflation pressures.
- EUR enters a new 98-108 range in 2017. EU politics is set to weigh on the EUR in H1-17, but we expect political concerns to fade in H2 and the prospect of ECB tapering in 2018 to become a tailwind for the currency at a time when the USD appreciation cycle may be near completion.
- On GBP, assuming Article 50 is invoked in early 2017 Brexit concerns/realities should erode business and consumer confidence and drag GBP/USD back to/through $1.20 in H2-17 , albeit aided by a stronger USD trend.
- A BoJ committed to its inflation target against a backdrop of higher US Treasury yields should see USD/JPY trending higher in 2017.

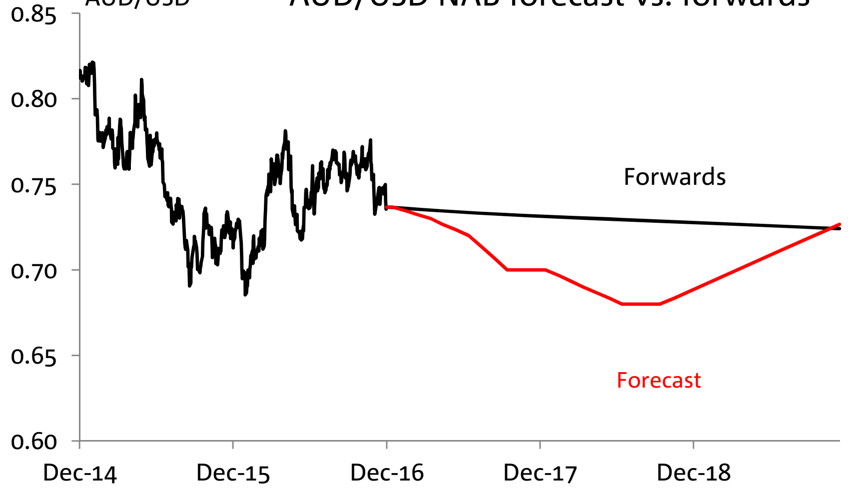
FORECASTS

	Mar-17	Jun-17	Sep-17	Dec-17
Majors				
AUD/USD	0.73	0.72	0.70	0.70
NZD/USD	0.70	0.68	0.67	0.67
USD/JPY	115	115	118	118
EUR/USD	0.98	1.00	1.02	1.04
GBP/USD	1.21	1.20	1.19	1.20
USD/CHF	1.05	1.06	1.06	1.06
USD/CAD	1.33	1.35	1.37	1.37
USD/CNY	7.20	7.24	7.18	7.17
Australian Cross Rates				
AUD/NZD	1.04	1.06	1.04	1.04
AUD/JPY	84	83	83	83
AUD/EUR	0.74	0.72	0.69	0.67
AUD/GBP	0.60	0.60	0.59	0.58
AUD/CHF	0.77	0.76	0.74	0.74
AUD/CAD	0.97	0.97	0.96	0.96
AUD/SGD	1.10	1.09	1.09	1.08
AUD/KRW	913	922	875	868
AUD/CNY	5.26	5.21	5.03	5.02
AUD TWI	64.0	63.5	61.8	61.6

FOREIGN EXCHANGE OUTLOOK *down but opposing AUD & NZD risks*

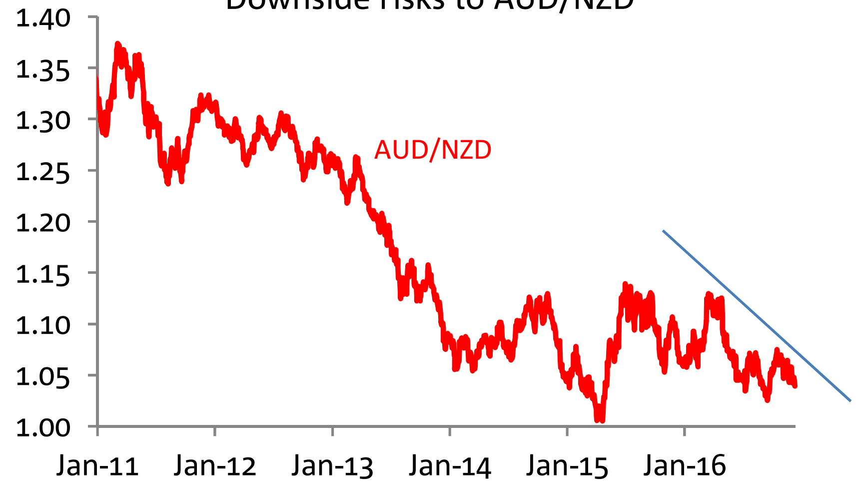
- USD strength in 2017 should take the AUD towards the 70c mark, but if the RBA cuts rates this would make a move sub 70 much more likely.
- Risks to our AUD outlook are tilted to the downside. If commodity prices give back all of their H2-16 gains and the Fed undertakes more than 2 hikes in 2017, then AUD risks ending next year closer to 65c than 70 cents.
- The balance of risk favours NZD/USD moderating next year, but the NZD is seen either holding its ground or rising in cross-rate terms.
- NZ domestic factors remain positive and although core inflation is seen on a mild upward trajectory, the market is likely to price in a rising chance of an H2-2017 tightening as the year progresses.
- Our base case is for AUD/NZD to trade through parity in 2018, but given that we are more positive on NZ's economic prospects relative to Australia, the risk is that this may happen sooner, rather than later.

AUD/USD NAB forecast vs. forwards



Source: NAB, Bloomberg

Downside risks to AUD/NZD



Source: NAB/BNZ, Bloomberg

FOREIGN EXCHANGE OUTLOOK *Weaker EM Asia*

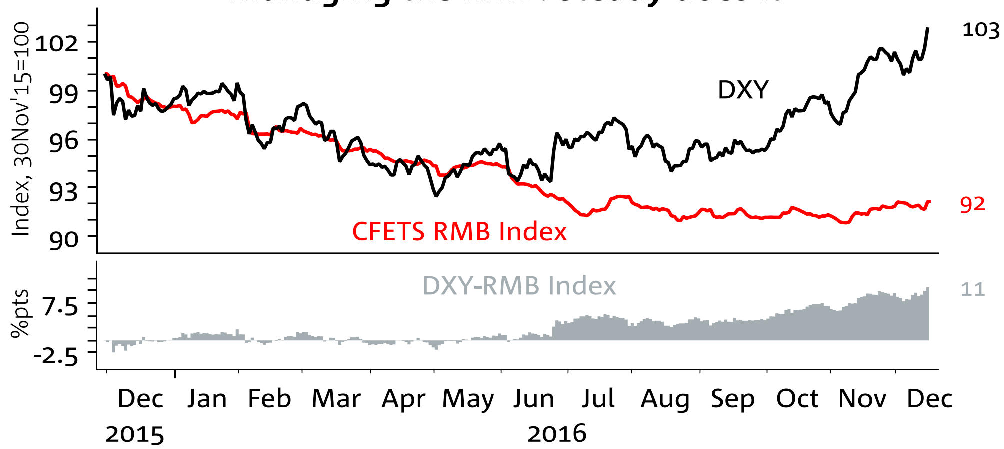
Julian Wee

- USD/Asia is expected to trend higher on the back of both higher interest rates and a stronger US dollar.
- Diverging monetary policy is another reason for higher USD/Asia – China, India, Korea and Malaysia are expected to cut rates in 2017.
- USD/CNY could be one of the strongest regional risers in H1 2017 if there is an outbreak of US-China trade tensions after the new US administration takes office. USD/CNY could head above our current 7.24 mid 2017 forecast.
- The CNY will likely be kept stable against the CFETS basket, which means appreciation against the non-USD portion of the basket, especially the EM sub-section.
- USD/SGD is likely to be the most sensitive to the expected USD/CNY moves, reaching a high of 1.55 in H2 2017.
- The USD/MYR looks to also be strongly upwardly biased given lacklustre fundamentals and inadequate FX reserves. Political uncertainty will add to the upward pressure.
- South Korea is likely to see elections in 2017, which will keep the USD/KRW supported.
- The INR and PHP are seen as regional outperformers due to strong domestic growth and better BoP fundamentals, assuming no outbreak of political uncertainties.

FORECASTS

	Mar-17	Jun-17	Sep-17	Dec-17
USD/CNY	7.20	7.24	7.18	7.17
USD/IDR	14000	14100	14200	14100
USD/INR	69.0	69.0	68.5	68.2
USD/KRW	1250	1280	1250	1240
USD/MYR	4.65	4.75	4.85	4.85
USD/PHP	50.5	51.0	51.5	51.0
USD/SGD	1.50	1.52	1.55	1.55
USD/THB	36.5	37.0	37.5	38.0
USD/TWD	33.3	33.6	33.5	33.4

Managing the RMB: Steady does it



Source: National Australia Bank, Macrobond

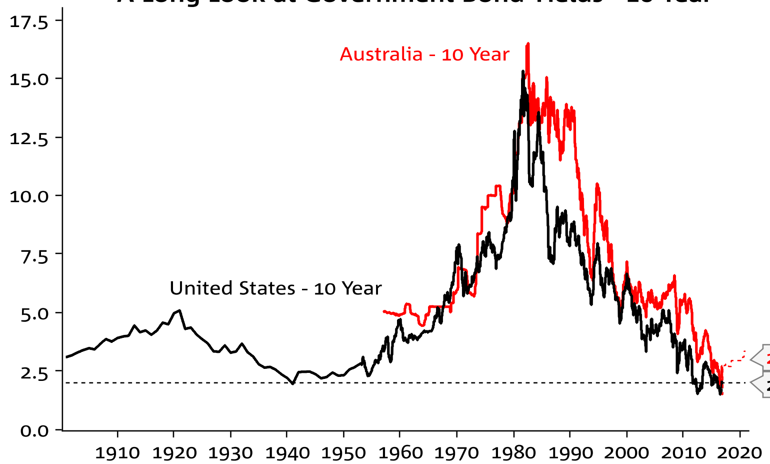
FIXED INCOME AND INTEREST RATES *Decline in yields comes to an end*

- The more than three decade long decline in bond yields likely ended in 2016 as inflation stopped falling and monetary policy in Europe and Japan found the limits of negative rates and QE.
- Bond yields have already risen and for the longer end of the curve a lot of good news is priced.
- While our bond forecasts show a flat profile in 2017 the mix of events in the year ahead suggest that ranges will be wide and we would not be surprised to see UST10s testing 3% in H1-17.
- In a broader context, with Fed funds forecast to peak at 2.5% in 2019, UST10s are not expected to spend an extended period above 3%. Risks are to the upside though as our Fed fund forecasts do not yet reflect potential fiscal stimulus.

FORECASTS

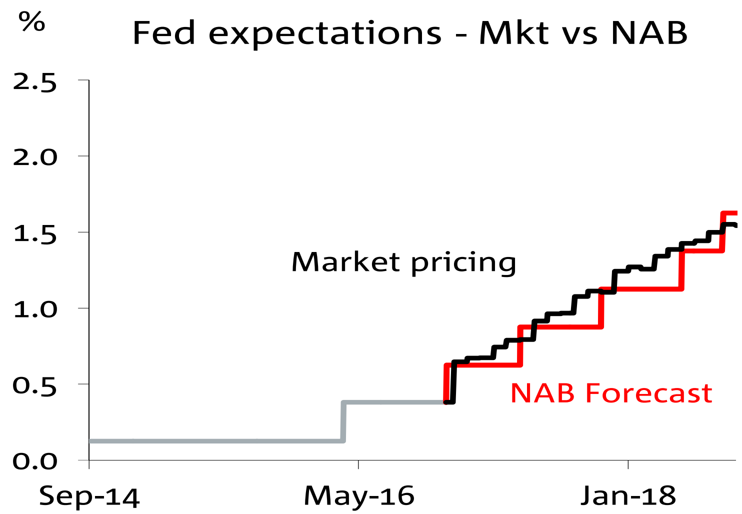
	20-Dec	Mar-16	Dec-16	Mar-17	Jun-17	Sep-17	Dec-17
Aust rates							
RBA Cash rate	1.50	*2.00*	*1.50*	*1.50*	*1.25*	*1.00*	*1.00*
3 Year Swap Rate	2.19	*2.0*	*2.1*	*2.1*	*2.0*	*2.0*	*2.1*
10 Year Swap Rate	3.08	*3.0*	*2.9*	*3.0*	*3.0*	*3.0*	*3.0*
Offshore Policy Rates							
US Fed funds	0.75	*0.50*	*0.75*	*0.75*	*1.00*	*1.00*	*1.25*
ECB deposit rate	-0.40	*-0.40*	*-0.40*	*-0.40*	*-0.40*	*-0.40*	*-0.40*
BoE repo rate	0.25	*0.50*	*0.25*	*0.25*	*0.25*	*0.25*	*0.25*
BoJ excess reserves ra	-0.10	*-0.10*	*-0.10*	*-0.10*	*-0.10*	*-0.10*	*-0.10*
RBNZ OCR	1.75	*2.25*	*1.75*	*1.75*	*1.75*	*1.75*	*1.75*
China 1yr lending rat	4.35	*4.10*	*4.35*	*4.10*	*4.10*	*4.10*	*4.10*
10 Year Benchmark Bond Yields							
Australia	2.86	*2.8*	*2.70*	*2.75*	*2.80*	*2.75*	*2.70*
United States	2.56	*2.0*	*2.30*	*2.40*	*2.50*	*2.50*	*2.50*
New Zealand	3.42	*0.0*	*3.10*	*3.25*	*3.30*	*3.35*	*3.30*

A Long Look at Government Bond Yields - 10 Year



Source: National Australia Bank, Macrobond

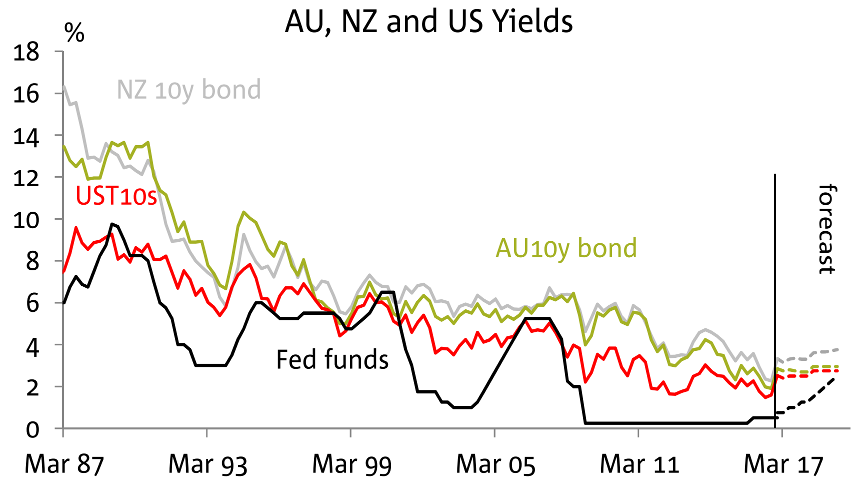
Fed expectations - Mkt vs NAB



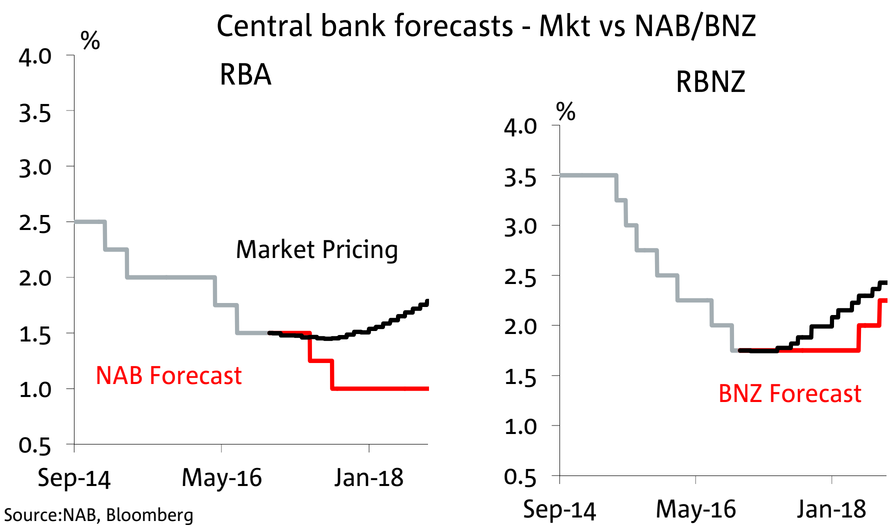
source: NAB, Bloomberg

FIXED INCOME AND INTEREST RATES *Steeper yield curves into 2017*

- Higher US treasury yields will maintain upward pressure in AU and NZ rates, but compared to history the expected move is modest and the lower for longer theme continues.
- Domestic fundamentals should support the front end of AU and NZ rates and trading opportunities are opening as we see the market mis-pricing both the RBA and the RBNZ.
- Into 2017 we look for tactical opportunities to trade against premature pricing of the start of RBNZ hikes, or under-pricing of the full hiking cycle. Strategically we look to enter long or received positions in the AU curve ahead of expected RBA rate cuts.
- The backdrop of upward pressure on global yields and domestic fundamentals will maintain steepening pressure in both the AU and NZ yield curves into 2017 (as discussed in the Themes section).
- The AU 3y10y curve is expected to spend an extended period of time above 100bps in 2017 with risk of 150bps being tested if US 10y Treasury yield is breaking above 3% at a time when the RBA is easing.
- The NZ 2y10y curve is expected to trade up to at least 125bps in H1-17 before flattening later in 2017 as the market focuses on the imminent start of an RBNZ hiking cycle.



Source: NAB, Bloomberg

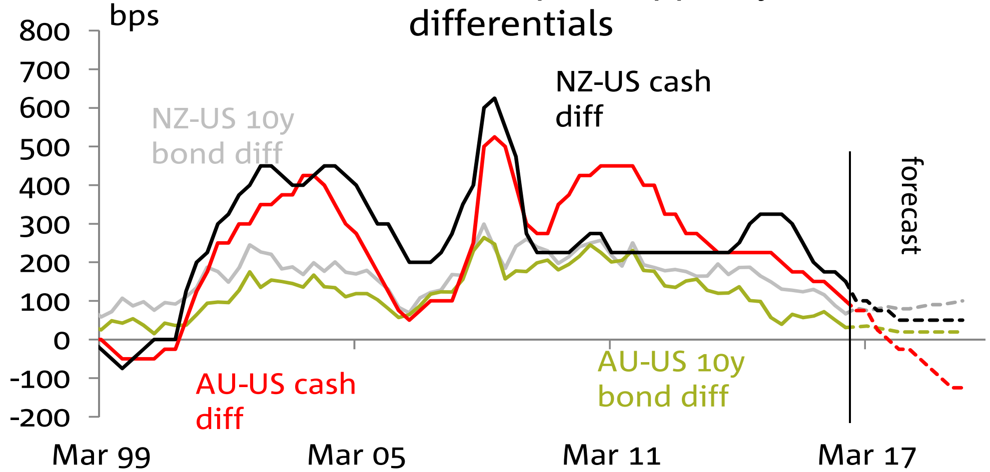


Source:NAB, Bloomberg

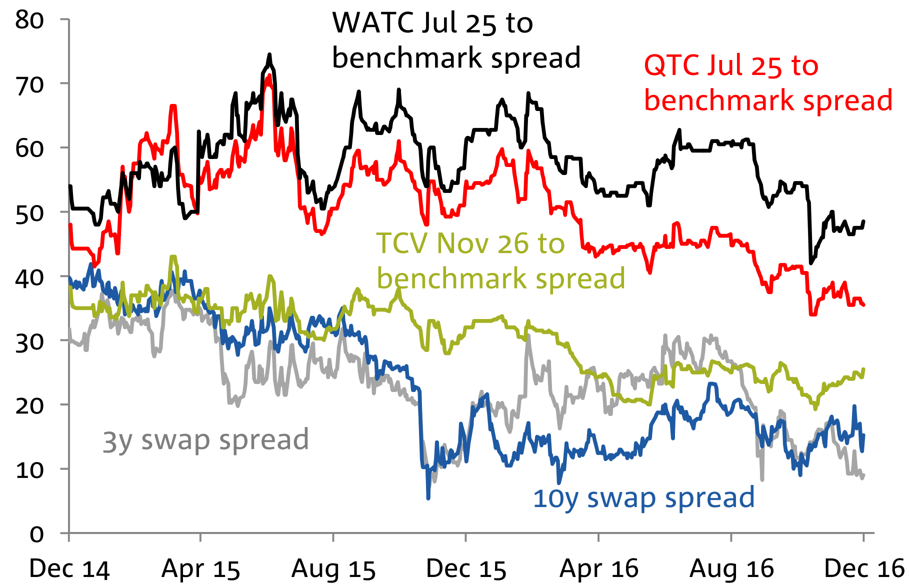
FIXED INCOME AND INTEREST RATES *Spreads remains tight*

- The fundamental backdrop should be supportive to AU and NZ rates with tighter cash differentials in 2017 resulting in unchanged to tighter yield differentials further out the curve.
- This will be most pronounced in the Australian curve where we see AU cash rate trading below Fed funds in late 2017. Weighing on AU bonds will be supply and the risk of moderating offshore demand as the yield pick up becomes less appealing, while AUD is under pressure. For now we see the AU-US 10y differential struggling to break below 20bps and in H1-17 would trade a range of around 20-45bps.
- NZGBs should be supported by limited debt issuance, a favourable yield pickup over peers and contained downside risk to the NZD. We look to trade a range of 60-100bps on NZ-US 10y differential.
- The NZ-AU cash differential points to AU bonds out-performing NZ through 2017.
- While higher yields and steeper curves will create increased hedging activity from corporates, in Australia the cash rate profile should mean it is fairly modest leaving swap spreads largely range bound (ie 8-25bps).
- Bond supply dynamic and range bound swap spreads should maintain narrowing pressure in semi-spreads. Given current levels, we favour longer dated non AAA semis.

Fudamental backdrop to support yield differentials



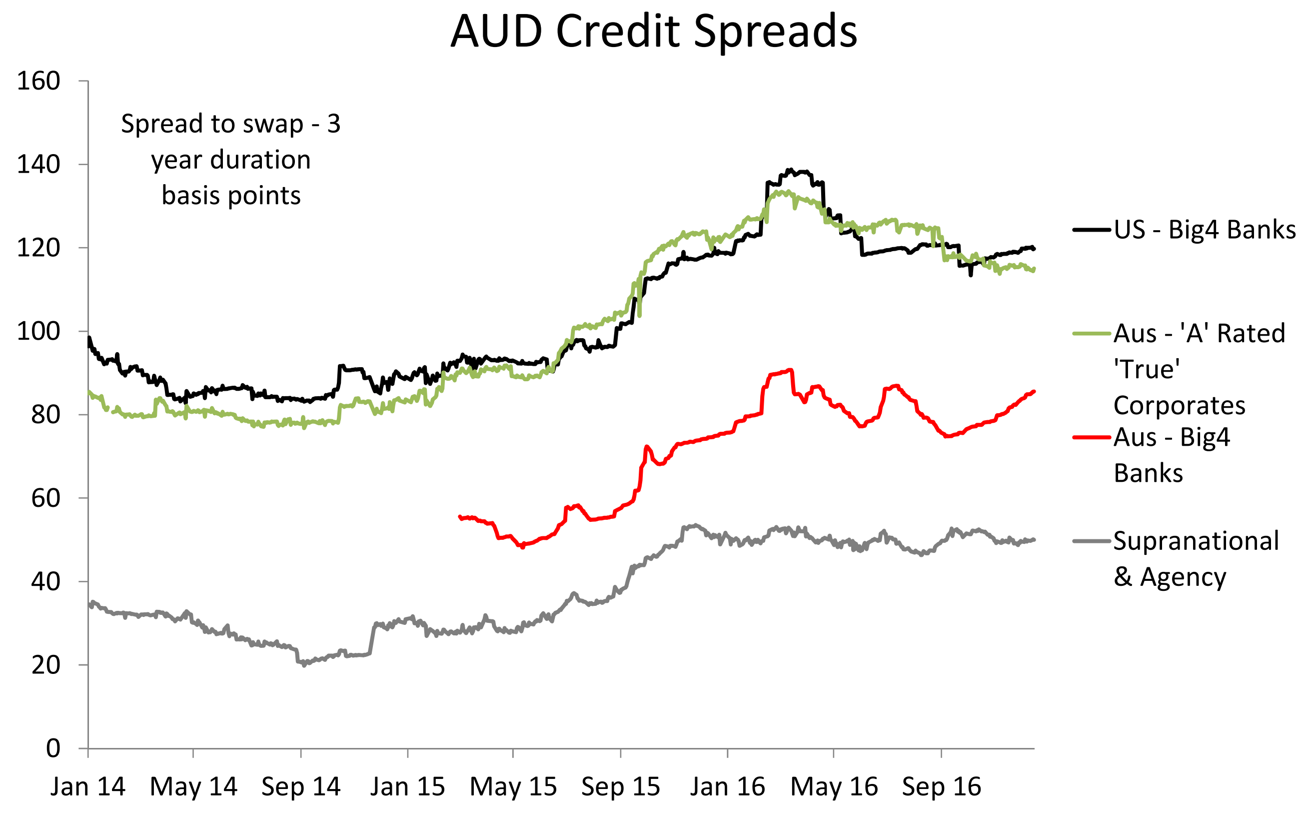
Source: NAB, Bloomberg



source: NAB, Bloomberg

CREDIT MARKETS *Idiosyncratic risks challenge solid outlook.*

- Australian corporate credit spreads are expected to trade across a wider range in 2017. Increasingly, investors are considering rising idiosyncratic events and 'fat tail' positioning.
- Spreads across some of the more liquid sectors are already around the wides seen in 2016 and are likely to push wider in coming months as the pressure from rising US interest grows. Nevertheless, global investor appetite remains both solid and also partly unfulfilled. While that is unlikely to change through 2017 and will provide tightening pressure, those same tensions had existed through most of 2016 (and before US rate rise expectations grew) and it's unlikely that the tight levels of 2016 will be breached in the coming year.



Source: NAB Credit Research Indicies

- A higher running yield & shorter average duration, combined with positive capital returns resulted in the non-FI corporate bond sector generating the best Australian fixed income returns in 2016. The same factors are expected to drive that sector's outperformance again in 2017 – but with rising idiosyncratic risks posing challenges.

CREDIT MARKETS *Fattening tails in 2017*

Potential Bearish Drivers

Global:

- Political uncertainty - Europe (& US?)
- Protectionism, trade wars & currency manipulation
- Chinese hard landing
- Rising US rates ...
  - ➢ Rising corporate bond supply
  - ➢ Stressing stretched US (mainly) corporate balance sheets...
  - ➢ Rising corporate defaults
  - ➢ US bank asset quality concerns
- US capacity pressures and rising labour costs.
  - ➢ Pressure on US corporate earnings (from rising labour costs & ↑US$) & stretched balance sheets having limited capacity to absorb cash flow stress
- Rewound bank regulation & a return to more aggressive bank business models

Australian:

- Sovereign downgrade
- Housing market weakness

Potential Bullish Drivers

- Surging US economic growth, supported by Trump
- A wind-back of US rate rise expectations
- Strengthening Chinese growth
- Status quo returning to European politics
- Strengthening European recovery
- US corporate tax cuts flow through to increased earnings & debt reduction
- Strong investor appetite maintained, with limited bond supply (&/or increased ECB QE)

'Base Case'

Global:

- Reasonable level of US economic growth (2-2½%)
- Solid China growth (>6%)
- Ongoing discipline of corporate capital deployment
- Stabilising global default rates (US lower on reduced oil & gas defaults)
- ECB QE extended as announced (€60bn /pcm April-Dec 2017)

Australian:

- Apartment market soft landing

Spread Widening ⟷ **Spread Tightening**

CREDIT MARKETS *Global bank regulatory push enters its end-phase*

AN END TO REGULATORY CHANGES?

- The post-crisis regulatory-push enters its end-phase.
- Basel Committee is on-track for finalising global framework by early 2017. Increased capital requirements unlikely in the main.
- APRA to spend 2017 'consulting' on Australia's application of remaining Basel Committee proposals:
  - Standardised Credit Risk (SA-CCR) & Capital Floors.
  - Operational Risk, Interest Rate Risk in Banking Book.
  - Leverage Ratio, Total Loss Absorbing Capacity (TLAC).

AUSTRALIAN BANK OUTLOOK

- Modest funding requirement in 2017 - the major banks are more pre-funded than is usual & supply may be lower than expected particularly if asset growth remains modest.
- Banks remain under longer-term ratings pressure due to: 1) a potential sovereign downgrade, 2) rising systemic concerns around housing; 3) and a probable resolution regime.
- The biggest ratings risks in 2017 are posed by resolution regime announcement and/or a sovereign downgrade, although in both case this would have limited funding and pricing impacts give the base case for many investors is for a one-notch downgrade in 2017.

EUROPEAN & UK BANK OUTLOOK

- Divergent BRDD implementation attempted to be resolved by EU with eventual Tier 3 route for all.
- France, Spain, Sweden, Holland & Denmark to issue.
- Germany & Italy to re-think subordinating senior.
- UK & Switzerland printing HoldCo debt for TLAC.
- Bad loans, bad strategies, bad economies and bad performances apply variably to all European banks.
- French bank Tier 3 to outperform (in time).

US BANK OUTLOOK

- US banks ready to add to current advantages v peers.
- Well ahead of the global regulatory curve.
- Conduct fines largely completed for all.
- Significant regulatory unwinding from Trump admin is, in our view, difficult and unlikely. At *worst*, it happens but is only credit neutral / mildly negative.
- While almost every other global bank has retreated to core/home markets, the US banks retained global presences and are primed to capitalise on reduced competition.

National Australia Bank

bnz

COMMODITIES *Bulk resource prices to ease; better NZ dairy prices*

- Notable this year has been the vigorous step up in the bulk prices, iron ore and coal. The RBA's bulk commodities spot price index has more than doubled this year (+145.3%) lifting the RBA's export commodity price index by 38.3%, supporting the terms of trade. Iron ore and thermal coal prices have doubled from their lows; met coal prices have quadrupled.
- Producing a "perfect storm" for prices has been a combination of lower China and global coal supply and solid Chinese economic growth and specifically steel demand. Supply shortfalls seem likely to ease to an extent.
- Some price moderation lies ahead. Even so, the terms of trade is no longer restricting growth. RBA forecasts foresee the terms of trade shifting from a "*substantial headwind …. to a slight tail breeze*".
- Australia's terms of trade is forecast to rise in 2016-17 by 13.5% but then ease by 5.1% in 2017-18.
- Across the Tasman, the **NZ** dairy outlook is much stronger than the past two very weak years. Wholemilk powder (WMP) prices are expected to average around US$3,300/T in 2017, significantly higher than the circa US$2,500/T achieved in 2016.

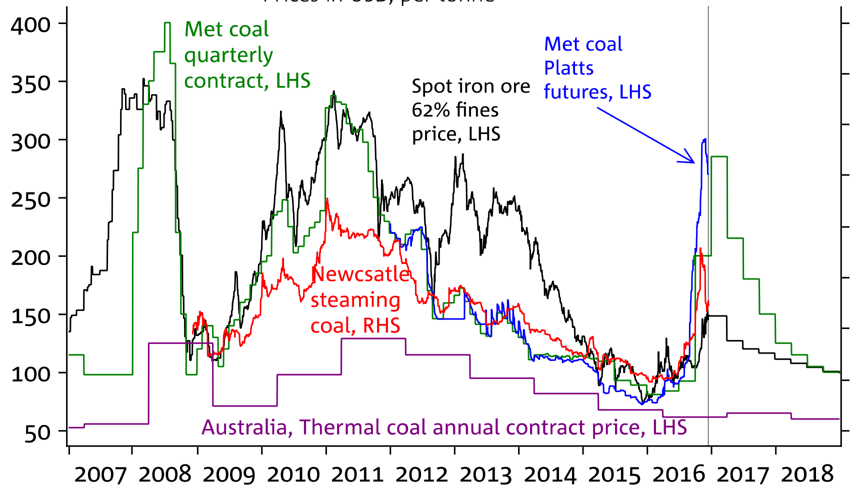
Commodity prices ($US)

	Current spot	Mar-17	Jun-17	Dec-17	Jun-18
WTI oil	51.9	*51*	*52*	*55*	*57*
Iron ore	81.2	*69*	*65*	*60*	*56*
Hard coking coal	270	*285*	*215*	*150*	*115*
Thermal coal	86.2	*62*	*65*	*65*	*60*
Gold	1141	*1150*	*1130*	*1060*	*1010*
Copper	5487	5200	5180	5180	5210
Aus LNG (*)	9.14	*7.20*	*7.55*	*8.03*	*8.66*
NZ WMP (**)	3593	*3600*	*3300*	*3100*	*3000*

Hard coking coal is quarterly contract price; thermal coal is Japanese fiscal year contract.
(*) Implied Australian LNG export prices; "spot" shown is JLNG price converted to $A.
(**) Wholemilk powder; "spot" shown is average of forwards to 6m.

Iron ore and coal prices

Prices in USD, per tonne



Source: National Australia Bank, Macrobond

COMMODITIES *Chinese steel demand key; supply rises to moderate prices*

IRON ORE

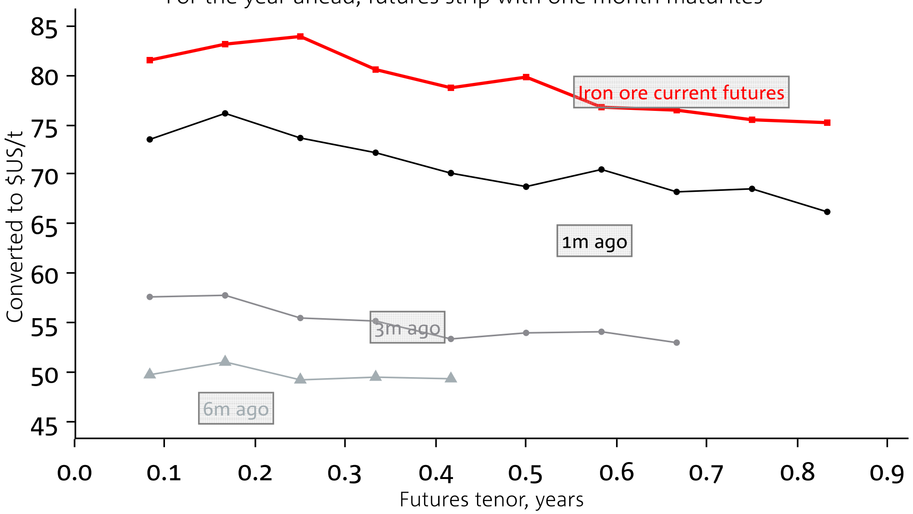
- Chinese steel demand will likely be key, though the unclear extent of US infrastructure spend could play a part.
- Recent Chinese policy measures have been taken to slow the growth in property prices. Early signs suggest that the property market may be slowing, flowing into weaker construction activity and steel demand.
- NAB's forecast is that the iron ore price will ease to between $60-69/t in 2017.

COAL

- After cutting production this year, China has recently eased production restrictions to cool coal prices.
- Lower Chinese coal supply has especially supported metallurgical coal prices that have spiked to as high as ~$300/t. Thermal coal prices have also been strong, more than doubling to over $80/t.
- NAB's forecast is that met coal quarterly contract prices will ease from Q1 '17's $285/t to $150/t by Q4.

Dalian iron ore futures

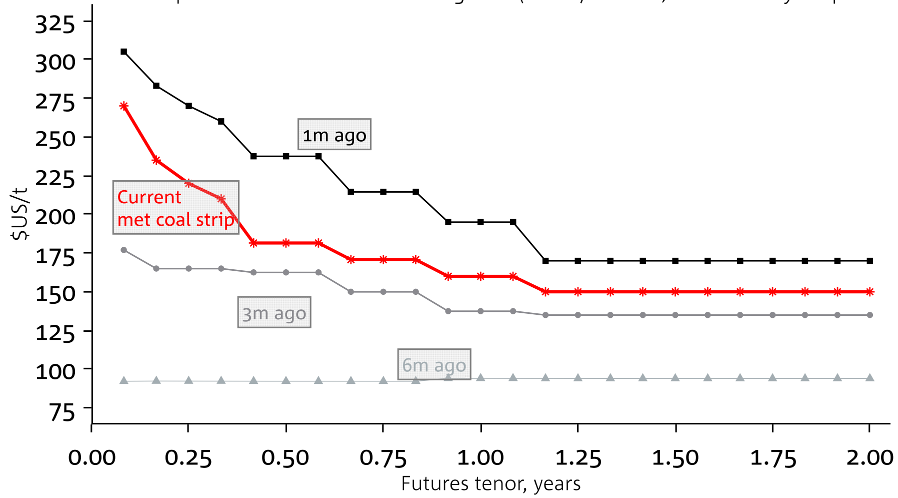
For the year ahead, futures strip with one month maturites



Source: National Australia Bank, Macrobond

Met coal futures

Australian premium low vol hard coking coal (Platts) futures, 1m maturity strip



Source: National Australia Bank, Macrobond

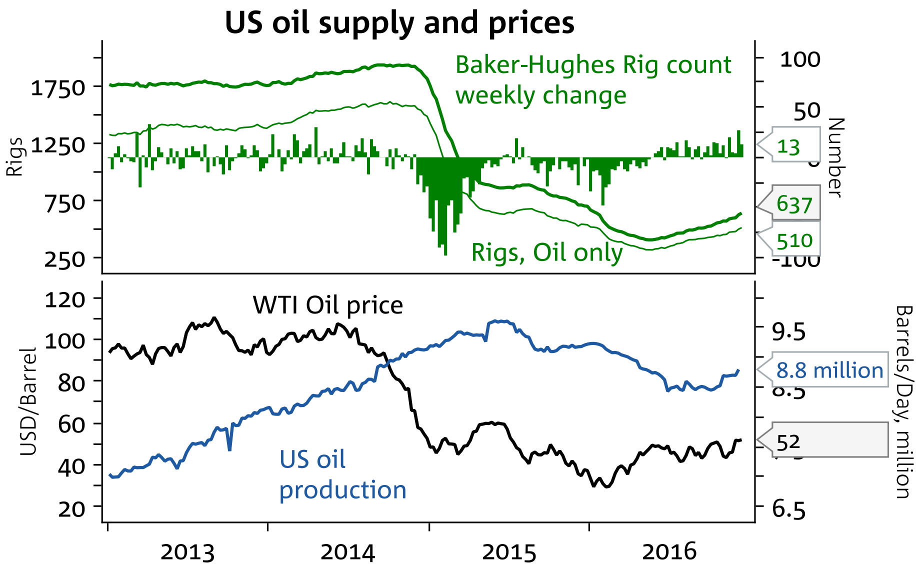
COMMODITIES *Oil higher for now; dairy outlook has improved*

OIL

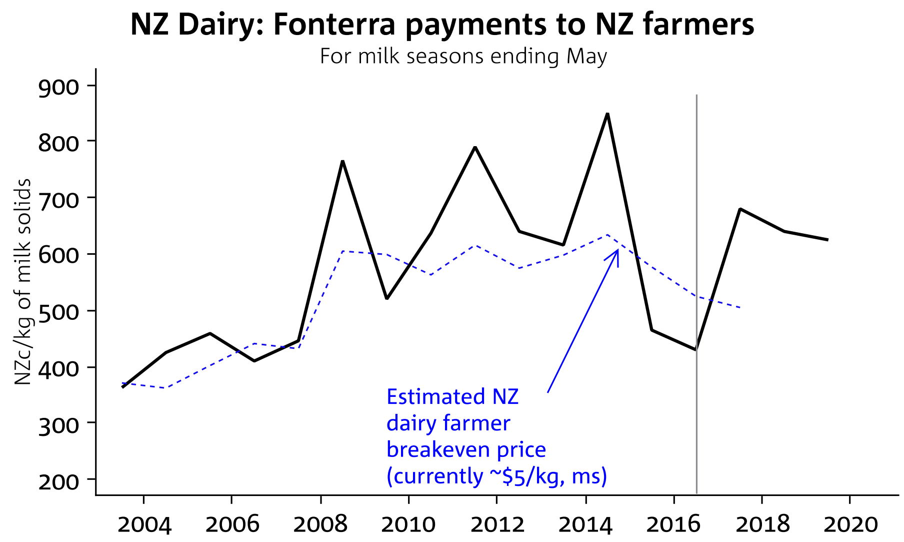
- OPEC and non-OPEC producers agreed to cut output next year by 1.8mbpd, sufficient, if followed through, to eliminate the net global supply overhang.
- A big swing factor remains the elasticity of US shale oil production. Rig count numbers have been rising for some months with production now also increasing.
- NAB forecasts WTI to trade in the low $US50s next year, reaching $US55 by the end of the year.

DAIRY

- A brighter picture has emerged. Wholemilk powder prices are expected to average US$3,300/t in 2017, up from US$2,500/t for 2016. Tightening milk supply from the EU, Australia and NZ has supported prices.
- Fonterra payments to NZ farmers is expected to exceed $6/kg over the coming two years, well above an estimated farmer breakeven of close to $5. Higher dairy prices will underpin NZ's terms of trade, forecast to be nudging record levels during 2017.



Source: National Australia Bank, Macrobond



Source: BNZ, Macrobond

Contacts

FX Strategy

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

Rodrigo Catril
Currency Strategist
+61 2 9293 7109

Jason Wong
Currency Strategist
+64 4 924 7652

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44 207 710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 1588

Australian Market Economics

Ivan Colhoun
Chief Economist, Markets
+61 2 9237 1836

David de Garis
Senior Economist
+61 3 8641 3045

Tapas Strickland
Economist
+61 2 9237 1980

NZ Economics

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

Doug Steel
Senior Economist
+(64 4) 474 6923

Craig Ebert
Senior Economist
+(64 4) 474 6799

Interest Rate Strategy

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

Alex Stanley
Senior Interest Rate Strategist
+61 2 9237 8154

Kymberly Martin
Senior Market Strategist
+64 4 924 7654

Credit Research

Michael Bush
Head of Credit Research
+61 3 8641 0575

Simon Fletcher
Senior Credit Analyst
+61 2 9237 1076

Andrew Jones
Credit Analyst
+61 3 8641 0978

Asia Research

Christy Tan
Head of Markets Strategy/Research, Asia
+852 2822 5350

Julian Wee
Senior Markets Strategist, Asia
+65 6632 8055

European Research

Nick Parsons
Head of Research, UK/Europe, and Global Co-Head of FX Strategy
+44 207 710 2993

Gavin Friend
Senior Markets Strategist
+44 207 710 1588

Global Markets Research

Peter Jolly
Global Head of Research
+61 2 9237 1406

Group Economics

Alan Oster
Chief Economist
+61 3 8634 2927

Important Notice