ECONOMICS

28 Jun. 10

Business **Weekly**

Solid export performance continues

This Week

The economic recovery continues with GDP expanding 0.6% in the March quarter and marking one full year of growth. Driving much of the improvement over the March quarter was a robust recovery in the productive sectors. In particular, non-food manufacturing, forestry and mining activity, construction and wholesale trade expanded healthily (click here for more detail). The continued recovery in these industries reinforces our view that underlying momentum within the economy continues to improve. The contribution from the export sector was clearly evident throughout the quarter and stronger export incomes are likely to remain a key driver of economic recovery over the next year. Merchandise trade figures for May also point to a continuation of the export-led recovery in Q2. Strength in key trading partners, particularly from Australia, China and other Asia, continues to support demand and prices for primary export commodities.

The Reserve Bank is likely to be pleased with the current mix of growth, as the household sector takes a back seat in driving this economic cycle. We continue to expect the RBNZ to increase the OCR 25 basis points in July. However, last week's net migration data may trigger some concern around the downside risks to consumer confidence. It has been widely anticipated that a recovery in permanent departures to Australia would slow the pace of net migration from 20,000 per annum to around 10,000 per annum later this year. However, May's figures suggest net inflows are slowing more sharply, increasing the risk net migration could turn negative later this year. As a note of caution, monthly data are often volatile and two months of weak inflows do not make a trend. Nonetheless, it is one area the RBNZ may start to watch more closely, as previous periods of net outflows contributed to weakness in the housing market.

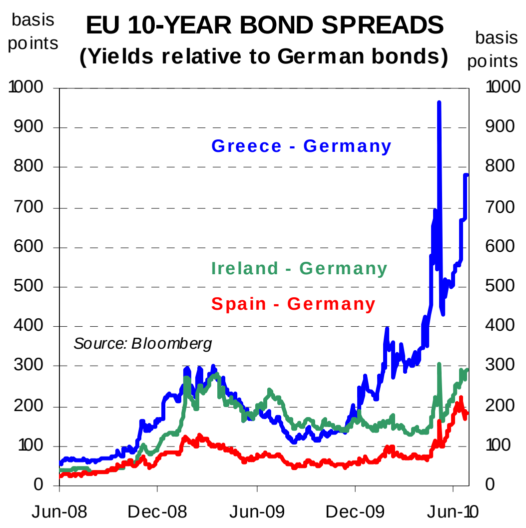
Last week's GDP release was partially eclipsed by the political drama unfolding across the Tasman. Kevin Rudd's leadership was challenged Wednesday night, and by Thursday morning Julia Gillard had stepped up to be the new Prime Minister of Australia. Markets responded favourably to change, with the new leadership team expected to maintain a degree of policy consistency. In our view the change is expected to have little bearing on the strongly positive prospects for the Australian economy.

Until recently, all has been relatively quiet on the European front with market sentiment improving over recent weeks. However, there is some concern that the end of the month may trigger another round of investor angst: see chart of the week below.

Click here for:

Foreign Exchange	• NZD remained relatively buoyant last week, but lost ground on the JPY.
Interest Rates	• Domestic rates follow offshore movements lower.
Week Ahead	• Credit Card Spending, Current Account, GDP and Merchandise Trade Balance.
Week in Review	• Current Account, GDP and Trade Balance confirm NZ recovery on track.
Global Calendars	• US employment, Euro Business Climate, US, UK, EZ manufacturing reports due.

Chart of the week



- June 30 marks a key date for European financial markets, with the potential for large selling of Greek bonds. Big pension funds, which are typically passive investors, will be required to drop Greek bonds (due to Greece's recent ratings downgrade to near junk status) when global bond indices are re-indexed at the end of the month.
- End of the month also marks a deadline for many European banks to pay back cheap funds borrowed from the ECB a year ago. There has been some speculation borrowed money had been invested in higher yielding bonds, including Greece.
- Reflecting potential selling pressure this week, credit spreads on Greek bonds relative to German bonds have spiked toward previous highs. Markets also remain concerned about default, as credit default swaps surged over the week to record levels, pricing in a 68.5% chance of default in the next five years.

Foreign Exchange Market

FX Rates	Current*	Week ago	Month ago	6 mths ago	Year ago	ST Bias	Support^	Resistance^
NZD/USD	0.7149	0.7110	0.6803	0.7047	0.6446	FLAT	0.7000	0.7250
NZD/AUD	0.8177	0.8070	0.8008	0.8000	0.7986	FLAT/DOWN	0.8050	0.8250
NZD/JPY	63.86	64.55	61.95	64.54	61.78	FLAT/DOWN	63.00	66.00
NZD/EUR	0.5775	0.5720	0.5529	0.4915	0.4585	FLAT/DOWN	0.5700	0.5800
NZD/GBP	0.4749	0.4777	0.4676	0.4414	0.3927	FLAT/DOWN	0.4700	0.4800
TWI	68.4	68.1	66.0	64.6	60.8	FLAT/DOWN	67.5	69.0

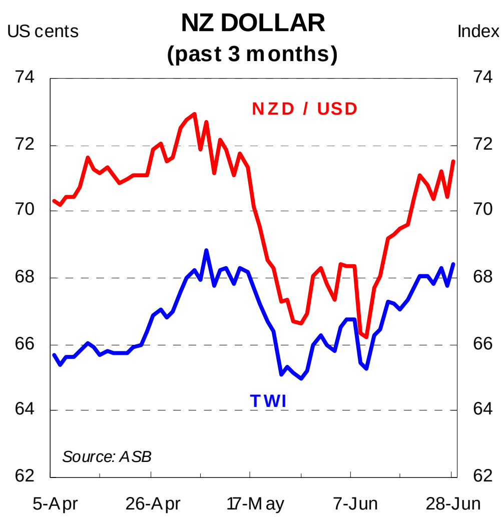
^Weekly support and resistance levels * Current is as at 10.00 am Monday; week ago as at Monday 5pm

- The NZD remained relatively buoyant last week, and ended higher against the USD, AUD, and EUR.
- The currency market liked the new UK Government's tough Budget. In addition, one member of the Bank of England's policy committee voted in favour of an immediate interest rate increase. In response to these events, the Pound strengthened and NZD/GBP eased.
- The NZD eased slightly against the JPY last week, but our currency was not alone in losing ground against the Yen. JPY strength last week reflects bond repatriation, as Japanese investors remain discouraged by low US bond yields.
- Bond yields in the US are down to the levels reported during the height of the financial crisis. The low yields are putting downward pressure on the USD, particularly USD/JPY. Data this week could add to the downward pressure on the USD against the major cross rates – particularly Friday night's Non-farm Payrolls report.
- The NZD is trading near our forecast peaks for Q2/Q3. With little in the way of local data due this week, the focus will be mainly offshore for the FX market this week. At these levels, the NZD is vulnerable to negative sentiment regarding the global growth outlook. US data and sharemarket performance will be important for NZD direction.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
May Building Consents	29/6	10.45am	-

Potential currency movers from offshore this week: US personal income and spending (28th); Japanese industrial production, European Business Climate Indicator, US house prices, US consumer confidence (29th); German unemployment, UK GDP, US ADP employment survey (30th), UK, Euro zone, & US ISM manufacturing reports, US pending home sales, jobless claims (1st); Euro zone unemployment; US payrolls, wages, factory orders (2nd). Speeches: Evans, Duke, Lockhart (30th).



Medium-term outlook: [Last Quarterly Economic Forecasts]

- We expect the USD will continue to gain support over the remainder of 2010. The US economic outlook continues to improve, with data demonstrating a broader-based expansion. We expect that US bond yields will eventually adjust higher reflecting the firmer US economy. As a result, the higher US bond yields will support the USD. In addition, the AAA-rated US bond market remains the major alterative to the Eurozone government bond market.
- We have already revised down our EUR forecasts three times this year, and recently revised down the outlook once again for the same reasons. Eurozone GDP growth is expected to under perform the US economy over 2010 and 2011. The deterioration in the EU growth outlook will see the differential between US and Eurozone interest rates widen, reducing support for the Euro. In addition, more than half of Eurozone government debt is no longer AAA rated, with uncertainty continuing to cloud the outlook and reducing investor appetite.
- While we have revised down our NZD outlook slightly, we continue to see support coming from strong commodity prices and the RBNZ tightening cycle. In addition, NZ's relatively healthier outlook for net government debt will make the NZD look favourable relative to European and US peers.
- Relative to the AUD, the NZD has already made up quite a bit of ground. The NZD is likely to continue to modestly outperform the AUD as the RBNZ continues to lift rates and the interest rate differential narrows slightly.

Interest Rate Market

Wholesale interest rates	Current	Week ago	Month ago	6 mths ago	Year ago	ST Bias
Cash rate	2.75	2.75	2.50	2.50	2.50	FLAT
90-day bank bill	3.09	3.10	2.98	2.79	2.81	FLAT
2-year swap	4.25	4.39	4.36	4.58	3.88	FLAT
5-year swap	4.98	5.13	5.23	5.57	5.42	FLAT
5-year benchmark gov't stock	4.80	4.91	4.90	5.48	4.90	FLAT
NZSX 50	3034	3048	3049	3206	2768	DOWN

* Current is as at 10.00 am Monday; week ago as at Tuesday 5pm. Please note that we have recently changed the NZ govt 5-year benchmark bond to April 2015 maturity (from April 2013). This does cause some distortion in the comparison against the previous levels (i.e. month ago).

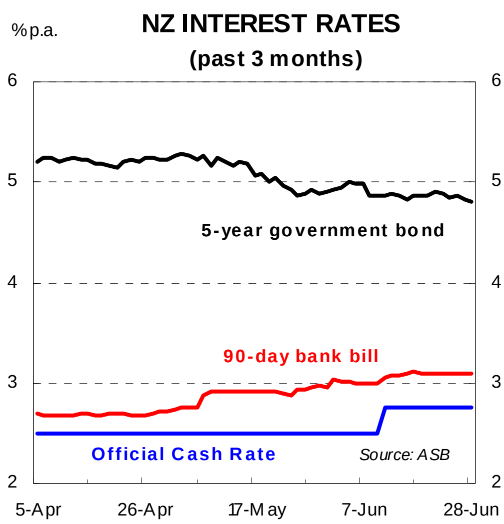
- Domestic interest rates followed offshore movements to end the week lower. This was despite the greater than expected narrowing of the Q1 current account deficit and Q1 GDP coming in broadly in line with market expectations.
- Interest rates fell globally as a credit downgrade of investment bank BNP Paribas from AA to AA- and revaluation of the Chinese yuan led markets to reassess global growth prospects. Ho-hum US data also weighed on market sentiment, with existing home sales below market expectations.
- The increased risk aversion led to a decline in equities and further deterioration in sovereign debt spreads. In particular, Greek 5-year credit default swaps hit a record high of 958 bps, and the price of Greek sovereign default within 5 years is now priced at 68%.

Short-term outlook:

Key data	Date	Time (NZST)	Market expects
May Building Consents	29/6	10.45am	-

Comment: Domestic markets are likely to continue to follow offshore movements. Market focus has turned to the G20 summit. Meanwhile, US non-farm payrolls data this Friday will shed further light on how the recovery in their economy is evolving, and thus provide some direction on global growth prospects.

Medium term outlook: [Last Quarterly Economic Forecasts]



- The RBNZ began removing monetary policy stimulus at the June meeting with a 25 basis point OCR increase. In addition, the RBNZ indicated it will look to continue to increase the OCR over the coming year as economic and financial market conditions allow.
- The RBNZ left its projection for the 90-day interest rate broadly unchanged at the June *MPS*. It continued to note that higher bank funding costs, upward slope of the yield curve and the fact that a greater proportion of borrowers are now on floating rate mortgages will "reduce the extent to which the OCR will need to be increased relative to previous cycles". This is in line with our expectations that OCR increases will be in 25 basis point increments this year and eventually peak at 5%.
- The RBNZ forecasts headline CPI inflation to peak at 5.3% in June 2011, boosted by a raft of Government policy changes including tobacco excise tax, the implementation of the Emissions Trading Scheme and increase in GST to 15%. We expect these changes will boost headline inflation to a peak of 5.7%, and see upside risks to the RBNZ's key assumption that medium-term inflation expectations will remain anchored. This is in light of the fact that two year ahead inflation expectations are already elevated at 2.8%.
- The RBNZ has revised down its NZ economic growth outlook slightly and explicitly notes that if the Eurozone situation deteriorated the main impact on NZ would be via higher bank funding costs. We are less optimistic than the RBNZ that the recent strength in NZ export commodity prices will continue.
- We expect that the OCR will be increased by 25bp at each meeting until the OCR reaches 5%. Given continued uncertainty in the European economy, markets are currently pricing in some risk of a pause at some point in this cycle.

NZ Data Preview: a look at the week ahead

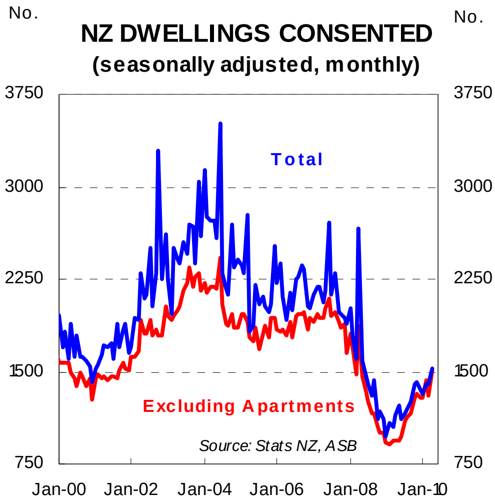
Data	Date	Time (NZST)	Previous	Market expects	ASB expects
May Building Consents – residential mom	29/6	10.45am	+8.5%	-	-
May RBNZ Credit Aggregates – business yoy	29/6	3.00pm	-8.2%	-	-

Tuesday 29 June

June Building Consents

Dwelling consent issuance picked up 8.5% over April, led by a 15.5% increase in core consent issuance (i.e. excluding the volatile apartment component). The surge in April follows a relatively disappointing March. Overall, building demand appears to be picking up, albeit gradually. The subdued recovery over the early part of the year could have been due to the uncertainty around the property outlook ahead of the May 2010 Budget. With the Budget details now revealed, it is possible that the recovery in consent issuance could gather more momentum from June. Adding to that, the prospect of higher GST after October may prompt some to bring forward construction plans.

Non-residential consent issuance remained subdued with year-to-date issuance now around 10.5% lower than that of the previous year. This is in line with the weak commercial building intentions seen in business surveys in recent months.

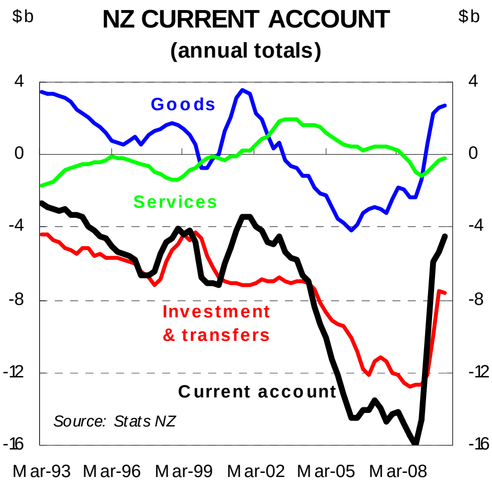


NZ Data Review: weekly recap

Q1 Current Account

The current account recorded an unadjusted surplus of $176 million in the March quarter, bringing annual deficit to just 2.4% of GDP. Adjusting the current account for seasonal affects, the current account recorded a deficit of $1.3 billion, compared to the previous quarter's deficit of $2.9 billion. The quarter's smaller deficit largely reflects stronger dairy prices. Meanwhile, the combined seasonally-adjusted investment income and transfers deficit was also smaller this quarter, partly due to stronger income earned abroad by NZ-owned foreign entities.

On a trend basis the cyclical improvement in the current account appears to have peaked. During the recession, very weak import demand and low profitability of foreign-owned NZ subsidiaries resulted in the annual current account deficit shrinking to $4.4 billion from a peak of $16 billion in December 2008. As the economic recovery continues to gain traction, outflow of income will also lift, as will import demand.

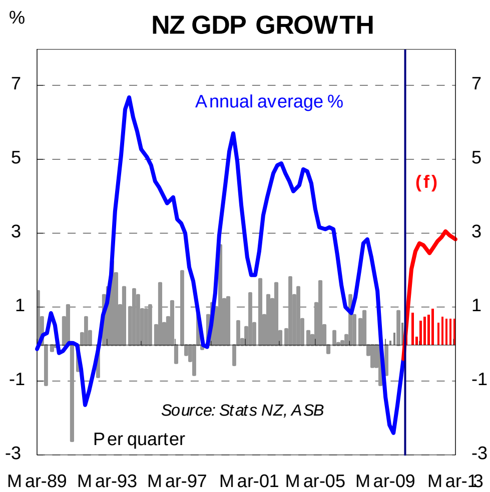


Q1 GDP

The NZ economy grew for a fourth consecutive quarter with GDP increasing 0.6% in the March quarter. Driving much of the improvement over Q1 was a robust recovery in non-food manufacturing, forestry and mining activity, construction and wholesale trade.

The economy is now entering its second year of recovery. It is becoming increasingly clear that future growth is likely to be driven by the economy's core goods-producing sectors, in part stimulated by strong demand for exports. The recovery in global economic growth, particularly in the Asia-Pacific region, has helped boost demand for NZ exports and commodity prices. Areas such as forestry and mining have been solid contributors to growth over the past year. Added to this, strong demand in Australia has likely underpinned the gathering momentum in the manufacturing sector.

Overall, the data reinforced our view that underlying momentum within the core productive sector continues to improve.

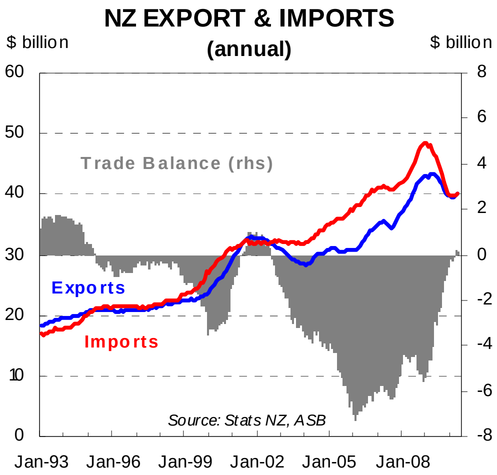


May Trade Balance

The $814 million trade surplus in May brings the annual surplus to $91 million. Exports benefited from seasonal strength in agricultural production, as well as recovering commodity prices. Meanwhile, imports continue to recover at a gradual pace.

The strong trade surplus has been one of the key drivers in the dramatic narrowing of the current account deficit over the past year. Initially, weak imports, as a result of the recession, were largely behind the stronger trade surplus. However, more recently the solid surplus has been driven by rising export commodity prices offsetting the recovery in import demand. In particular, dairy and forestry has been largely behind much of the recovery in export receipts.

Part of the recovery in export prices can be attributed to the recovery in global demand, and hence are likely to be sustained over the next few years (in particular forestry prices). The stronger export incomes will be a key contributor to the economic confidence and recovery over the next year.



Global Data Calendars

Note: Calendar 2 is in UK times. Add 11 hours for NZ times.

Calendar - Australasia, Japan and China

Date	Time NZT	Econ	Event	Period	Unit	Last	Forecast Market	Forecast ASB/CBA
Mon 28 Jun	11.50	JP	Retail trade	May	m%ch	0.5	~	~
					y%ch	4.9	~	~
	15.00	NZ	NBNZ business confidence	Jun	Index	48.2	~	~
Tue 29 Jun	10.45	NZ	Building permits	May	m%ch	8.5	~	~
	11.30	JP	Overall household spending	May	y%ch	-0.7	~	~
	11.30	JP	Jobless rate	May	%	5.1	~	~
	11.30	JP	Job-to-applicant ratio	May	ratio	0.5	~	~
	11.50	JP	Industrial production	May	m%ch	1.3	~	~
					y%ch	25.9	~	~
	16.00	JP	Vehicle production	May	y%ch	50.8	~	~
	17.00	JP	Small business confidence	Jun	index	46.7	~	~
Wed 30 Jun	13.00	AU	DEWR skilled vacancies	Jun	m%ch	1.0	~	~
	13.00	AU	HIA new home sales	May	m%ch	6.2	~	~
	13.30	AU	Private sector credit	May	m%ch	0.2	~	~
					y%ch	2.1	~	~
	17.00	JP	Housing starts	May	y%ch	0.6	~	~
	17.00	JP	Construction orders	May	y%ch	-25.0	~	~
Thu 1 Jul	11.30	AU	Ai Group PMI	Jun	index	56.3	~	~
	11.50	JP	Tankan large manufacturing outlook	QII	index	-8.0	-1.0	
	11.50	JP	Tankan non-manufacturing outlook	QII	index	-10.0	-3.0	~
	11.50	JP	Tankan large all industrial Capex	QII	index	-0.4	5.1	~
	11.50	JP	Loans and discounts corporation	May	y%ch	-3.4	~	~
	13.30	AU	Retail sales	May	m%ch	0.6	~	~
	13.30	AU	Building approvals	May	m%ch	-14.8	~	~
	13.00	NZ	PMI manufacturing	Jun	index	53.9	~	~
	14.30	NZ	HSBC manufacturing PMI	Jun	index	52.7	~	~
	17.00	JP	Vehicle sales	Jun	y%ch	28.0	~	~
Fri 2 Jul	11.50	JP	Monetary base	Jun	y%ch	3.7	~	~

Calendar – North America & Europe

Please note all days and times are UK time, not local release day/times

Date	UK Time	Econ	Event	Period	Unit	Last	Forecast Market	Forecast CBA
Mon 28 Jun	~	GE	CPI	Jun	m%ch	0.1	~	~
	13.30	US	Personal income	May	%	0.4	~	0.5
	13.30	US	Personal spending	May	%	0.0	~	0.2
	13.30	US	PCE deflator	May	y%ch	2.0	1.8	~
	13.30	US	PCE deflator core	May	m%ch	0.1	0.1	~
					y%ch	1.2	1.2	~
Tue 29 Jun	09.30	UK	Net consumer credit	May	£bn	-0.1	~	~
	14.00	US	S&P/Case-Shiller composite-20	Apr	y%ch	2.3		
	14.00	US	Consumer confidence	May	~	63.3	62.8	~
Wed 30 Jun	07.00	UK	Nationwide house prices	Jun	m%ch	0.5	~	~
					y%ch	9.8	~	~
	08.55	GE	Unemployment rate	Jun	%	7.7	~	~
	09.30	UK	GDP	QI	q%ch	0.3	~	~
					y%ch	-0.2	~	~
	09.30	UK	Current account	QI	£bn	-1.7	~	~
	09.30	UK	Total business investment	QI	q%ch	6.0	~	~
	10.00	EZ	CPI estimate	Jun	y%ch	1.6	~	~
	13.15	US	ADP employment change	Jun	‘000	55.0	55.0	~
	13.30	CA	GDP	Apr	m%ch	0.6	~	~
Thu 1 Jul	08.55	GE	PMI manufacturing	Jun	Index	58.1	~	~
	09.00	EZ	PMI manufacturing	Jun	Index	55.6	~	~
	09.30	UK	PMI manufacturing	Jun	Index	58.0	~	~
	15.00	US	ISM manufacturing	Jun	Index	59.7	59.1	~
	15.00	US	Construction spending	Jun	m%ch	2.7	-0.7	~
	15.00	US	Pending home sales	May	m%ch	6.0	-20.0	~
					y%ch	24.6	~	~
	22.00	US	Total vehicle sales	May	mn	11.6	11.5	~
Fri 2 Jul	09.30	UK	PMI construction	Jun	Index	58.5	~	~
	10.00	EZ	PPI	May	m%ch	0.9	~	~
					y%ch	2.8	~	~
	10.00	EZ	Unemployment rate	May	%	10.1	~	~
	13.30	US	Change in nonfarm payrolls	Jun	‘000	431.0	-75.0	~

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