31 August 2009

Housing Boom Drives Recovery

- Business unequivocally upbeat
- Suggests GDP returning to trend
- Residential construction outlook particularly buoyant
- A severe dent to rate cut possibility
- More fuel for the NZD

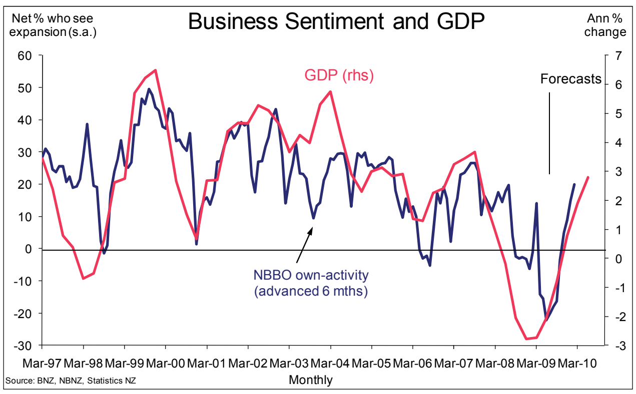
National Bank Business Outlook				
Net balance - next 12 months				
(All sectors)	**August**	**July**	Change	Average
General business outlook	**34.2**	**18.7**	15.5	4.7
Own business	**26.0**	**12.6**	13.4	24.8
Profits	**1.0**	**-13.8**	14.8	6.4
Employment	**-2.6**	**-6.8**	4.2	6.0
Investment	**2.3**	**-2.3**	4.6	13.7
Pricing intentions	**15.2**	**12.9**	2.3	20.2
Inflation expectations	**2.52**	**2.60**	-0.08	
Exports	**21.2**	**14.2**	7.0	33.0
(Own activity outlook)				
Retail	**23.9**	**7.0**	16.9	22.9
Manufacturing	**36.8**	**12.1**	24.7	26.2
Agriculture	**15.1**	**6.5**	8.6	23.8
Construction	**35.7**	**20.0**	15.7	10.9
Services	**23.6**	**15.2**	8.4	28.3

Today's National Bank Business Outlook produced an unequivocally buoyant future picture for the New Zealand economy. In short, it suggests that, not only is the recession fast nearing its end but that GDP growth will soon be back up to trend. Moreover, there is a clear indication that it will be the housing market that is at the forefront of this expansion.

Whether or not this proves to be the case is, of course, a moot point but with this confidence indicator being so consistent with many others in foretelling better times ahead, it would be foolhardy to deny its implications.

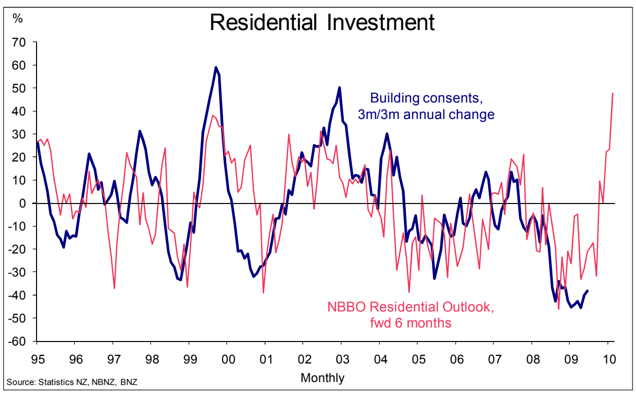
Heading the charge was the own-activity indicator. This has proven to be a good leading indicator of GDP in the past and we see no reason why it should not be this time around. We seasonally adjust this series so as to remove the obvious happiness that descends as winter ends. On this seasonally adjusted basis, own activity expectations have risen to their highest level since April 2007. This is consistent with GDP growth headed for around 2.75%.

Interestingly, the optimism was reasonably widespread, with retailers the most optimistic since February 2007, manufacturers their happiest since May 2002 and the construction industry the most buoyant since March 2001. Both the services and agriculture sectors remain subdued when compared to their respective norms though even here confidence is nudging higher.



We have been running the line that any pick up in activity was likely to be led by residential construction. Our rationale for this was that there appeared to be insufficient supply given the current migration-led population growth. And that falling mortgage interest rates, tax cuts and a shift higher in consumer sentiment would give the sector a kick start. Clearly industry players think likewise. A staggering net 47.6% of respondents believe residential construction will push higher. This would normally be consistent with a 50% increase in residential building permits! We are not so euphoric in our thinking but are further encouraged to stick with our view that housing will be a dominant feature of the expected upturn. Nonetheless, we again warn that if house prices run hot rather than building activity this will create substantial future problems for the sustainability of the expected expansion.

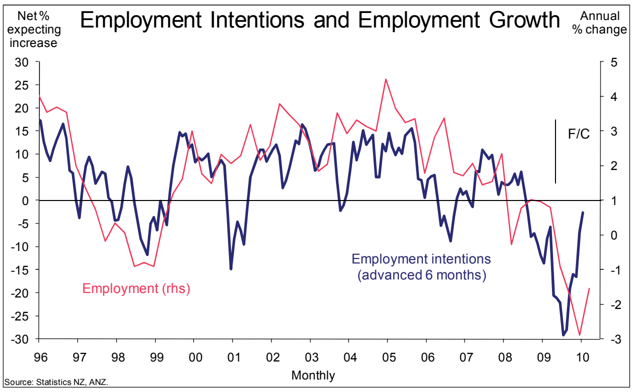
We also note that, while the residential outlook is brightening, the same cannot be said for non-residential construction. Non-residential is a function of growth in employment and, hence, will tend to lag the economic cycle. Today's survey is consistent with this.



Indeed employment intentions remain negative. Be that as it may, perhaps the most heartening aspect of the survey was that employment intentions continue to improve – so much so that they are now suggesting our employment reduction forecasts are too pessimistic. We remain convinced that there is still substantial fall-out to come through the labour market but at least the latest set of business surveys make us feel more confident that our 7.5% forecast peak in the unemployment rate will prove accurate. This being so, the unemployment rate will top out miles lower than the 1991/92 recession and, surprisingly, lower than the 1998 drought-and-Asia-crisis-affected result.

Consistent with the general optimism displayed in the survey, profit and investment expectations also lifted. Profit expectations were the highest they have been since October 2007. They were particularly strong for the construction sector but particularly weak for agriculture.

Investment intentions were their highest since February 2008 but, not surprisingly given the amount of spare capacity in the economy, remained negative.



Of course the disconcerting aspect of this survey is the fact the shape of the upcoming expansion seems to remain heavily domestically focussed. The possibility of an economic rebalance still seems a distant dream leaving the economy extremely vulnerable for the foreseeable future. Sure exporter hopes are picking up too but just not enough.

While the overall tenor of the survey was extremely positive, we are quick to note that the GDP track it implies is no greater than we have forecast and our track is almost identical to the Reserve Bank's. Accordingly, the survey will not have the RBNZ scurrying to push interest rates higher particularly when the NZD is doing more than its fair share of the work in returning monetary conditions to the more neutral level that might be demanded by an improving economic outlook. Indeed, the survey's strength is likely to provide further support for dollar bulls and add more weight to the Reserve Bank Governor's seemingly new-found realisation that there's not much that can be done about it. Accordingly, it will be very interesting to see the RBNZ's new currency track when it produces its upcoming Monetary Policy Statement.

Notwithstanding this, the survey is probably strong enough to caution against any further rate cut by the Bank. In addition, pricing expectations are consistent with headline inflation settling at the mid point of the RBNZ's target band. This is not a view we share but it does show that the disinflationary momentum in the business sector is abating as growth expectations stabilise. In part, therefore, as a consequence of today's survey we have lowered our expectations of a further rate cut to just 30%.

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