

20 September 2010

Drought's Drag on Q2 GDP

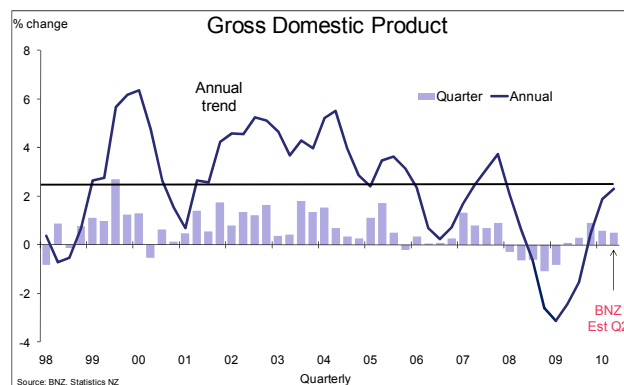
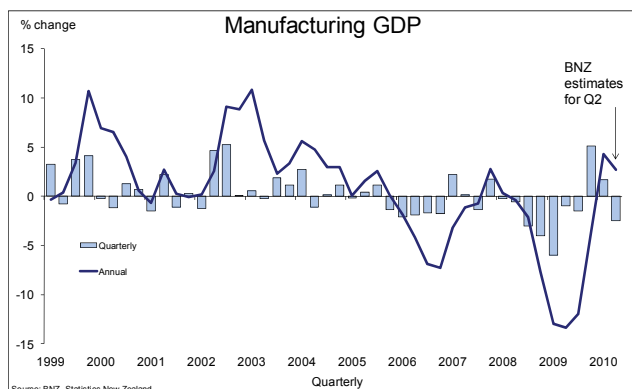
- We are low-balling Q2 GDP growth with 0.5%
- As drought hits farm output, manufacturing
- Market consensus is 0.8%, RBNZ expects 0.9%
- Current account deficit probably expanding anew
- August tourism likely solid, but immigration soft
- PSI holds up, as does consumer sentiment

We are low-balling Thursday's June quarter GDP growth figure, with 0.5% (2.3% y/y). The market consensus is 0.8%. And the RBNZ had 0.9% built into its Monetary Policy Statement of last week, meaning the Bank could well be left looking overly optimistic on the economy, still. However, our estimate is not to imply economic growth is fundamentally sedate. In fact, it mostly reflects what we think will be a big one-off hit from the late-summer drought. This should greatly curtail on-farm production in Q2, which, in turn, will weigh heavily on manufacturing activity.

Specifically, we reckon on-farm production fell 3.0% in the June quarter and manufacturing declined 2.5%. If both of these were simply flat instead, then we'd have 1.0% on the board for Q2 GDP growth.

On-farm output, we presume, will register a marked drop in milk production in Q2 (in order to tally with the slight increase for the full-year season) and a vacuum of on-farm meat production and downstream processing. And with food processing comprising approximately one third of New Zealand's manufacturing sector these days, it's easy to see how it would leave a hole in the manufacturing numbers as well.

Moreover, it looks as though ex-food manufacturing struggled in the June quarter - at least by the light of the



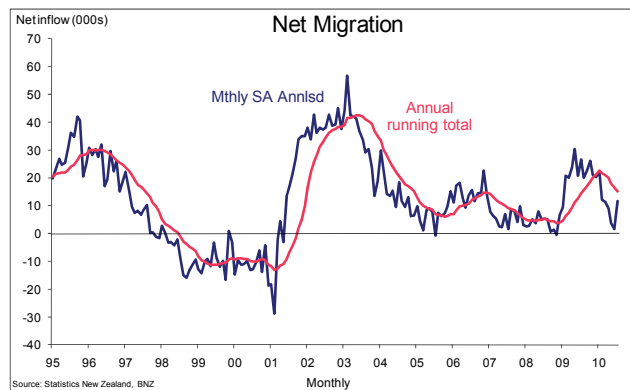
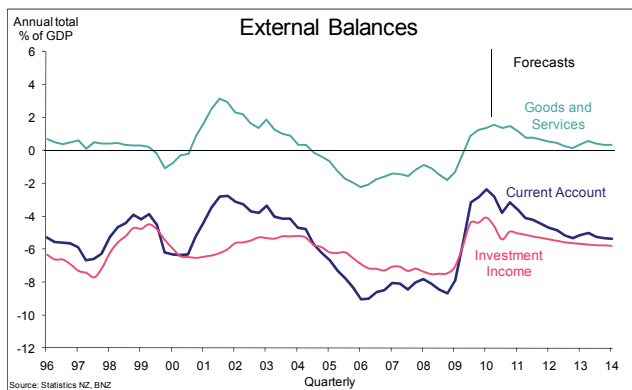
quarterly manufacturing survey figures. Curiously, though, most every other indicator of manufacturing activity for Q2 looked reasonable – including industrial exports, imports, the PMI and the many other survey measures. So while we have taken a negative view on 2010 Q2 manufacturing, we're still open-minded that it might not be that bad.

Otherwise in the Q2 production GDP accounts, we should see the great majority of sectors putting on weight, ranging from ounces to pounds. Construction will no doubt be the standout gainer, but we also expect to see another solid increase in forestry production and ongoing advances in the retail and wholesaling areas.

This should reflect, from the expenditure way of looking at GDP, in a reasonable advance in consumer spending and strong residential and non-residential building activity. However, exports and business investment in plant, equipment and transport goods might be a bit touch and go in Q2, and with a run-down in manufacturing inventories certainly set to be a drag on the GDP calculations.

Of course, Wednesday's Balance of Payments might have us fine-tuning our GDP expectations at the death (or at least the risks around them) based on the export and import detail on goods and services it provides. However, we suspect the main story will be of renewed expansion in the nation's current account deficit.

Of course, it will likely be only a minor expansion. And from a deficit starting point of "just" 2.4% of GDP for the year ended March 2010. Although bear in mind we might even see an altered estimate on this, as Statistics NZ is due to institute its annual benchmark revisions this quarter. These revisions, to be clear, are additional to the ones Statistics NZ announced and published last week, as

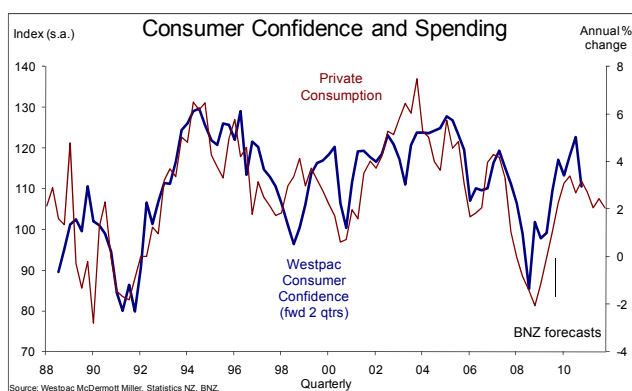


it re-worked the recent many years of data, owing to better data sources and matchings.

Material revisions to history aside, the 2.8% proportion we anticipate for the year to June 2010 external deficit (\$5.32b, based on \$0.5b for the June quarter, flattered by seasonality) will signal the start of an expansion in the external deficit over the coming year and beyond. This will be something to keep an eye on – especially amid fiscal deficits that are probably going to prove structurally higher than many seem to presume.

Already on the data front, this morning, we've seen the Performance of Services Index, at 51.4, holding its head above water in August. It's effectively doing doggy paddle, having taken a mouthful of water in July, with a near-flat 50.4. New orders remained comfortably in expansion mode, with 53.9.

Even more encouraging was the resilience in last week's WMM consumer confidence index, which, while down a bit from June, was consistent with a normal pace in consumer spending growth. This suggests this afternoon's ANZ-RM version will be similarly robust.



And the relative optimism of consumer sentiment warns against getting too down in the mouth from the flatness in recent retail sales and electronic card transactions (with a likely continuation of this theme in Tuesday afternoon's credit card billings, for August). Beyond this, however, we are still picking a trend pick-up in consumer spending (albeit with the Canterbury earthquake bound to distort the headline spending figures, near term).

In this light, it will also be interesting to see how Wednesday afternoon's WMM Employment Confidence Survey does. While we're not expecting any noticeable jump in this index (108.2 in June), it should likely remain consistent with underlying improvement in the labour market. This is what most of the other labour market indicators have been pointing to at least.

The remaining NZ economic report to mention for this week is August's one for International Travel and Migration. For short-term visitor arrivals we expect sustained clear annual gains, but we'd be surprised if the month's net immigration figure rebounds any further than it did in July. We still believe the trends in arrivals and departures make for near-flat immigration for the foreseeable future.

Also watch for any announcements from Fonterra on Thursday, as it meets to finalise its payments for last season's production. It might even go so far as to comment further on the current season's payment forecasts.

Finally, a reminder, especially to our international readers, that NZ clocks go forward one hour, to GMT + 13 hours, this Sunday morning (2:00am). So by this time next week we'll be one hour the worse for wear, but with later sunsets to make up for it.

craig_ebert@bnz.co.nz

Domestic Interest Rates

New Zealand interest rates saw a widespread rally over the week as the RBNZ held rates steady and produced a clearly dovish statement. The futures and OIS market finished the week by pushing the pricing for the next hike back to March 2011, with roughly 50% chances of 25bp hikes for the subsequent meetings next year. This seems reasonable for the next 6 months or so as the RBNZ seems to clearly be on hold for some time, but we suspect risks are to the upside for yields further out the curve if inflationary pressures build.

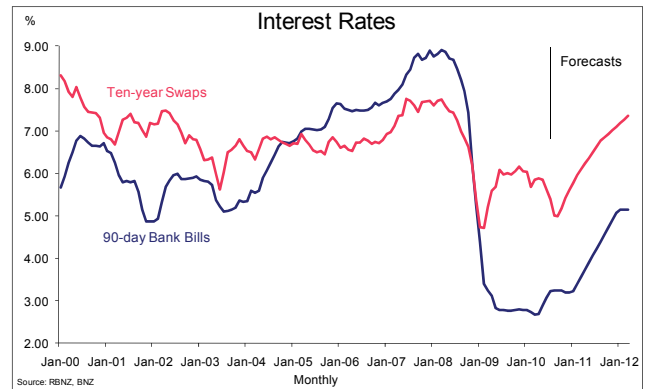
The New Zealand Government bond market performed strongly, notably outperforming swaps for the first time in several weeks. The tender was well supported with strong bid to cover ratios and the market rallied strongly afterwards. With the RBNZ in no hurry to hike and relatively attractive yields available in New Zealand, we will likely outperform offshore in the coming week.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
10-Sep-10	3.19%	4.21%	5.41%	3.88%	5.04%	116
17-Sep-10	3.17%	4.05%	5.28%	3.80%	5.00%	120
Change (bps)	-2	-16	-13	-8	-4	4

Reuters pgs BNZL BNZM

The swaps market rallied with the rest of the market following the RBNZ, with receivers dominating the shorter dates in the market. Receiving interest in longer dates was less apparent and the curve steepened somewhat on the week. The GDP result will be the major piece of data on the week, aside from that it is likely that flow and offshore moves will drive the New Zealand swaps market.

nick_webb@bnz.co.nz



Interest Rate Technicals

NZD 5yr Swap Rate

Outlook: Higher
 MT Resistance: 4.53%
 MT Support: 4.06%

Market did not close above 4.53% and has retraced to 4.42%. Look for range to hold near term and trade a break.



pete_mason@bnz.co.nz

NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Rangebound
 MT Resistance: +73
 MT Support: +10

Market rejected near term support at +42. Look for a range trade between +42 and downward sloping resistance now coming in at +73. A break of either of these lines will give us the next move.



Foreign Exchange Market

After skirting 8-month highs of nearly 0.7400 early last week, the NZD/USD subsequently ran out of puff.

Global market conditions provided clear tailwinds for the NZD last week. Upbeat economic news out of China and Europe kept risk appetite on the front foot. The MSCI World Equity Index rose 1.5% over the week to 4-month highs and our risk appetite index (which has a scale of 0-100%) tracked up to nearly 60%.

At the same time, sentiment towards the USD deteriorated noticeably as speculation the Fed could loosen already mega-loose monetary policy sent US bond yields tumbling. Against a broadly weaker USD, the EUR/USD climbed nearly 3% over the week and the AUD/USD was launched to 25-month highs above 0.9450.

However, flagging support from the domestic backdrop ensured the NZD underperformed. Not only did July retail sales disappoint, but the RBNZ's notably dovish September MPS also weighed on the currency. The RBNZ lopped around 120bps worth of tightening off its interest rate track, causing yield-hungry investors to take flight from the NZD. After coming within a whisker of 8-month highs around 0.7400 on Tuesday, the NZD/USD finished the week closer to 0.7260. Meanwhile, NZD/AUD dived to 5-month lows below 0.7750 as 2-year NZ-AU swap spreads plunged to the lowest level on record (-130bps).

Reuters pg BNZFWDS

The key event in the coming week will be the FOMC policy announcement on Wednesday morning, NZ time. Investors will be on the look out for any hints the Fed may restart quantitative easing. We suspect it will take further clear deterioration in US economic data for the Fed to consider such drastic action. As such, there is unlikely to be much change in the Fed's language this week. If we're right, a mild bounce in US bond yields and the USD could be in the offing. This is particularly so given short positions in the USD reached the highest level in a month last week.

On the local front, keep an eye out for Thursday's NZ Q2 GDP figures. These look set to undershoot the Reserve Bank's 0.9%q/q estimate. We are looking for 0.5%, with the consensus at more like 0.8%. We're also bracing for an increase in the Q2 current account deficit (to about 2.8% for the year to June 2010, from 2.4%) when June quarter balance of payments figures are released on Wednesday.

All up, we suspect the weight of uninspiring NZ economic news and the prospect of a rebound in the USD will keep NZD/USD rallies limited to 0.7330 this week. Initial support is eyed on dips towards 0.7145.

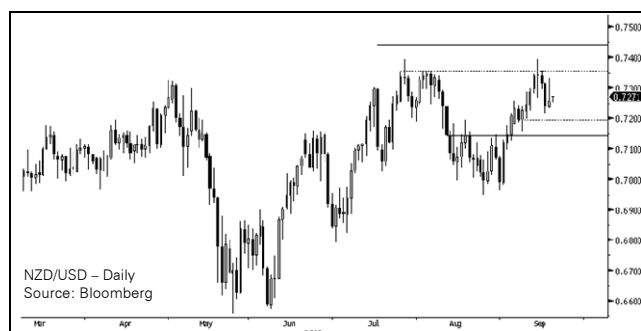
mike_s_jones@bnz.co.nz

Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
 ST Resistance: 0.7355 (ahead of 0.7445)
 ST Support: 0.7195 (ahead of 0.7145)

Repeated failures to breach key resistance at 0.7355 suggest the uptrend may be running out of steam, but momentum will remain positive while 0.7160 holds.



mike_s_jones@bnz.co.nz

NZD/AUD

Outlook: Sell a rally
 ST Resistance: 0.7795 (ahead of 0.7885)
 ST Support: 0.7660 (ahead of 0.7615)

Having achieved our target of 0.7785, we now look for additional near-term downside. A break below initial resistance at 0.7715 would pave the way for a deeper correction towards 0.7660.



Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 20 September				Thursday 23 September			
NZ, BNZ PSI (Services), August s.a.			50.5	NZ, GDP, Q2	+0.5%	+0.8%	+0.6%
NZ, ANZ-RM Consumer Confidence,			116.3	US, Existing Home Sales, August		4.10m	3.83m
Tuesday 21 September				Friday 24 September			
Aus, Stevens Speaks, Regional Policy				US, Leading Indicator, August		+0.1%	+0.1%
US, NAHB Housing Index, September		14	13	US, Volcker Speaks			
Tuesday 21 September				US, Jobless Claims, week ended 18/09		450k	450k
NZ, External Migration, August s.a.			+970	UK, BBA Home Loans, August		34k	34k
NZ, Credit Card Billings, August			-1.2%	Euro, PMI Manufacturing, September 1st est		54.5	55.1
Aus, RBA Minutes, 7 Sep Meeting				Euro, PMI Services, September 1st est		55.5	55.9
US, FOMC Policy Announcement	0.25%	0.25%	0.25%	Friday 24 September			
US, Housing Starts, August		550k	546k	US, Bernanke Speaks, Financial Crisis			
Wednesday 22 September				US, Durables Orders, August		-1.0%	+0.4%
NZ, WMM Employee Confidence, Q3			108.2	US, New Home Sales, August		295k	276k
NZ, Balance of Payments, Q2	-2.8%	-2.8%	-2.4%	US, Fed's Lacker Speaks, Economic Outlook			
Aus, Westpac Leading Index, July			flat	Germ, IFO Index, September		106.4	106.7
Jpn, All Industry Index, July		+1.0%	+0.1%	Sunday 26 September			
UK, BOE Minutes, 8/9 Sep Meeting				NZ, Daylight Saving Begins, +1hr to +13:00GMT			
Euro, Industrial Orders, July		-1.4%	+2.3%				

Historical Data

	Today	Week Ago	Month Ago	Year Ago		Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS					FOREIGN EXCHANGE				
Call	3.00	3.00	3.00	3.00	NZD/USD	0.7266	0.7302	0.7048	0.6426
1 mth	3.12	3.11	3.10	3.14	NZD/AUD	0.7739	0.7855	0.7943	0.7983
2 mth	3.20	3.19	3.20	3.23	NZD/JPY	62.29	61.56	60.32	61.82
3 mth	3.15	3.19	3.24	3.28	NZD/EUR	0.5567	0.5745	0.5547	0.4605
6 mth	3.24	3.27	3.33	3.34	NZD/GBP	0.4640	0.4753	0.4535	0.3893
GOVERNMENT STOCK					NZD/CAD	0.7496	0.7553	0.7392	0.7294
11/11	3.63	3.80	3.57	3.90	TWI	66.93	67.83	66.23	60.78
04/13	4.05	4.24	3.97	4.90	NZD Outlook				
04/15	4.56	4.72	4.43	5.54					
12/17	5.01	5.15	4.85	6.06	<p>Source: BNZ, RBNZ</p>				
05/21	5.28	5.44	6.53	-					
CORPORATE BONDS									
BNZ 05/13	5.10	5.18	5.03	-					
BNZ 09/16	6.18	6.23	5.95	-					
FON 04/14	5.65	5.72	5.53	-					
FON 03/16	6.18	6.21	5.87	-					
GEN 03/14	5.63	5.70	5.61	7.19					
GEN 03/16	6.23	6.29	6.02	7.98					
TRP 06/20	6.39	6.42	6.19	7.93					
SWAP RATES									
2 years	3.80	3.90	3.76	3.92					
3 years	4.04	4.13	3.95	4.67					
5 years	4.42	4.51	4.22	5.42					
10 years	5.00	5.07	4.78	6.20					

Contact Details

BNZ Research

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

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Economist
+(64 4) 474 6923

Mike Jones
Strategist
+(64 4) 472 4767

Main Offices

Wellington
60 Waterloo Quay
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 474 6145
FI: 0800 283 269
Fax: +(64 4) 474 6266

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
129 Hereford Street
PO Box 1461
Christchurch 8140
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Rob Henderson
Chief Economist, Markets
+(61 2) 9237 1836

John Kyriakopoulos
Currency Strategist
+(61 2) 9237 1903

Wellington
Foreign Exchange
Fixed Income/Derivatives

+800 642 222
+800 283 269

Sydney
Foreign Exchange
Fixed Income/Derivatives

+800 9295 1100
+(61 2) 9295 1166

London
Foreign Exchange
Fixed Income/Derivatives

+800 333 00 333
+(44 20) 7796 4761

New York
Foreign Exchange
Fixed Income/Derivatives

+1 800 125 602
+1877 377 5480

Hong Kong
Foreign Exchange
Fixed Income/Derivatives

+(85 2) 2526 5891
+(85 2) 2526 5891

24 HOUR FOREIGN EXCHANGE SERVICE

Phone Toll Free 6am to 10pm NZT – Wellington Office
0800 739 707 10pm to 6am NZT – London Office – Sam Hehir

ANALYST DISCLAIMER: The person or persons named as the author(s) of this report hereby certify that the views expressed in the research report accurately reflect their personal views about the subject securities and issuers and other subject matters discussed. No part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in the research report. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Markets Division of National Australia Bank Limited, a member of the National Australia Bank Group ("NAB"). The views of the author(s) do not necessarily reflect the views of NAB and are subject to change without notice. NAB may receive fees for banking services provided to an issuer of securities mentioned in this report. NAB, its affiliates and their respective officers, and employees, including persons involved in the preparation or issuance of this report (subject to the policies of NAB), may also from time to time maintain a long or short position in, or purchase or sell a position in, hold or act as advisors, brokers or commercial bankers in relation to the securities (or related securities and financial instruments), of companies mentioned in this report. NAB or its affiliates may engage in these transactions in a manner that is inconsistent with or contrary to any recommendations made in this report.

NEW ZEALAND DISCLAIMER: This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.

US DISCLAIMER: This information has been prepared by National Australia Bank Limited or one of its affiliates or subsidiaries ("NAB"). If it is distributed in the United States, such distribution is by nabSecurities, LLC which accepts responsibility for its contents. Any U.S. person receiving this information wishes further information or desires to effect transactions in the securities described herein should call or write to nabSecurities, LLC, 28th Floor, 245 Park Avenue, New York, NY 10167 (or call (877) 377-5480). The information contained herein has been obtained from, and any opinions herein are based upon, sources believed to be reliable and no guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose. Any opinions or estimates expressed in this information is our current opinion as of the date of this report and is subject to change without notice. The principals of nabSecurities, LLC or NAB may have a long or short position or may transact in the securities referred to herein or hold or transact derivative instruments, including options, warrants or rights with securities, or may act as a market maker in the securities discussed herein and may sell such securities to or buy from customers on a principal basis. This material is not intended as an offer or solicitation for the purchase or sale of the securities described herein or for any other action. It is intended for the information of clients only and is not for publication in the press or elsewhere.

National Australia Bank Limited is not a registered bank in New Zealand.