

15 June 2009

NZ Manufacturing Collapses Further

- Q1 manufacturing production looks awful
- Sales flattered by big run-down in dairy stocks
- PSI still in contraction zone during May
- H1N1 impacts being taken seriously, at last
- Dairy prices remain on the back foot
- RBNZ bungles message on OCR bias

One could be forgiven in thinking New Zealand's manufacturing sector performed remarkably well in the March quarter, especially in relation to collapsing industrial production internationally. Q1 sales slipped just 0.9% in nominal terms and actually rose a seasonally adjusted 0.2% in volume terms. However, the underlying picture was actually awful. Make no mistake. We have suffered the global collapse.

March quarter manufacturing sales looked steady only because of a massive draw-down in previously bloated inventory of dairy products (a pattern also consistent with the recent "rebound" in dairy exports). They were not, in other words, reflective of better production.

Indeed, we believe dairy production, and thus processing, declined in the March quarter – partly related to the weather and partly because processing companies were sending a strong message to farmers to ease back a bit as they struggled to sell stock, amid tumbling prices.

We get a similar impression of manufactured meat products, in that rising Q1 sales belied an underlying contraction in processing in the quarter (although, unlike for dairy, meat prices were, for the most part, holding up reasonably well in the early stages of 2009).

The clearest signs of weak manufacturing production, however, came from the ex-agriculture components of this morning's report. While inventories have been less of an issue in this area, sales slumped a seasonally adjusted

6.5%, to be 14.7% lower than 2008 Q2, just before the global slump began in earnest. And the weakness has been across virtually all sub-categories of non-agriculture manufacturing. Few have escaped the global carnage, it would seem.

This all implies manufacturing will be a significant sore spot in the Q1 GDP accounts (due 26 June), for the second quarter running. We expected as much. And so we've kept our March quarter GDP estimate at -0.7%.

For our final word on Q1 activity, we'll have to wait for Wednesday's energy production statistics, which are now published by the Ministry of Economic Development directly, rather than via Statistics NZ. These include electricity and gas production, but also oil output, which is becoming increasingly important to get a handle on given the emergence of the Tui and Maari fields.

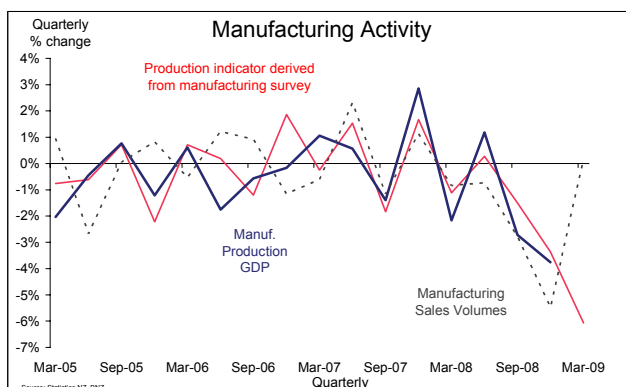
By and large, though, it seems fair to say New Zealand's industrial production has been contracting markedly over the last six months or so. This aligns with the messages from the BNZ Capital-Business NZ Performance of Manufacturing Index. And while this index is not quite as negative as it was a few months ago, it is hardly yet back into expansion territory – something also the case for the global PMI's.

And it's not as though the services sector is doing much of a job in holding the fort. New Zealand's was 46.2 in May, in figures published this morning (with, incidentally, no more NZ data to note for the rest of this week). Internationally, the PSI's are mainly below the 50 level that denotes breakeven.

The other thing making us nervous about the presumed economic recovery is the H1N1 virus. Some weeks ago we warned that folk were not taking it seriously enough as a genuine threat to economic activity. Now they seem to be.

This flu has every potential to be much nastier than usual ones, as the population has little to no familiarity with it. Southern hemisphere countries, of course, will be the guinea pigs in this respect, as we're beginning winter, when influenzas are more prone to spread. The death rate is not the issue. It's the impact of the flu on economic behaviour that's important.

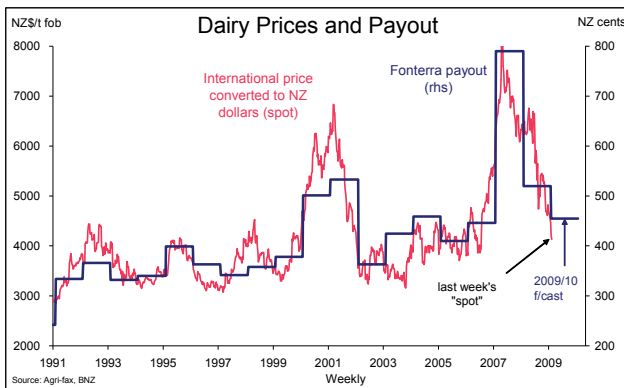
Local businesses, already bearing the brunt of the recession, need to think about how they'll cope with a good proportion of their staff at home in bed, not just the usual few. And firms working in high-contact areas,



such as hospitality, event management, accommodation, and so on, need to know how to minimise any fallout. The impacts on tourism have at least been acknowledged early, but might still be more damaging than appreciated. Just think of all the Australians planning their usual ski trips to New Zealand (with Melbourne recently being described as the swine flu capital of the world).

Domestically, consumers could well get a touch cautious. In the least, spending could be compromised simply as more people are stuck at home (either looking after themselves, or looking after the kids).

The other thing that has come at the worst of times for the economy is the further slippage in dairy prices (like the H1N1 virus, something given short shrift in last week's MPS). While they slipped last week just a tad further in US dollar terms, the higher exchange rate exerted a broader dampening influence. Those hoping the \$4.55 payout is a very conservative initial estimate of the final remuneration might want to think again.



Yet, New Zealand's exchange rate has been finding strength, partly from the recovery in global commodity prices. That would be tolerable if, like Australia, we produced copper, lead, nickel, zinc, tin, wheat, or even iron ore. But we don't. Our biggest commodity export is dairy, where prices remain under serious downward pressure. International prices for our other main food exports have, at best, simply held up.

Related to this, we're left with the clearer impression the RBNZ got a bit ahead of itself at last week's MPS, at just the wrong time. Most notably, it once again failed to appreciate the mindset the market was moving into – one of upside pressure on global interest rates and peripheral currencies (like New Zealand's) – and so shouldn't have backed off its easing bias as much as it appeared to do.

We believe risks remain significant of the presumed economic recovery faltering, if emerging for real in the first place. So we will keep monitoring the case for further OCR easing seriously. We believe the RBNZ should want to get that message across as well.

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Domestic Interest Rates

NZD interest rates were dominated in the last week by the RBNZ's decision to keep the Official Cash Rate on hold and the clear signal there were no more cuts forecast.

Prior to the meeting the market was pricing less than a 50% chance of a cut, so the RBNZ's message caught the market somewhat and a significant sell-off resulted. The futures & OIS curve are now pricing only a small chance of additional cuts to the OCR with the first hikes now being priced for early in 2010, significantly earlier than the track predicted by the RBNZ in the MPS.

The short end of the swaps market saw the most dramatic move in the wake of the OCR with a significant increase in yields. The market seemed very long in the 2-year part of the curve having absorbed a considerable amount of mortgage-book paying in the past few months. The change in tone saw a sell-off which went through some stop-loss levels, resulting in 2-yr swap trading as high as 3.98% before recovering somewhat later on Friday. The yield curve flattened considerably at the same time, as the long yield failed to move markedly. Direction is a little difficult to tell from here, the carry arguments are stronger than ever to receive 2-yr swap

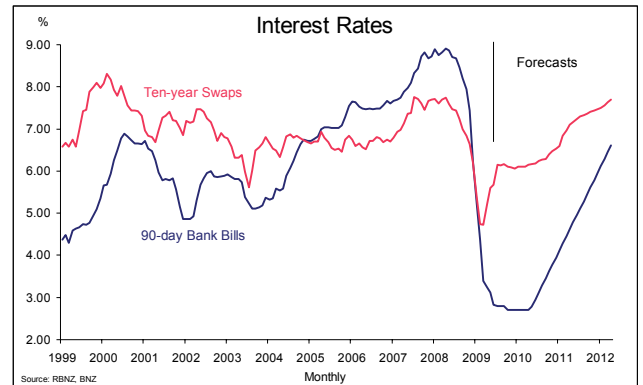
	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
5-Jun-09	2.69%	3.69%	5.94%	3.60%	6.08%	248
12-Jun-09	2.86%	3.80%	6.01%	3.86%	6.09%	223
Change (bps)	17	11	7	26	1	-25

Reuters pgs BNZL BNZM

but there is still consistent payside interest and seemingly not enough investor interest coming the other way to bring yields down significantly.

The bond market flattened somewhat on the week but escaped the worst of the sell off seen in swaps. There was some respite in the global bond rout over the week which helped to keep things in check. In addition, there was still considerable interest in paying EFP to support the market. Issuance will continue to weigh on kiwi bonds, while the market seeks direction both from offshore moves and the swaps market.

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Interest Rate Technicals

NZD 5yr Swap Rate

Outlook: Bearish
 MT Resistance: 5.75%
 MT Support: 5.17%

The 5-year swap rate has broken resistance at 5.17% and looks set to head higher. Only a move below the 5.17% level would negate this outlook.



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

Outlook: Steepening
 ST Support: +122

Steepening continues unabated and we will wait for a pullback to see where resistance is. Support is still at the previous resistance, of +122.



Foreign Exchange Market

The NZD/USD spent most of last week consolidating within a 0.6150-0.6450 range.

After weakening steadily since mid-April, the USD found a bit of reprieve last week. Growing speculation the Fed may hike rates before year-end boosted short-dated US bond yields and saw the US yield curve flatten. At the same time various officials, including the Japanese and Russian Finance Ministers, reiterated support for USD denominated assets and acknowledged the USD was unlikely to lose its status as a reserve currency any time soon. The net result tended to see the USD strengthen. The USD Index failed to break below 79.00 and spent last week going sideways in a 79.00-81.50 range.

While last week's RBNZ statement made it clear the "OCR could still move modestly lower over coming quarters" and that rates would remain "at or below the current level through until the latter part of 2010", this wasn't enough to stop market participants from being convinced the central bank has done its dash with regards to interest rate cuts. NZ 2-year swap rates rose about 25bps late last week (from 3.61% to 3.86%) and this was all that was needed to prompt further buying in the NZD.

Reuters pg BNZFWDS

While the generally firmer USD saw the uptrend in NZD/USD stall towards the end of the week, dips remained well supported with some macro and Asian accounts noted buyers towards the day's lows.

Looking ahead, with little on the local data calendar, USD sentiment will hold the key to the near-term fortunes of the NZD/USD. While we expect the USD to break lower eventually, the consolidation may have further to go near-term. We will probably need to see a reversal of last week's US yield curve flattening to see the USD weakness resume. If not before, we would expect the Fed statement on 24 June to remind markets about the likelihood of an exceptionally low level of Fed funds rate for an extended period of time. Until then the yield curve/USD correlation seems to be working reasonably well.

While the USD Index remains above 79.00, we suspect NZD/USD will struggle to break above 0.6500-0.6550. However, while market participants remain convinced the RBNZ is approaching the end of its tightening cycle (and NZ swap rates continue to move higher), we expect NZD/USD to remain well supported towards 0.6250.

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Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
 ST Resistance: 0.6470 (ahead of 0.6550)
 ST Support: 0.6230 (ahead of 0.6155)

Momentum indicators remain bullish, but the uptrend continues to stall above 0.6450. While the currency continues to trade above the 20-day high of 0.6155, we'd view dips as buying opportunities.

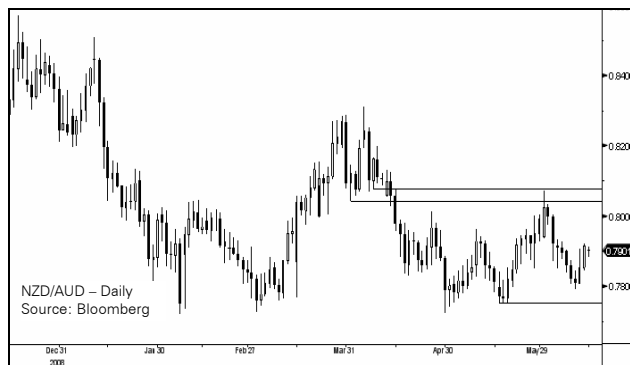


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NZD/AUD

Outlook: Buy a dip
 ST Resistance: 0.8050 (ahead of 0.8075)
 ST Support: 0.7750 (ahead of 0.7725)

Momentum indicators are neutral and the repeated failure to sustain dips below 0.7750 suggests a period of consolidation is in order.



Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 15 June				Wednesday 17 June <i>continued...</i>			
US, NAHB Housing Index, June		17	16	UK, BOE Minutes, 3/4 Jun Meeting			
US, Empire Manufacturing, June		-4.6	-4.5	UK, Average Earnings, April 3m y/y	+0.2%		-0.4%
US, Fed's Evans Speaks, Financial Crisis				UK, Unemployment rate (ILO), April		7.3%	7.1%
Tuesday 16 June				Jpn, BOJ Monthly Report			
Aus, RBA Minutes, 2 Jun Meeting				Euro, Trade Balance, April (s.a.)	-€1.5b		-€2.1b
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%	US, Current Account, Q1 s.a.	-\$84.8b		-\$132.8b
UK, CPI, May y/y	+2.0%	+2.3%		US, CPI ex food/energy, May y/y	+1.8%		+1.9%
Euro, Labour Costs, Q1 y/y	+3.0%	+3.8%		Thursday 18 June			
Euro, CPI, May y/y 2nd est		flat	flat(P)	UK, Retail Sales vol., May	+0.3%		+0.9%
US, Industrial Production, May		-1.0%	-0.5%	US, Leading Indicator, May	+1.0%		+1.0%
US, PPI ex-food/energy, May y/y	+3.2%	+3.4%		US, Philly Fed Index, June		-17.4	-22.6
US, Housing Starts, May		485k	458k	US, Jobless Claims, week ended 13/06		605k	601k
Germ, ZEW Sentiment, June	+35.0	+31.1		US, Geithner Testifies, Fin. Services Cmmttee			
Wednesday 17 June				Friday 19 June			
Aus, Dwelling Commencements, Q1	-3.0%	-2.0%	-9.9%	Jpn, BOJ Minutes, 21/22 May Meeting			
Aus, Westpac Leading Index, April			+0.3%	Germ, PPI, May y/y	-3.6%		-2.7%

Historical Data

	Today	Week Ago	Month Ago	Year Ago		Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS					FOREIGN EXCHANGE				
Call	2.50	2.50	2.50	8.25	NZD/USD	0.6395	0.6249	0.5861	0.7507
1 mth	2.85	2.76	2.84	8.60	NZD/AUD	0.7900	0.7867	0.7814	0.7989
2 mth	2.84	2.74	2.84	8.65	NZD/JPY	62.93	61.60	55.67	81.09
3 mth	2.81	2.69	2.76	8.65	NZD/EUR	0.4572	0.4477	0.4345	0.4872
6 mth	2.83	2.73	2.83	8.70	NZD/GBP	0.3893	0.3916	0.3861	0.3855
GOVERNMENT STOCK					NZD/CAD	0.7154	0.6999	0.6905	0.7728
07/09	2.65	2.63	2.77	7.07	TWI	60.60	59.63	57.03	67.76
11/11	3.79	3.77	3.52	6.66	NZD Outlook				
04/13	4.84	4.80	4.37	6.48					
04/15	5.48	5.47	4.94	6.47	<p>Source: BNZ, RBNZ</p>				
12/17	6.00	6.02	5.40	6.42					
CORPORATE BONDS									
BNZ 09/10	4.29	4.26	4.04	-					
BNZ 05/15	7.43	7.44	6.78	-					
GEN 03/14	7.48	7.43	6.86	-					
GEN 03/16	8.04	8.07	7.49	-					
TRP 12/10	4.63	4.57	4.83	8.03					
TRP 06/20	7.84	7.95	7.41	7.89					
SWAP RATES									
2 years	3.85	3.69	3.41	7.92					
3 years	4.56	4.39	4.01	7.73					
5 years	5.30	5.23	4.69	7.56					
10 years	6.08	6.14	5.49	7.45					

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