29 June 2009

Economy to Reverberate from Dairy Clanger

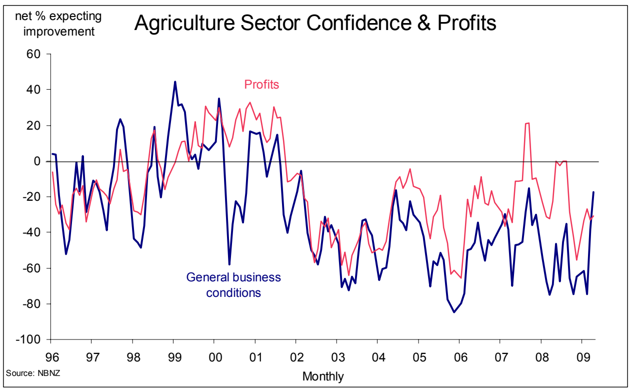
- Business confidence to falter
- Dairy payout disappointment to weigh heavily
- May's exports a picture of strength
- Profits crucial to near-term prospects

One of the ironies of last week's GDP release – which, in a headline sense at least, printed worse than we expected – is that it makes it more clearly suggests the worst is probably behind us. Two consecutive quarters of -1% growth, as we saw in both December 2008 and March 2009, are unlikely to be repeated; indeed, we expect modest growth to re-emerge in the second quarter of 2009, after another, but much smaller, contraction in Q2.

So far, so good. The problem is that it won't feel like things are that much better for many. The labour market will be the obvious sore point, something we expect to be echoed by tomorrow's Westpac-McDermott Miller employee confidence survey. Appreciation that employment conditions will continue to worsen, even while growth prospects start to improve, seems to have gained greater public acceptance in recent months and, as such, we'd be surprised if the Westpac's survey's headline reading didn't slide further from March's 93.2 (already more than 30 points lower than March 2008).

But it's equally true that the broad headline improvement in conditions we anticipate will mask a great deal of disparity amongst the detail. At the industry level, it's very much a case of the haves, and the have nots. This was the story of Q1's GDP data, and we expect it to be reinforced in spades in June's National Bank Business Outlook survey, due tomorrow afternoon.

The agriculture sector is particularly vulnerable to slippage, we suspect. Tomorrow's survey update, conducted during the first half of June, is the first since Fonterra's opening payout forecast was broadcast.

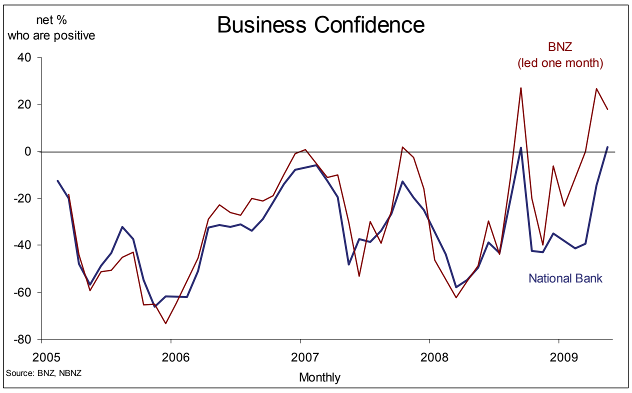


Trade Balance - May			
$NZ million	**Actual**	Mkt Expected	Previous
Exports	**3,960**	3,700	**3,645**
Imports	**3,101**	3,400	**3,327**
Monthly Balance	**858**	350	**319**
Yearly Balance	**-3,044**	-3,589	**-4,072**

The announcement was a clanger, hitting dairy farmers just at a time when the outlook was seemingly a little less cloudy. Most obviously, rural confidence will have taken a beating, reversing some (or all?) of the lift of recent months. But in hitting dairy farmers where it hurts most – the bottom line – profit expectations will also look that much more horrid, from the already shaky position recorded in May's survey.

It remains to be seen whether the reverberations of the Fonterra announcement will drown out any murmurs of revival being heard elsewhere, but we wouldn't bet against it. Tony Alexander's informal sentiment survey, usually a good lead on the NBNZ equivalent, took a slight turn for the worse in its June edition, despite being run ahead of the dairy payout bombshell. As such, a dip back into negative territory for NBBO's headline confidence looks a likely proposition. This was always the risk, quite frankly – May's reading was the best in seven years, and looked highly susceptible to a correcting fall, given prevailing uncertainties, still. The poor dairy payout forecast simply heightens the chances, and probable magnitude, of such.

So, too, does the elevated value of the NZ dollar, which was threatening the 60-mark, on a trade-weighted basis, by mid-June, by when most of the survey forms were probably filled out. And though the NZD/AUD cross – crucial to much of NZ's manufacturing export base – was essentially unchanged at survey time, at around 78c,



from a month earlier, it had traversed a 2c range in the interim. So it's not just the value of the currency, in level terms, that's generating consternation - the volatility's not doing exporters any favours either.

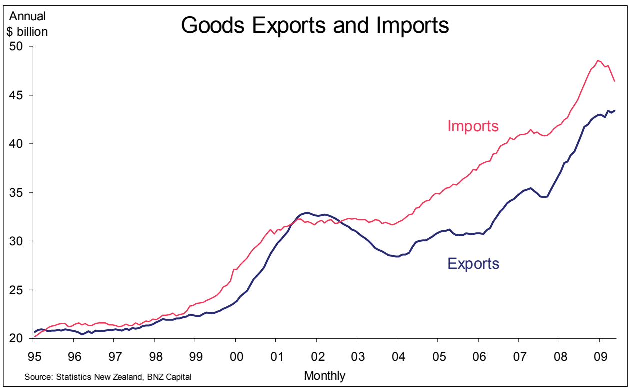
All of which might suggest exporters could be lumped in with the have-nots. But in the context of this morning's monthly merchandise trade figures, such a label would seem misplaced. May's export value, of a touch under $4b, was the highest such reading on record for a May month, and very close to the all-time high-water mark set in March.

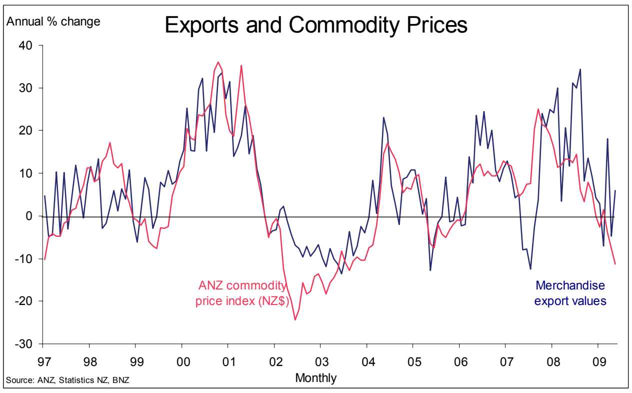
Amidst fears of faltering offshore demand, it was most pleasing to note the positive indicators, volume-wise, in May's export figures. Dairy product export volumes reached a new monthly peak, partly a bounce-back from last season's drought, and horticulture exports maintained their April, admittedly peak-season, highs. Even meat export volumes managed to hang in there, despite the dearth of lambs for slaughtering.

And in a month where primary products were the prize performers, log exports were the real winner; the monthly volume of log and timber exports tipped 1 million cubic metres for the first time in May.

The bulk of these log exports headed to China, gelling, incidentally, with the anecdote that we've been picking up. In fact, 80% of May's annual increase in export values was due to higher exports to China (comprising mostly logs and dairy), a fact Statistics New Zealand noted in its release. For all the global tribulations, we remain of the long-term view that NZ is in a prime position to service the resource demands of Asian emerging economies, and May's merchandise figures seem to support such a view.

But while export volumes would appear to be robust, the same can't be said for prices, where the impact of the higher NZ currency is most obvious. Indeed, NZD commodity prices looked like they slipped further in June, not helped by softening in USD-denominated dairy prices in recent weeks. June's ANZ commodity prices, due Thursday, will provide the latest word.





Against May's stellar exports – which exceeded our expectations by some margin – imports were about as weak as we figured they would be, falling to about $3.1b, nearly 21% below a year ago. Much of that annual decline reflected lower oil prices, though; consumption goods imports were about flat by annual comparison, and investment goods, pleasingly, managed a 5% gain.

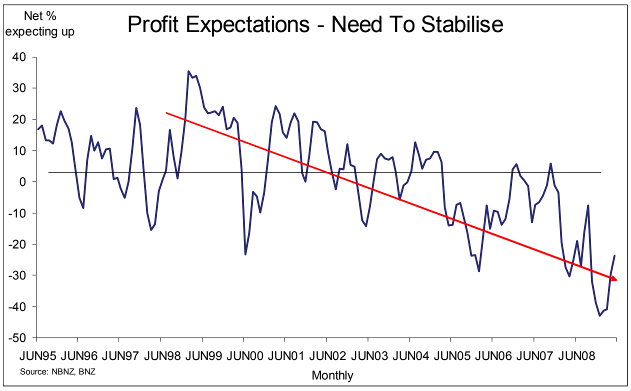
Net, May's monthly surplus of $858m (in conjunction with an upward revision to April's surplus) lowered the annual merchandise deficit to a little over $3b. A year earlier it was nearly $4.8b. That's a huge turnaround, with obvious implications for the balance of payments. We'll reserve our full judgement until we see June's monthly data, of course. At the very least, though, May's merchandise data reinforces our notion that the current account deficit remains on an abating trend for the meantime.

Also released this morning, May's building consents were much of a muchness. Ex-apartment consents were down 3.2% m/m, to be nearly 38% lower than last May. Like the economy more broadly, we believe the worst for residential building is behind us, with a handful of housing-related activity indicators pointing to stabilisation. The latest of these was this afternoon's household credit figures, for May, in which growth in household borrowing lifted to an annualised 4.9% (from the November 2008 trough of -1.2%).

By contrast, the value of non-residential consenting was about 35% higher in May than a year earlier, following another hefty gain in April. Both monthly gains represent substantial one-offs (the Christchurch airport extension in April and various sports stadiums in May) rather than a genuine sustained lift in activity, though. We expect a pull-back to "normal" levels in the months ahead; anticipation of such within the construction sector could also be reflected in softer expectations in May's NBBO.

One sector that has held up reasonably well, to date, is government services, in registering a 3.1% y/y lift in activity in Q1's GDP figures. But the government sector's not immune to the trials of the broader economy, most obviously exposed via the painful shrinkage in its tax take. The extent of the squeeze will be revealed in May's update of the Crown's monthly financial accounts, released Friday morning.

We expect these to look awful, perhaps even compared to the fairly recent forecasts produced for May's Budget. It's really just a matter of degree. What will be clear is that the government's key revenue streams are under continued pressure, with corporate profit tax perhaps the most afflicted of these. On this front, firms' own profit expectations are fairly dismal, suggesting little relief on the horizon. And another push lower, reflecting Fonterra's poorer-than-expected 2009/10 payout, if nothing else, is likely in the National Bank survey's measures of such, we'd judge. That would not only further undermine the outlook for the government's finances, but overshadow near-term growth prospects more broadly.



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Domestic Interest Rates

Reuters pgs BNZL BNZM

NZD interest rates saw a small rally on the week without any great conviction. The 3-month bank bill remains tightly rangebound with a 2.79%-2.83% range quite strong. The market is pricing just a 20% chance of a further 25bp cut to the OCR, with a very flat curve priced till the end of the year. Hikes begin to be priced from early in 2010. The weak Q1 GDP number of last Friday failed to move the futures market too much, as the small rally that resulted saw aggressive profit takers.

The government bond market also had a quiet week, generally taking cues from offshore moves. The tender was well supported with 200m of bonds taken with a bid to cover ratio of nearly 3:1. We see the choppiness continuing in the coming week, with it likely that NZ will underperform offshore markets, matching sell offs but failing to keep pace on rallies.

The swaps market saw a reasonable rally on the week, with offshore moves again a driver. One major story was the under-performance of the belly of the curve, with 2yr-5yrs steepening while 5yr-10yrs flattened. This was a combination of the general flattening in offshore curves combined with the good carry (around 10bps per 3-months) available from paying 2s5s. The kiwi swap market will likely be pushed by flow and offshore moves in the coming week. The domestic focus hinges on Tuesday afternoon's NBNZ business survey – the first to capture the bad forecasts for the dairy payout.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
19-Jun-09	2.81%	3.90%	6.06%	3.92%	6.20%	228
26-Jun-09	2.81%	3.88%	6.02%	3.84%	6.08%	224
Change (bps)	**0**	**-2**	**-4**	**-8**	**-12**	**-4**

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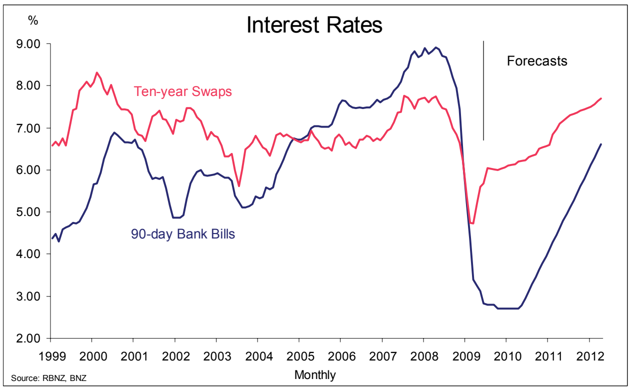

Interest Rate Technicals

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NZD 5yr Swap Rate

Outlook: Bearish

MT Resistance: 5.75%

MT Support: 5.15%

The 5-year swap rate has broken resistance at 5.15% and looks set to head higher. Short term resistance is at 5.46% and we expect this to break and head towards the 5.75% level. Only a move below the 5.15% level would negate this outlook.

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

Reuters pg BNZWFWDS

NZD/USD spent last week muddling around in a 0.6250-0.6500 range. The global backdrop hasn't been providing much in the way of direction – global growth expectations seem to be stabilising and the USD appears caught in a sideways shuffle.

While we expect the USD to trend lower eventually, we're not convinced the USD is ready to take a step lower just yet. The recent Fed statement, which hosed down expectations of near-term rate hikes by saying that rates will remain at "exceptionally low" levels for an extended period", has the potential to weigh on the USD. However, the recent wobbles seen across global equities and the problems still present in Europe make us wary. There is a lot of global data to keep an eye on this week – US non-farm payrolls, Japan's Tankan and the ECB policy decision. But we'll need to see the USD Index break out of its 78.00-82.50 range before we're confident we're seeing the start of a new trend in the USD.

The sense that NZ has weathered the global ructions in relatively good shape has provided a bit of support for the NZD over the past few months. However, we shouldn't ignore recent warnings from Governor Bollard and Prime Minister Key about the fragility of NZ's green shoots and that the recent tightening in financial conditions (thanks to a higher NZD and higher interest rates) is a threat to NZ's recovery. Friday's weaker than expected Q1 GDP (it fell 1.0%q/q vs. 0.7% forecast) was the fifth consecutive quarterly drop and Q2 will possibly be another. This week's NBNZ Business Outlook (Tuesday) will provide a useful update as to whether the previous undertones of a mild recovery remain or whether the NZ business sector is becoming doubtful.

Nor should we overlook the whopping NZ$4.6b worth of Eurokiwi and Uridashi bonds maturing in July. Next month's maturities are well above the NZ$1-1.2b worth of maturities seen in an average month. Uridashi and Eurokiwi investors tend not to hedge their currency exposure. As such, upcoming maturities are a potential downside risk to the NZD should these investors decide to switch out of NZD denominated assets.

So far in 2009, about 30% of these Eurokiwi and Uridashi bonds have been rolled into new NZD issues. It seems likely that many of the upcoming NZ maturities will be moved into AUD denominated assets. After all, Australia's triple-A rating is a grade above NZ's and yet Australian 3-year swap rates are some 75bps higher than those in New Zealand. As such, we wouldn't be surprised if selling from real-money accounts adds some weight to NZD, particularly against the AUD, in the next few weeks.

In the absence of a major surprise from the global backdrop or the USD, the recent choppy range trading in NZD/USD looks likely to continue again this week. However, concern about the fragility of NZ's recovery and impending Eurokiwi and Uridashi maturities should help limit NZD/USD bounces towards 0.6500-0.6550.

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Foreign Exchange Technicals

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NZD/USD

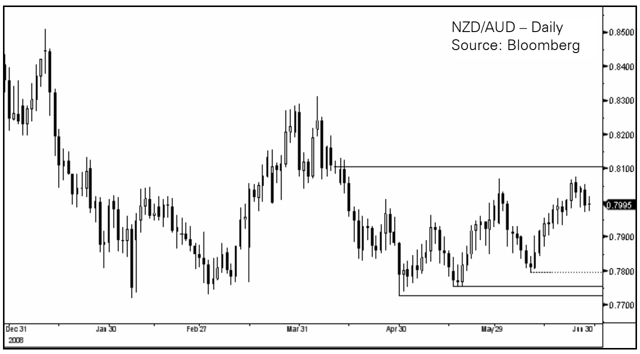
Outlook:	Buy a dip
ST Resistance:	0.6480(ahead of 0.6550)
ST Support:	0.6250 (ahead of 0.6155)

While the currency trades above its 20-day low of 0.6155, we'd view dips as buying opportunities. A break above 0.6480 will open up the topside back towards the June high of nearly 0.6600.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8070 (ahead of 0.8110)
ST Support:	0.7780 (ahead of 0.7755)

The market is approaching an interesting junction. A failure to break above 0.8100 would be viewed as a sell signal, while a convincing break above 0.8100 will suggest further upside potential.



Key Upcoming Events

	Forecast	Median	Last
Monday 29 June			
NZ, Household Credit, May y/y			+2.6%
NZ, Building Consents, May (res, #)			+11.2%
NZ, Merchandise Trade, May	+$113m	+$375	+$276m
Jpn, Industrial Production, May 1st est		+7.0%	+5.9%
Jpn, Retail Trade, May y/y		-2.6%	-2.8%
Euro, Economic Confidence, June		71.0	69.3
Tuesday 30 June			
NZ, NBNZ Business Survey, June			+2.0
Aus, Private Sector Credit, May	+0.2%	+0.2%	+0.1%
Jpn, Unemployment Rate, May		5.2%	5.0%
Euro, M3, May y/y		+4.6%	+4.9%
Euro, CPI, June y/y 1st est		-0.2%	flat
US, Chicago PMI, June		39.0	34.9
US, Shiller Home Price Index, April y/y		-18.8%	-18.7%
US, Consumer Confidence, June		55.2	54.9
Germ, Unemployment, June		8.3%	8.2%
Wednesday 1 July			
Aus, Building Approvals, May	-2.5%	+3.0%	+5.1%
Aus, Manufacturing PMI (AiG), June			37.5
Aus, Retail Trade, May s.a.	+0.5%	+0.5%	+0.3%
Jpn, Tankan (lge manuf), Q2		-43	-58

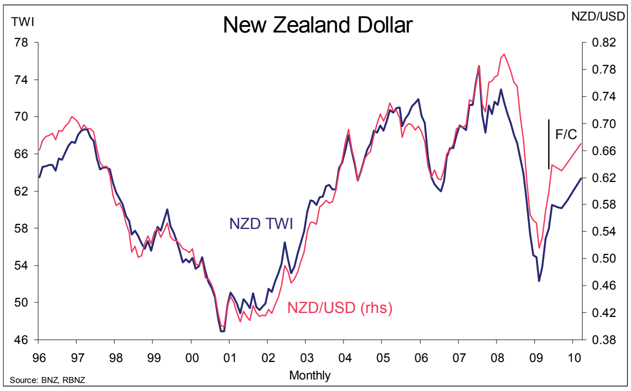
	Forecast	Median	Last
Wednesday 1 July *continued...*			
UK, CIPS Manuf Survey, June		46.4	45.4
US, ADP Employment, June		-390k	-532k
US, ISM Manufacturing, June		44.5	42.8
US, Pending Home Sales, May		+0.5%	+6.7%
US, Construction Spending, May		-0.6%	+0.8%
Germ, Retail Sales - vol, May		flat	+0.5%
China, PMI (NBS), June			53.1
Thursday 2 July			
NZ, ANZ Comdty Prices ($NZ), June			-1.5%
Aus, International Trade, May	+$200m	-$125m	-$91m
UK, BOE Credit Conditions Survey, Q2			
Euro, Unemployment Rate, May		9.4%	9.2%
Euro, PPI, May y/y		-5.6%	-4.6%
Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
US, Non-Farm Payrolls, June		-350k	-345k
US, Factory Orders, May		+0.8%	+0.7%
Friday 3 July			
Aus, Services PMI (AiG), June			39.9
UK, CIPS Services, June		51.5	51.7
Euro, Retail Sales, May		-0.1%	+0.2%
US, Holiday, Independence Day (observed)			

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	8.25
1 mth	2.78	2.80	2.75	8.61
2 mth	2.81	2.84	2.78	8.66
3 mth	2.81	2.81	2.77	8.67
6 mth	2.82	2.82	2.80	8.62
GOVERNMENT STOCK				
07/09	2.58	2.65	2.68	6.99
11/11	3.88	3.90	3.66	6.39
04/13	4.87	4.90	4.57	6.34
04/15	5.50	5.54	5.19	6.35
12/17	6.02	6.06	5.72	6.35
CORPORATE BONDS				
BNZ 09/10	4.21	4.30	7.50	-
BNZ 05/15	7.27	7.40	8.68	-
GEN 03/14	7.11	7.19	7.25	-
GEN 03/16	7.84	7.98	7.65	-
TRP 12/10	4.60	4.65	7.00	7.93
TRP 06/20	7.83	7.93	6.95	7.73
SWAP RATES				
2 years	3.82	3.92	3.55	7.81
3 years	4.57	4.67	4.18	7.61
5 years	5.36	5.42	4.92	7.45
10 years	6.06	6.20	5.76	7.30

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6450	0.6426	0.6151	0.7610
NZD/AUD	0.7997	0.7983	0.7858	0.7916
NZD/JPY	61.43	61.82	58.27	80.80
NZD/EUR	0.4586	0.4605	0.4384	0.4823
NZD/GBP	0.3908	0.3893	0.3861	0.3815
NZD/CAD	0.7432	0.7294	0.6893	0.7688
TWI	60.76	60.78	58.46	67.65

NZD Outlook



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