

6 July 2009

Has the QSBO Recovered Enough?

- Tuesday's QSBO to have shaken March fear
- But its substance will simply be less negative
- Profit expectations key to business outlook
- Thursday's ECT will set June's spending tone
- House prices stabilising, for now

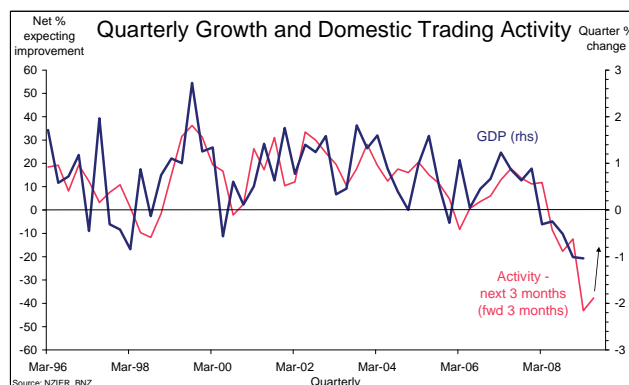
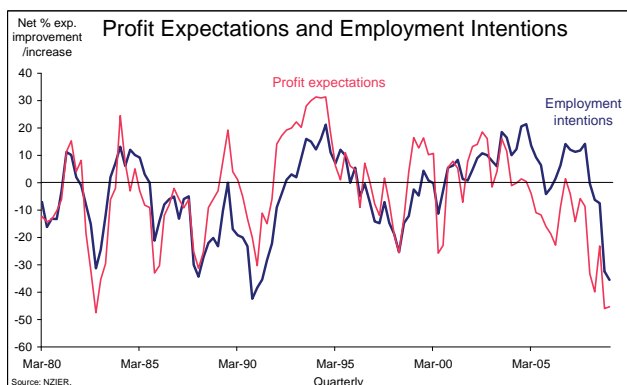
Tomorrow morning's Quarterly Survey of Business Opinion (QSBO) will set the tone for the week, locally. We know it will look substantially better than the previous one. But then the previous survey was taken back in March – in the heart of world economic darkness – and so was understandably the worst NZ business survey in at least four decades.

The big question for the June QSBO, therefore, is not has it recovered but has it recovered enough? We're not so sure it has, and certainly not in the right areas.

To be sure, net confidence has probably scrambled back to near flat, from -65 in March. While risks remain, the abject fear from that time has passed to a clear extent. And QSBO reported and expected trading-conditions will likely look much less negative than the -47 and -38 readings they respectively registered back in March. We're anticipating June results in the negative teens.

The litmus test for us, however, will be profit expectations. These have traditionally provided solid leading information on the business cycle. Of course, these were seriously negative in the March, with a net 45% of firms expecting profits to fall. This indicator needs to get up closer to its long-term average, of about -7, to give us confidence the NZ business sector is turning the corner. We don't believe we're quite there yet.

And so we'd expect to see the QSBO expectations on employment and investment mired in negative territory –



albeit not quite as far south as we witnessed in the March issue – as firms keep cutting costs in order to help restore profitability. These are essentially the messages we've seen in the month to month business surveys.

What the monthly surveys haven't done so well, by design, is tell us the degree of slack that is opening up in the economy. This is where the QSBO is a treasure chest of information. We expect its capacity usage measures to confirm further softening in relation to available capital and labour – it's just a matter of marking the degree.

It's a reminder that for as long as GDP undershoots its typical quarterly expansion then spare capacity will keep opening up. More plant and equipment becoming idle, more buildings vacant and more folk "in between jobs".

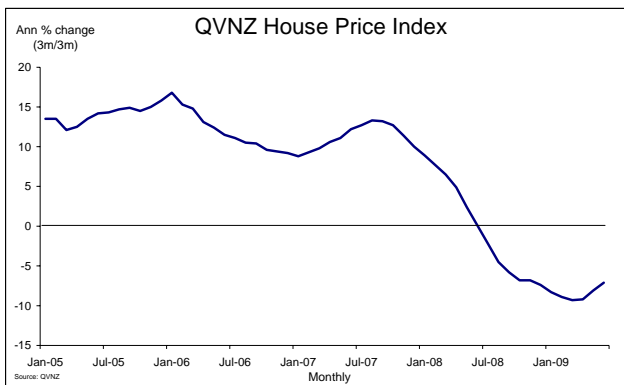
To stop the rot we need to know GDP growth is not just turning positive, but running above long-term norms. We seem some ways from that, as Tuesday's QSBO is bound to show. It's just the rate of slippage that seems to be abating for the moment.

Other than the QSBO, it's a quiet data week in New Zealand. The only other item in the schedule is Thursday's Electronic Card Transactions (ECT). These will be our first insight into June spending. Previous months have shown reasonable, if mixed, gains. Perhaps we'll see another?

But even if June does see a further increase in the ECT series we'll be left none the wiser on what it really means about the economy. We say this noting the winter sales seemed to have kicked off early this year, with discounting particularly ferocious in some quarters – all despite the colder than normal weather over May and June. Could it be that retailers overstocked for a tax-cut bonanza that simply didn't arrive?

It's a reminder of the underlying issue of needing to make a buck, not just that turnover might be improving. It's also good reason to keep an eye on profitability reports from merchants in tomorrow's QSBO, not just from the in-focus manufacturing sector and newly exposed service sector.

Finally, we note the stabilising tones from the latest Quotable Value NZ house price index. Its three-month to June index was down 7.1% on last year – a lessening annual fall, implying the month-to-month moves are probably now going sideways, rather than down any further.



This undoubtedly reflects improved demand, underpinned by substantially lower mortgage rates and probably also a bit of catch-up from buying postponed during the frightened times of late-2008 and early-2009.

But home prices have also been propped up, artificially, by restrained supply on a number of fronts. New home building has tanked to unusually low levels, for example, as have sales listings of existing homes. These will have to pick up at some stage, by potentially big degrees, with recent signs of better demand simply egging this process on.

Supply of housing should also be well afforded by the abundance of vacant sections in many parts of the country (an overhang from the prior housing mania) – although this does rely on sellers getting as real on price as sellers are beginning to be now in respect of existing homes.

Fundamentally, we believe house prices remain over-valued based on long-term metrics. Not as much as the 30% we proposed early last year. There's been some correction since then. But home prices still appear too high to be consistent with a properly cleared market. So the medium-term prognosis is not without real risks of a further leg lower – especially to the extent that the supply due to come back on stream turns into a flood. We might get a fairly valued housing market yet.

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Domestic Interest Rates

NZD interest rates rallied strongly on the week, underpinned by a buoyant Australian market. The very front of the curve continued to hold to its tight range but good rallies were seen in all maturities further out the curve, with a significant flattening of the curve the consequence. In terms of pricing, the market still thinks there is a small chance of a further cut to the OCR, with the 90 day bank bill track forecast to be very flat to the end of the year, from which point hikes begin to be priced.

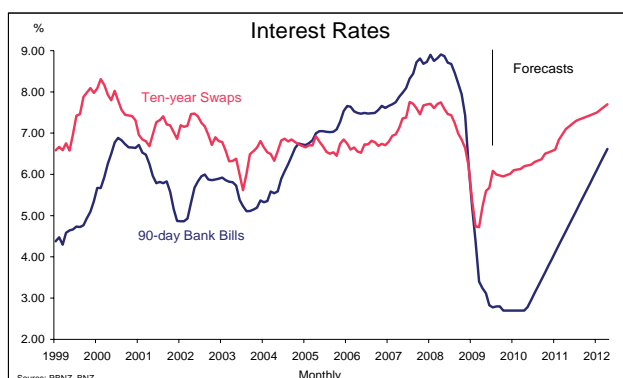
The bond market performed well last week, with a good bid tone throughout. The tender went exceptionally well with \$200m of 2021 maturity bonds taken with a 4:1 bid to cover ratio. The strong tone looks set to continue for the coming week, but both the Australian and US markets are close to key resistance levels. If these break, a major rally could result. If not, we will likely play recent ranges. Additional support for the bonds is coming from the upcoming 15/07/09 maturity which will see approximately \$3.8 billion redeemed.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
26-Jun-09	2.81%	3.88%	6.02%	3.84%	6.08%	224
3-Jul-09	2.80%	3.69%	5.79%	3.70%	5.86%	216
Change (bps)	-1	-19	-23	-14	-22	-8

Reuters pgs BNZL BNZM

The swaps market followed the trend, rallying and flattening over the week. Bond issuance, both locally and in the form of Uridashis provided some solid receiving interest and helped to push through some lesser mortgage book paying. The steepness of the yield curve seems to be pushing a lot of the retail mortgage flow into 2-yr and shorter maturities, where the risk is more readily absorbed by the market helping to let yields fall. Carry remains very attractive for receiving short-end swap, although there will likely be some profit taking before we rally much further from current levels.

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Interest Rate Technicals

NZD 5yr Swap Rate

Outlook: Bearish
 MT Resistance: 5.75%
 MT Support: 5.15%

The 5-year swap rate has come back to test the 5.15% support area. Expect this to hold and yields to head higher. If this level does not hold then we could move down to the 4.60/70% area.



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

Outlook: Steepening
 ST Support: +122

The market has taken a breather here, but has not pulled back far. We therefore expect the steepening trend to continue.



Foreign Exchange Market

NZD/USD closed down 2.4% during last week, the victim of faltering global risk appetite, renewed concerns about the fragility of New Zealand's economic outlook and impending Uridashi and Eurokiwi redemptions.

Questions around the status of USD as the global reserve currency also resurfaced during the week. China's central bank repeated its call for the creation of a new sovereign reserve currency to reduce the dollar's global domination. However, Dallas Fed president Richard Fisher brushed off the Chinese comments, stating "I don't see the dollar being supplanted as the leading currency in the world." Chinese officials also appeared to subsequently soften their remarks somewhat, noting that there would be no sudden changes to policies for its foreign reserves (most of which are USD denominated). Overall, USD sentiment improved during the week, with the DXY index closing at around 80.30, from below 80.00 at the beginning of the week.

Against this backdrop, the NZD/USD steadily weakened, exacerbated by diminishing investor risk appetite. US non-farm payrolls data showed a loss of 467,000 jobs during June (considerably worse than the expected 365,000 decline), providing a stark reminder that worsening labour markets will provide a significant hurdle to global economic recovery. Growth-sensitive currencies, including AUD and NZD, came under selling pressure as a result. NZD/USD closed at around 0.6300, from the week's opening of about 0.6450.

Reuters pg BNZFWDS

For the local week ahead, tomorrow's QSBO will set the tone. We suspect the headline indicators will rebound. However, this would say as much about the economic depths plumbed in March as the prospects for genuine recovery. Indeed, some of the key measures – most notably profit expectations and investment/employment intentions – will probably look extremely weak, still. We suspect it will provide a clear warning of the fragility of New Zealand's economic outlook.

Offshore events will remain a driving force for NZD in the short-term, though. Wall St's negative reaction to the worse than expected US jobs data last week might signal the start of a deeper correction in financial markets, and a turn for the worse in investor risk appetite. The profit reporting season, starting this week, will only keep the heat on. If global woes resurface, it would be a negative for currencies like the NZD and AUD which have been beneficiaries of the "green shoots" rally that started in mid-March.

There is solid resistance in the NZD now towards the 0.6450-0.6550 region and we would see selling rallies back towards that area as the favoured strategy at the moment. Immediate support rests at the 0.6250/0.6275 level, which has held since early June. A breach of this level on a broadening of USD strength would open the way for a deeper retracement towards the US60cent area.

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Foreign Exchange Technicals

NZD/USD

Outlook: Sell a rally
 ST Resistance: 0.6450 (ahead of 0.6550)
 ST Support: 0.6275 (ahead of 0.6125)

Solid resistance at 0.6450 favours selling rallies. A breach of 0.6250 would open up the downside toward 0.6000.



NZD/AUD

Outlook: Consolidation
 ST Resistance: 0.8050 (ahead of 0.8150)
 ST Support: 0.7825 (ahead of 0.7725)

Failure to break 0.8100 last week suggests further consolidation within the ranges of recent months is on the cards.



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Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 6 July				Thursday 9 July continued...			
US, ISM Non-Manuf, June		46.0	44.0	Aus, Employment, June	-25k	-25k	-2k
Aus, TD Inflation Gauge, June y/y			+1.5%	Aus, Unemployment Rate, June	5.9%	5.9%	5.7%
Tuesday 7 July				UK, BOE Policy Announcement	0.50%	0.50%	0.50%
NZ, QSBO, Q2	-5		-65	UK, Trade Balance, May		-£2.85b	-£3.01b
Aus, RBA Policy Announcement	3.00%	3.00%	3.00%	Euro, ECB Monthly Bulletin			
Aus, Construction PMI (AiG), June			46.9	US, Wholesale Inventories, May		-1.0%	-1.4%
UK, Industrial Production, May		+0.2%	+0.3%	US, Jobless Claims, week ended 04/07			614k
Germ, Factory Orders, May		+0.5%	flat	China, Business Climate Indicator, Q2			105.6
Wednesday 8 July				Friday 10 July			
Aus, Housing Finance, May	flat	+1.5%	+0.9%	UK, PPI (core output), June y/y		+1.1%	+1.2%
Aus, Consumer Sentiment - Wpac, July			100.1	US, Import Prices, June		+2.0%	+1.3%
Jpn, Machinery Orders, May		+2.4%	-5.4%	US, Mich Cons Confidence, July 1st est		70.6	70.8
Jpn, Eco Watchers Survey (outlook), June			43.3	US, International Trade, May		-\$30.0b	-\$29.2b
Euro, GDP, Q1 3rd est		-2.5%	-2.5%	Monday 13 July			
Germ, Industrial Production, May		+0.5%	-1.9%	NZ, Retail Trade, May	+1.0%		+0.5%
Thursday 9 July				Jpn, Industrial Production, May 2nd est			+5.9%P
NZ, Electronic Card Transactions, June			+0.7%	China, Trade Balance (\$US), June			+\$13.39b

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	0.6280	0.6426	0.6249	0.7582
1 mth	2.81	2.80	2.76	8.58	NZD/AUD	0.7900	0.7983	0.7867	0.7875
2 mth	2.79	2.84	2.74	8.61	NZD/JPY	60.32	61.82	61.60	80.96
3 mth	2.80	2.81	2.69	8.55	NZD/EUR	0.4499	0.4605	0.4477	0.4830
6 mth	2.82	2.82	2.73	8.58	NZD/GBP	0.3856	0.3893	0.3916	0.3824
GOVERNMENT STOCK					NZD/CAD	0.7297	0.7294	0.6999	0.7722
07/09	2.64	2.65	2.63	6.95	TWI	59.59	60.78	59.63	67.55
11/11	3.69	3.90	3.77	6.27	NZD Outlook				
04/13	4.68	4.90	4.80	6.27					
04/15	5.28	5.54	5.47	6.31					
12/17	5.79	6.06	6.02	6.32					
CORPORATE BONDS									
BNZ 09/10	3.99	4.30	4.26	-					
BNZ 05/15	7.15	7.40	7.44	-					
GEN 03/14	7.26	7.19	7.43	-					
GEN 03/16	7.70	7.98	8.07	-					
TRP 12/10	4.56	4.65	4.57	7.97					
TRP 06/20	7.70	7.93	7.95	7.74					
SWAP RATES									
2 years	3.72	3.92	3.69	7.86					
3 years	4.45	4.67	4.39	7.67					
5 years	5.22	5.42	5.23	7.48					
10 years	5.88	6.20	6.14	7.28					

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