27 July 2009

Let the Good Times Roll

- RBNZ to reiterate low OCR for extended period
- As NZD strength, ongoing economic risks, weigh
- RBNZ prudential measures a de facto tightening
- July's NBNZ business survey could go either way
- June's import decline to outpace fall in exports
- Building consents, credit, to signal housing repair

With everyone and their dog expecting the Reserve Bank to hold its cash rate at 2.50% this Thursday, the news will be in its few paragraphs of commentary. Will it signal a shift to the sanguine, validating the market's view of rate hikes starting six months hence? We hope not. We believe the Bank will, as it should, stand its ground amid overly excited markets – in essentially reiterating the cautious undertones of its June Statement.

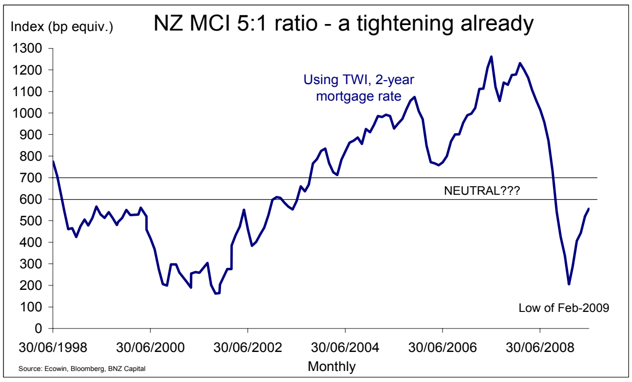
It might even leave in the "or below" part of the "we expect to keep the OCR at or below the current level through until the latter part of 2010" phrase of its June MPS. We think it probably should, for good measure.

To be sure, signs of some sort of recovery continue to bud. We have captured this in our latest research piece *Recession in its Death Throes* (24 July 2009). The economic information – both in New Zealand, and abroad – has, by and large, improved. So too have financial markets continued to exhibit signs of repair. The RBNZ will have to acknowledge these.

However, it's also true the economic and financial backdrop remains fragile and the most uncertain it's been in many a decade. We are still feeling our way through a thick fog, in uncharted waters, that only the benefit of much more time will make clear. As much as things might genuinely brighten, we might next encounter further hiccups or major disappointment.

As it is, the world and local economies have, at best, stopped contracting. While many Asian economies have exhibited signs of bouncing back, it will take another three to six months to see if this is more than a dead tiger bounce. And while the rate of contraction in most other countries is abating, it's certainly signifying continued slippage, into a bigger hole, in relation to supply.

Even if there is a genuine pick-up at hand the RBNZ should hardly be concerned by it at this early stage, given the large amount of economic slack that will keep CPI and wage pressures muted for a good while yet.



And even when there does need to be a tightening of monetary policy there are a number of channels by which this can occur…well ahead of any signal the RBNZ sends about an imminent OCR hike.

Much of this will simply come via the financial markets. Just as they priced substantially more in the way of OCR cuts than the RBNZ ever did in the recent easing cycle, so they will try to front-run the Bank on the tightening cycle, right the way along the wholesale interest rate curve.

Knowing this, the Bank will most likely be either signing off on the market's view (as happened on the way down), or showing resistance to the market's timing and degree. It's most unlikely the RBNZ would have to force the markets to price in more rate hikes, earlier.

And this is especially so when the NZ dollar has every potential be the first cab off the rank in the tightening cycle. Indeed, the currency is well on its way to being so already. The TWI is now "about average" and clearly above where the June MPS judged it would be. More to the point, it looks set to defy the big fall the RBNZ "assumed" in its June MPS, as long as the economic and financial news continues to recover.

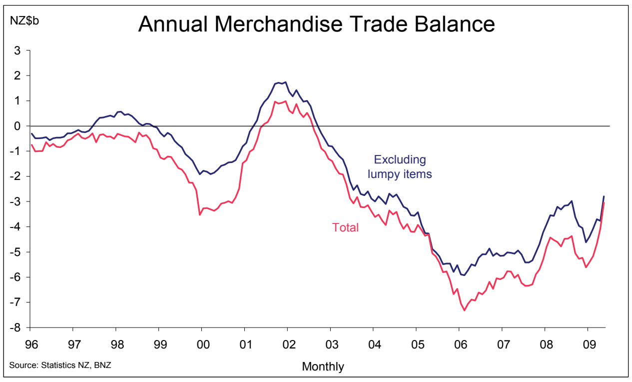
The exchange rate thus threatens to choke the timing and extent of economic recovery, twist the composition of growth unhelpfully back toward domestic demand rather than exports (thus sustaining current account concerns), as it forces local interest rates to play second fiddle. With this in mind, we would expect Governor Alan Bollard to express great discomfort this week with where the currency's at, and especially about the heights it might be eyeing.

But it's not just the currency and forward interest rates that promise to tighten policy well ahead of any OCR moves the RBNZ will feel compelled to signal. So too will the new prudential regulations the RBNZ has recently proposed for the local banking system. These will, in effect, drive funding costs even higher, as part of tightened prescriptions around lending in relation to funding.

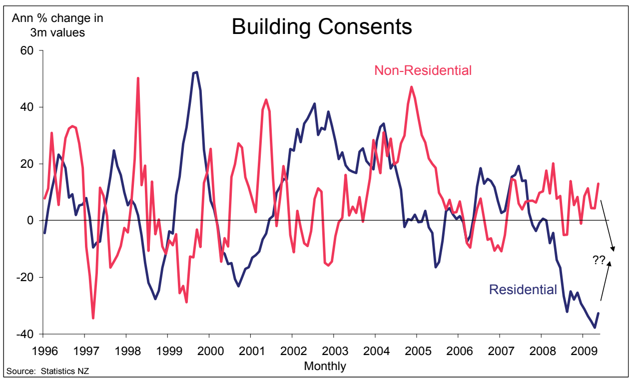
Of course, the Reserve Bank's new regulations are armed across a two-year window. And they're no great surprise, in that the RBNZ has been mulling them quite possibly, for many months. So, there should be no shock element. Still, the transition phase will certainly exert upward pressure on retail rates, albeit leaving the heavy lifting to the OCR, and expectations thereof, in respect of slowing demand.

It's only at any strong phase of the tightening cycle will the lending and funding ratios being prescribed by the Bank come into play, arguably taking the heat off the OCR to do all the work.

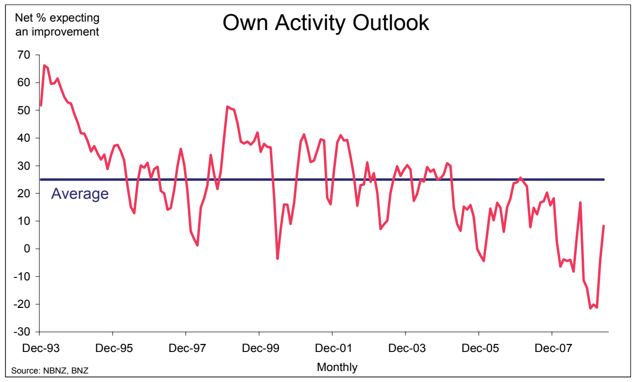
Ahead of Thursday's OCR meeting, the local data week begins with tomorrow's June merchandise trade figures. Imports (-16% y/y) probably fell faster than exports (-5% y/y). The expected monthly surplus, of $215m, would be plenty enough to signal further contraction in the current account deficit, while helping to limit the fall we estimate for Q2 GDP to just 0.2%.



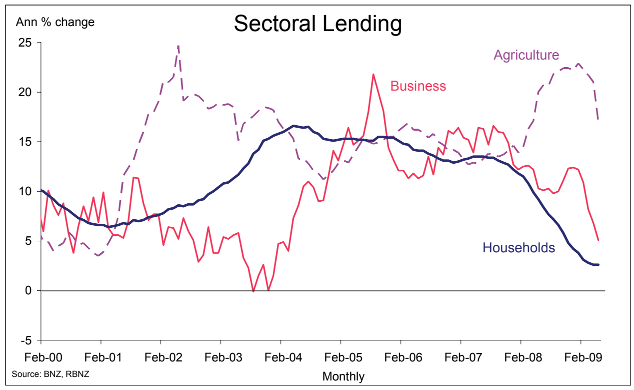
Then we have Wednesday morning's building consents. These seem set to reveal a clearer bounce in residential but, just as significantly, underlying weakness on the non-residential side of construction. Overall, however, bear in mind the potential for June's data to be bolstered by a rush to beat the 1 July increases to council consent processing fees.



Wednesday afternoon's NBNZ business survey promises to be the most important local news. Having steadily clawed its way back from the abyss over recent months, it could shift either way for this month of July. And either would be significant. We'll see.



The NZ data week ends with Thursday afternoon's credit aggregates for the month of June. These will likely register further recovery in mortgage lending (albeit gentle, if recent moderation in the week-to-week mortgage approvals data is any guide) but further sharp deceleration in credit to the agriculture/dairy sector.



The big focus, of course, will be on Thursday's RBNZ commentary. We believe it will disappoint those clamouring for OCR hikes by early next year. The economic and financial backdrop doesn't justify such a sanguine view, at this still-delicate, early, stage.

And even if we can believe a robust recovery is in the brewing, the RBNZ should not be trying to front-run the good news. To do so simply risks aggravating the upside in rates and the currency that will be well in train in that case anyway, on top of the de facto tightening that's implicit in the newly proposed prudential regulation. If there are good times on the near horizon the RBNZ should, in the first instance, just let them roll.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

NZD interest rates saw some volatility over the past week, only to end the period a touch higher. The moves seemed to be on the back of mixture of global themes, buoyant Australian rates and some local bank issuance. The very front end of the curve seems to be trading around tight ranges. With respect to what the market is pricing, it is factoring in only a 25% chance of a further cut at this weeks OCR meeting, with no further cuts priced in until the end of the year and hikes starting thereafter.

The bond market performed well again last week, with a strong bid tone throughout, outperforming a weaker Aussie market. Last week's sizable tender was absorbed easily, as offshore demand continued to be very strong. The Debt Management Office, at the markets request has increased the tender levels to accommodate the flood of demand. $400m of supply was easily absorbed last week. The 2011s sold off a modest 4bps to close the week at 3.83%, with the rest of the curve flatter overall.

The swaps market was a mixed bag, taking its lead from offshore markets, as well as some domestic issuance.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
20-Jul-09	2.80%	3.79%	5.76%	3.88%	6.07%	219
24-Jul-09	2.80%	3.83%	5.77%	3.93%	6.02%	209
Change (bps)	**0**	**4**	**1**	**5**	**-5**	**-10**

Early in the week we followed a weaker Aussie market as the "hope for a recovery" story really hit their market hard particularly in the front end, 2-yr swap traded upwards, towards the 3.93% region, the top of its recent range. We then saw some decent receiving interest generated via local bank issuance, flattening the curve further out. This week the market will continue to follow offshore movements and look to Thursday's OCR announcement for direction going forward. Receiving short end swaps continues to look attractive from a carry perspective at these levels.

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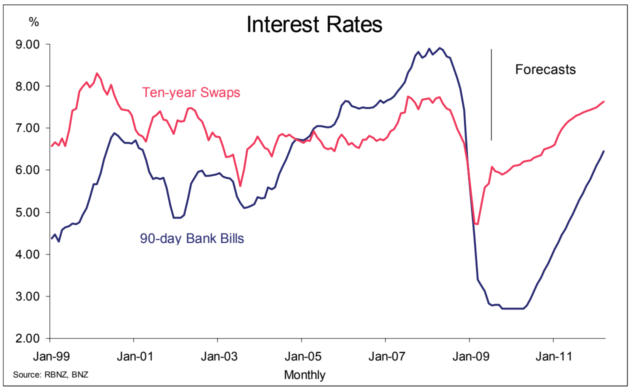

Interest Rate Technicals

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NZD 5yr Swap Rate

Outlook: Consolidation
ST Resistance: 5.48%
ST Support: 5.15%

The short-term range is in place and we look to trade a break of either. Our previous view of a break higher still seems the more likely scenario.

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

Reuters pg BNZWFWDS

The tail end of last week continued with risk appetite in improving heart but unable to inspire a break to new levels or ranges. Major currencies held steady, for the most part, and for the NZD/USD that meant trading within a half cent range centred near the 0.6550 level. The NZD bounced around with intraday nuances of equity and commodity indices.

Equity markets were encouraged higher by profit reports in the major economies, on balance, beating modest expectations. The S&P completed its best two-week performance since March of this year. However, Fed Chairman Ben Bernanke, in his six-monthly testimony, was not as upbeat on the US economy as was looked for, while stressing the powerful tools the Fed has to mop up the great amounts of liquidity it has sprayed around, when the time comes.

The exposure of the NZD to equity market performance continues in this week, with around one third of the S&P companies to release earnings reports. Will these justify a further rally? Or might we really need to wait until real-money funds, still largely cash up and out, come to the market, for a sustained equity rally to form?

On the international front, also note the US Treasury is auctioning a record US$115b in debt. On the data front there is the first cut at US Q2 GDP, and the Beige Book survey of July's economic and credit conditions, to gauge.

Locally, our attention is firmly on this Thursday's OCR review from the RBNZ. Everyone and their dog is expecting the cash rate to be held at 2.50%. As for the commentary, while the RBNZ is bound to acknowledge emerging rays of light, it will surely be balanced by talk of ongoing weak spots and risks.

Also, watch for Bollard to express discomfort with the currency, which has continued to grind higher (in defiance of steady fall assumed in the June MPS).

All of this suggests the RBNZ will probably reiterate its expectation of holding the OCR at or below current levels until well into 2010.

Ahead of the OCR meeting, Wednesday afternoon's NBNZ business survey could add some flavour. It could shift either way this time, following its constant clawback over prior months. Also watch for June's merchandise trade figures, building consents and credit aggregates, which should be mildly positive for the NZ dollar, albeit with plenty of mixed messages under the surface.

This week we will also be monitoring the maturing NZD Uridashi, as well as the continued large offering of Toshin funds in Japan, though again these carry miniscule opportunity to invest in NZ. The focus remains on developing nations, the BRIC nations and to some extent Australian opportunities.

From here, the base for the Kiwi appears in the first instance at 0.6500/0.6525 and, after posting fresh 2009 highs, resistance continues to look evident on moves towards the 0.6625/0.6650 window.

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Foreign Exchange Technicals

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NZD/USD

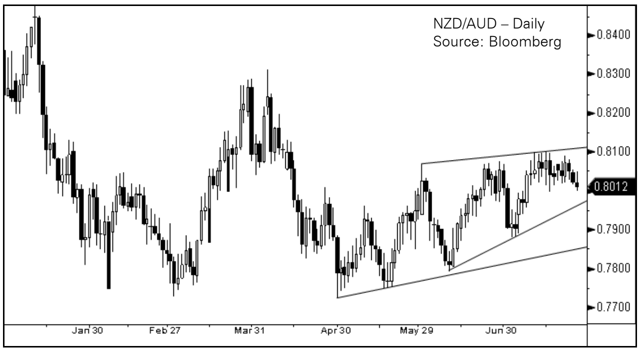
Outlook:	Consolidation
ST Resistance:	0.6625/50 (ahead of 0.6700)
ST Support:	0.6450/75 (ahead of 0.6325/50)

Solid resistance at 0.6650 favours selling rallies. A breach of 0.6425 would open up the downside toward 0.6325.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8100 (ahead of 0.8250)
ST Support:	0.7950 (ahead of 0.7850)

Consolidation continues, but consider selling rallies as an increasingly attractive option. Near support is seen at 0.7950.



Key Upcoming Events

	Forecast	Median	Last
Monday 27 July			
US, New Home Sales, June		352k	342k
Euro, M3, June y/y		+3.5%	+3.7%
Tuesday 28 July			
NZ, Merchandise Trade, June	+$215m	+$215m	+$858m
Aus, NAB Business Survey, Q2			
Aus, Stevens Speaks, Economic Policy			
UK, CBI Dist Trade Surv, July			-17
US, Consumer Confidence, July		49.0	49.3
US, Shiller Home Price Index, May y/y		-17.9%	-18.1%
Wednesday 29 July			
NZ, Building Consents, June (res, #)	+5.0%		+3.5%
NZ, NBNZ Business Survey, July			+6.0
Jpn, Retail Trade, June y/y		-2.5%	-2.7%
UK, Mortgage Approvals, June		47.0k	43.4k
US, Beige Book			
US, Durables Orders, June		-0.6%	+1.8%
Thursday 30 July			
NZ, Household Credit, June y/y			+2.6%

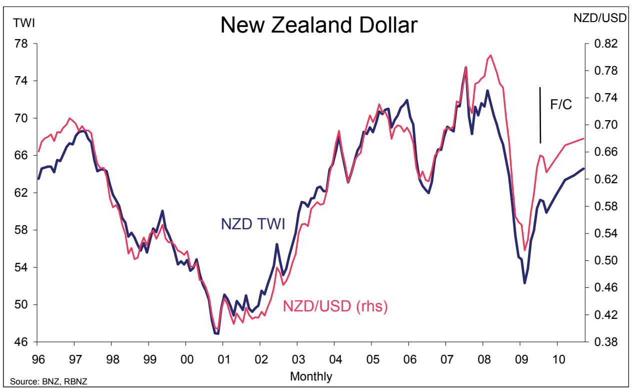
	Forecast	Median	Last
Thursday 30 July ***continued...***			
NZ, OCR Review	2.50%	2.50%	2.50%
Aus, Building Approvals, June	+5.0%	+8.0%	-12.5%
Aus, HIA Home Sales, June			-5.7%
Jpn, Industrial Production, June 1st est		+2.5%	+5.7%
Euro, Economic Confidence, July		75.0	73.3
US, Jobless Claims, week ended 25/07		580k	554k
Germ, Unemployment, July		8.4%	8.3%
Friday 31 July			
Aus, Private Sector Credit, June	flat	+0.1%	-0.1%
Aus, TD Inflation Gauge, July y/y			+1.4%
Jpn, CPI, June y/y		-1.8%	-1.1%
Jpn, Household Spending, June y/y (real)		+0.4%	+0.3%
Jpn, Unemployment Rate, June		5.3%	5.2%
Euro, CPI, July y/y 1st est		-0.4%	-0.1%
Euro, Unemployment Rate, June		9.7%	9.5%
US, Chicago PMI, July		43.0	39.9
US, Employment Cost Index, Q2		+0.3%	+0.3%
US, GDP, Q2 saar 1st est		-1.5%	-5.5%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	8.00
1 mth	2.78	2.79	2.78	8.28
2 mth	2.79	2.80	2.81	8.32
3 mth	2.74	2.79	2.81	8.28
6 mth	2.82	2.82	2.82	8.19
GOVERNMENT STOCK				
11/11	3.83	3.76	3.88	6.15
04/13	4.77	4.71	4.87	6.14
04/15	5.28	5.24	5.50	6.11
12/17	5.77	5.73	6.02	6.11
05/21	6.23	6.22	6.53	-
CORPORATE BONDS				
BNZ 09/10	4.02	4.02	4.21	-
BNZ 05/15	7.06	7.10	7.27	-
GEN 03/14	7.34	7.34	7.11	-
GEN 03/16	7.66	7.69	7.84	-
TRP 12/10	4.58	4.61	4.60	7.54
TRP 06/20	7.74	7.83	7.83	7.63
SWAP RATES				
2 years	3.93	3.85	3.82	7.39
3 years	4.66	4.58	4.57	7.26
5 years	5.36	5.33	5.36	7.19
10 years	6.02	6.03	6.06	7.13

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6563	0.6446	0.6450	0.7426
NZD/AUD	0.8014	0.8032	0.7997	0.7772
NZD/JPY	62.16	60.79	61.43	80.07
NZD/EUR	0.4612	0.4568	0.4586	0.4730
NZD/GBP	0.3989	0.3945	0.3908	0.3729
NZD/CAD	0.7125	0.7189	0.7432	0.7569
TWI	61.42	60.69	60.76	66.36

NZD Outlook



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