

3 August 2009

Labour's Misery Defined

- Unemployment to jump viciously
- As recession-induced job destruction gains pace
- Softer jobs market means lower wage inflation
- But not lower interest rates
- NZD won't be talked into submission

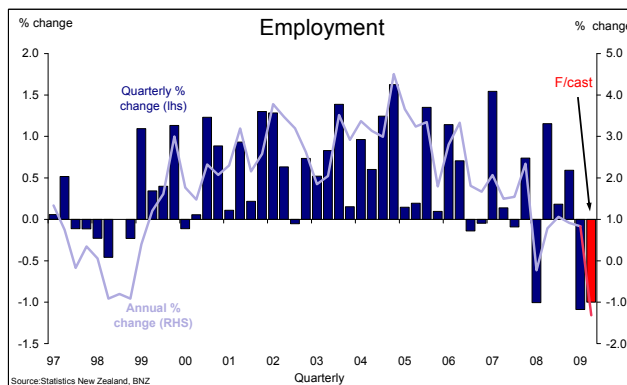
How the labour market responds to the economic downturn will help define how long the economy continues to shrink and how miserable we all feel. This week a fairly comprehensive picture of the evolution of this response will be gleaned following the release of the Labour Cost Index and Quarterly Employment Survey on Tuesday and the Household Labour Force Survey (HLFS) on Thursday.

While the labour market will help define the shape of the downturn, it is also important to remember that the labour market is a lagging indicator. Typically employment and unemployment lag real GDP and wage growth lags employment. Consequently, don't expect to see any signs in the respective releases that the economy is about to get any better any time soon.

In fact, to the contrary, we expect Thursday's HLFS report to reveal the sharpest quarterly jump in the unemployment rate since the 1991 recession. We are forecasting the rate to climb to 5.7% from 5.0%, returning the unemployment rate to its highest level since December 2000.

This corresponds to a 1.0% drop in employment for the quarter, which means a further 22,000 people lost their jobs, taking the total job loss for the six months ended June to 46,000.

It is the lagged nature of the employment response that creates substantive tension at this stage of the economic cycle. Most leading indicators of activity are now turning



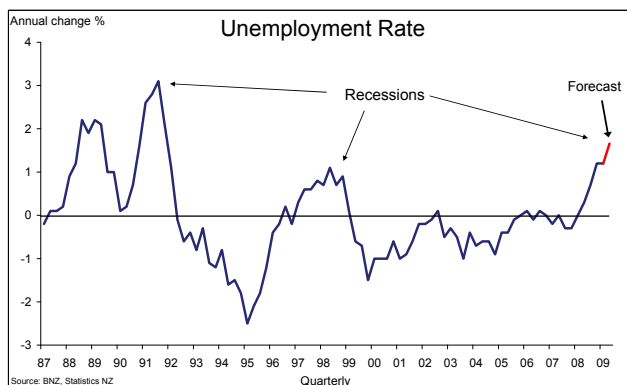
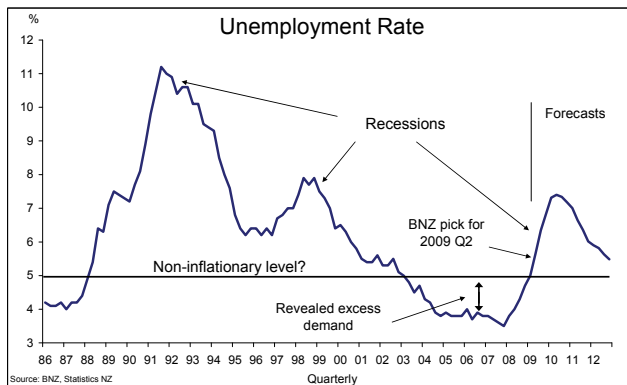
the corner and financial market commentators will increasingly talk of recovery. This will feel like a kick in the teeth to those still only just starting to feel the fall out from past drops in economic activity.

Indeed, we believe the unemployment rate will still have a long way to go after this week's release before it reaches its peak. We see that peak at 7.4% in June 2010.

It will come as no solace to those recently laid off but compared to economies offshore and to our own recent past history, the unemployment rate will remain relatively well contained. Recall that it peaked at 7.9% in June 1998 and 11.2% in September 1991.

The reason that it may feel worse, however, is the pace of change. If you've been unemployed for five years already then being unemployed for a further year comes as no surprise. But when you have been ensconced in what you thought was a stable job for some time and things change suddenly the disruption created is severe.

From a monetary policy perspective, the HLFS data are unlikely to provide any support to those wanting the RBNZ to lower interest rates further. The Bank's June



Monetary Policy Statement already incorporated the assumption that the unemployment rate would climb to 5.9% – higher than our own and the market’s view – with employment down 1.0% for the quarter.

It’s also worth recalling that for the last six years the unemployment rate has been at levels typically associated with heightened inflationary pressure. We’re not quite sure what the RBNZ is thinking right now but it used to be accepted that any unemployment rate much below 5.0% was likely to be inflationary. Accordingly, the level after the hike in June will prove to be only modestly disinflationary.

Nonetheless, with labour market conditions having eased as much as they have, the pressure on wages is unequivocally down. This is why we are forecasting the Labour Cost Index (for private sector salary and ordinary time wage rates) to rise just 0.5% for the quarter. This would take the annual rate down to 2.8% from a peak of 3.7% in September 2008. The annual increase will be the lowest since June 2005 and, in our opinion, is on its way down to a low of 1.4% by March 2011.

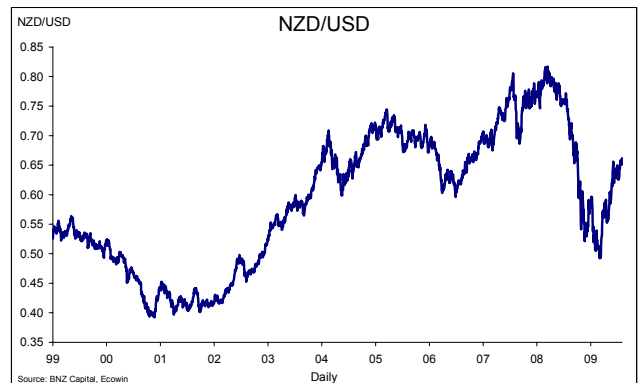
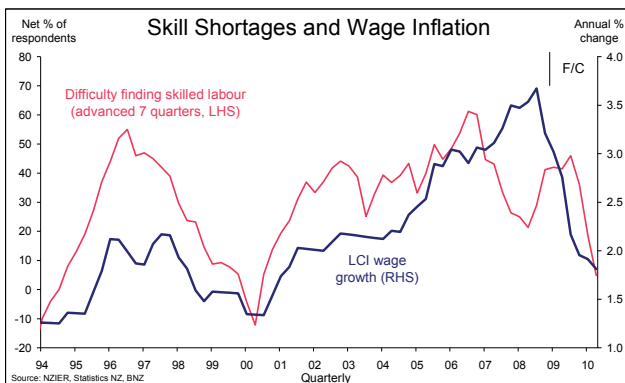
Quarterly Employment Survey data, also released on Tuesday, will be of lesser interest as both its wage and employment parts tend to be overshadowed by the other labour market data on offer during the week.

For the record, though, we are looking for a +0.4% increase in the actual, unadjusted filled jobs series (implying a seasonally adjusted fall of 0.9%) and for annual private sector wage growth to fall to closer to 4.0% than the just over 5.0% reported for the year to March.

Apart from the labour market data we’ll also be keeping an eye out for Tuesday’s commodity price index but don’t expect to see too much of a shift in level in either the world or New Zealand price of our commodity mix.

Last but not least, we will continue to watch the progress of the New Zealand dollar with some bemusement. We repeat our central view that provided the world at large continues to stay on its alleged recovery path and provided the New Zealand economy looks similarly placed, the New Zealand dollar will continue to find favour with international investors. This being so, no amount of jawboning by the central bank, or government, will likely have any long-lasting impact on the currency. Moreover, even was the central bank to cut the cash rate again it remains a moot point as to whether this would have a serious effect either. The fact that the NZD has recovered all the ground it lost immediately following last week’s RBNZ warning that it would cut rates again if the NZD stayed too lofty, is testament to this. A lower currency can’t be ruled out but don’t bank on it.

stephen_toplis@bnz.co.nz



Domestic Interest Rates

NZD interest rates have been volatile over the past week. Comments from the Reserve Bank of Australia shifted the risk for interest rate movements to the upside and resulted in a sizeable sell off in kiwi rates. We then rallied back after our own Reserve Bank warned it is prepared to cut the OCR should the currency remain robust. Overall, rates ended the week a fraction lower. The front end futures rallied a touch after the dovish statement from Governor Bollard. The OIS market is currently pricing in a 22% chance of a 25 point cut at the next OCR announcement, with no further cuts priced in until the end of the year and hikes starting soon thereafter.

The bond market, meanwhile, continues to perform well. Last week we saw bonds trading a tight 3-5 point range to end the week a little higher in yield, solid in comparison to sell-offs offshore. We are still seeing some good demand for long dated bonds from offshore investors. The bond tenders continue to do well with \$400 million easily absorbed last week.

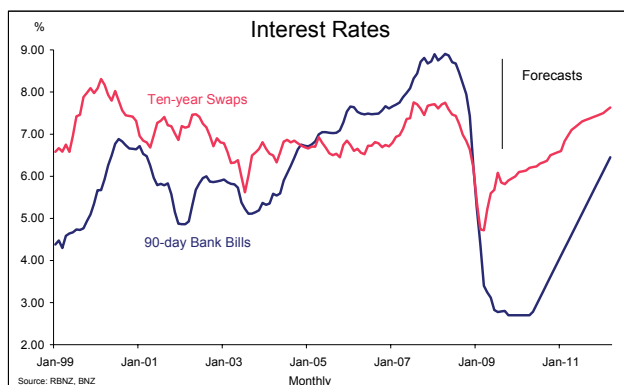
NZ swaps saw some decent movement last week, taking the lead from offshore markets early in the week.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
27-Jul-09	2.77%	3.81%	5.74%	3.90%	6.04%	214
31-Jul-09	2.79%	3.83%	5.75%	3.88%	5.94%	206
Change (bps)	2	2	1	-2	-10	-8

Reuters pgs BNZL BNZM

The RBA minutes were treated as hawkishly as they appeared; resulting in a sell off and flattening of the back end, with 2-year swaps trading all the way up to 4.07%. However, last Thursday's OCR statement quickly turned the market on its head as the surprisingly dovish statement from Bollard emphasised that a window for further easing was still open. This resulted in some decent receiving interest offering the curve down. The 2-year closed the week at around 3.87%. This week we feel that 2-year swaps have seen their range edge a little higher, possibly bound between the 3.80%-4.00% region. The possibility to reverse last week's flattening of the curve is also something to watch over the week, with one eye on the NZD.

james_d_chin@bnz.co.nz



Interest Rate Technicals

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.



pete_mason@bnz.co.nz

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

The Reserve Bank's cautious OCR commentary last Thursday initially knocked the boisterous NZD lower. Nonetheless, the Kiwi finished the week on a strong note, on a globally-driven combination of improving risk appetite, robust commodity prices and a broadly weaker USD (with DXY falling to new 2009 lows on Friday night).

Traders' stale short positions were squeezed out as stop loss orders were triggered above the 0.6585-90 level. Real money demand for portfolio rebalancing was also evident in month-end flows for fund managers, while NZD (and AUD) continued to garner support from Central Bank/sovereign names.

For their part, equity markets were further underpinned by the majority of US corporate results beating (weak) expectations for yet another week. The S&P 500 recorded its best July gain since 1997. And the not-as-bad-as-expected theme continued in the form of US Q2 GDP, which showed an annualised contraction of 1.0%, compared to the 1.5% fall expected (albeit that back revisions showed a deeper US recession, overall, than previously estimated).

Now that the US Corporate earnings season is behind us, markets will increasingly turn their attention to the economic data to determine whether the rally in equities and commodities will continue, or swoon. Speaking of which, it is a big week for US data, with non-farm payrolls the main focus (Friday). Ahead of this, keep an eye on US ISM, construction spending and factory orders.

Reuters pg BNZFWDS

Australia's also data-rich, with retail and international trade, jobs, and with Friday's Quarterly Monetary Statement an insight into whether the market's expected rate hikes sit comfortably with the RBA.

NZ data begin with Tuesday's Labour Cost Indexes and Quarterly Employment Survey wage statistics, which are expected to confirm continued deceleration, from last year's relatively strong pace. For Q2 employment, we anticipate Thursday's HLFS to confirm a drop of about 1.0% (-1.3% y/y). This implies a jump in the jobless rate to 5.7%, from Q1's 5.0%.

Also keep an eye out for Tuesday afternoon's ANZ commodity export prices. These are likely to be mixed, still, with the rising currency an obvious impediment to the NZD priced series. Fonterra, fresh from affirming its forecast for the 09/10 season at \$4.55 has the outcome of its monthly milk powder auction due for Wednesday morning, (NZT).

With a close just below the resistance window of 0.6625/0.6650 the New Zealand Dollar appears well placed this week to trade with an ongoing positive bias. Similarly, the NZD does not yet appear to be technically overbought – unless, of course, we see a major turnaround in the fortunes for equities and commodities this week, which would cloud global appetite for risk and investment diversification.

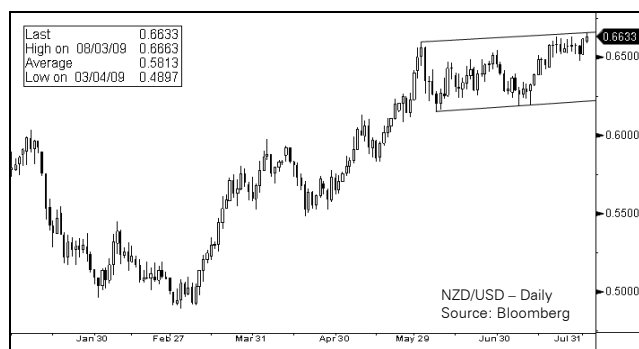
craig_ebert@bnz.co.nz

Foreign Exchange Technicals

NZD/USD

Outlook: Resistance looms
 ST Resistance: 0.6675 (ahead of 0.6700/0.6725)
 ST Support: 0.6525/50 (ahead of 0.6450/0.6475)

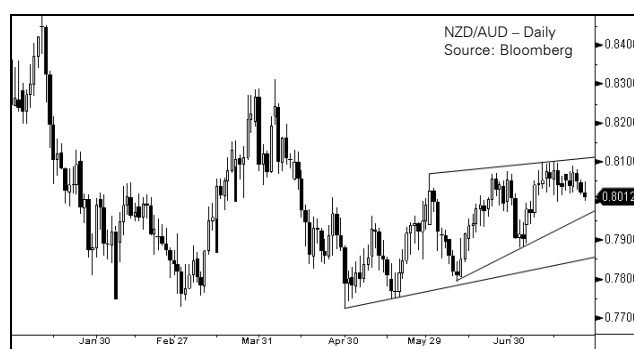
Solid resistance at 0.6675 may favour selling rallies. A breach of 0.6550 would open up the downside toward 0.6475.



NZD/AUD

Outlook: Sell rallies
 ST Resistance: 0.8100 (ahead of 0.8250)
 ST Support: 0.7850 (ahead of 0.7750)

Consider selling rallies as an increasingly attractive option. Support is seen at 0.7850.



Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 3 August				Wednesday 5 August <i>continued ...</i>			
UK, CIPS Manuf Survey, July		47.8	47.0	US, Factory Orders, June	-0.5%		+1.2%
US, Construction Spending, June		-0.5%	-0.9%	US, ISM Non-Manuf, July		48.0	47.0
US, ISM Manufacturing, July		46.5	44.8	US, ADP Employment, July		-340k	-473k
China, PMI (CLSA), July			51.8	Thursday 6 August			
Tuesday 4 August				NZ, HLF5 Employment, Q2	-1.0%	-0.8%	-1.1%
NZ, LCI Priv Ord Wages, Q2 y/y	+2.8%	+2.8%	+3.0%	NZ, HLF5 Unemployment Rate, Q2	5.7%	5.6%	5.0%
NZ, ANZ Comdty Prices (\$NZ), July			-5.0%	Aus, Unemployment Rate, July	6.0%	6.0%	5.8%
NZ, QES Priv Ord Wages, Q2 y/y	+4.0%	+3.9%	+5.1%	Aus, Employment, July	-20k	-18k	-21k
Aus, RBA Policy Announcement	3.00%	3.00%	3.00%	UK, BOE Policy Announcement	0.50%	0.50%	0.50%
Aus, House Prices, Q2	+2.0%	+2.0%	-2.2%	Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
Aus, Retail Trade, June s.a.	+0.5%	+0.5%	+1.0%	US, Jobless Claims, week ended 01/08		580k	584k
Euro, PPI, June y/y		-6.6%	-5.8%	Germ, Factory Orders, June		+0.6%	+4.4%
US, Pending Home Sales, June		+0.6%	+0.1%	Friday 7 August			
US, Personal Spending, June		+0.3%	+0.3%	Aus, Qtlly Monetary Statement			
Wednesday 5 August				UK, PPI (core output), July y/y		-0.5%	+0.1%
Aus, International Trade, June	-\$600m	-\$800m	-\$556m	US, Unemployment Rate, July		9.6%	9.5%
UK, CIPS Services, July		51.8	51.6	US, Non-Farm Payrolls, July		-325k	-467k
UK, Industrial Production, June		flat	-0.6%	Germ, Trade Balance, May		+€10.6b	+€9.6b
				Germ, Industrial Production, June		+0.5%	+3.7%

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	8.00	NZD/USD	0.6599	0.6563	0.6280	0.7282
1 mth	2.78	2.78	2.81	8.26	NZD/AUD	0.7899	0.8014	0.7900	0.7828
2 mth	2.79	2.79	2.79	8.32	NZD/JPY	62.51	62.16	60.32	78.37
3 mth	2.77	2.74	2.80	8.28	NZD/EUR	0.4625	0.4612	0.4499	0.4675
6 mth	2.82	2.82	2.82	8.11	NZD/GBP	0.3946	0.3989	0.3856	0.3685
GOVERNMENT STOCK					NZD/CAD	0.7103	0.7125	0.7297	0.7475
11/11	3.81	3.83	3.69	6.13	TWI	61.34	61.42	59.59	65.56
04/13	4.75	4.77	4.68	6.11	NZD Outlook				
04/15	5.26	5.28	5.28	6.11					
12/17	5.73	5.77	5.79	6.11					
05/21	6.21	6.23	6.53	-					
CORPORATE BONDS									
BNZ 09/10	3.92	4.02	3.99	-					
BNZ 05/15	6.84	7.06	7.15	-					
GEN 03/14	7.02	7.34	7.26	-					
GEN 03/16	7.51	7.66	7.70	-					
TRP 12/10	4.48	4.58	4.56	7.43					
TRP 06/20	7.63	7.74	7.70	7.57					
SWAP RATES									
2 years	3.86	3.93	3.72	7.27					
3 years	4.58	4.66	4.45	7.14					
5 years	5.25	5.36	5.22	7.08					
10 years	5.92	6.02	5.88	7.06					

Contact Details

BNZ Capital



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

Craig Ebert
Senior Economist
+(64 4) 474 6799

Mark Walton
Economist
+(64 4) 474 6923

Danica Hampton
Senior Strategist
+(64 4) 472 4767

Main Offices

Wellington
1 Willis Street
PO Box 2392
Wellington 6140
New Zealand
Phone: +(64 4) 474 6145
FI: 0800 283 269
Fax: +(64 4) 474 6266

Auckland
125 Queen Street
PO Box 2139
Auckland 1140
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) 9295 1199

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

Contact Phone Numbers

Wellington
Foreign Exchange +800 642 222
Fixed Income/Derivatives +800 283 269

Sydney
Foreign Exchange +800 9295 1100
Fixed Income/Derivatives +(61 2) 9295 1166

London
Foreign Exchange +800 333 00 333
Fixed Income/Derivatives +(44 20) 7796 4761

New York
Foreign Exchange +1 800 125 602
Fixed Income/Derivatives +1877 377 5480

Hong Kong
Foreign Exchange +(85 2) 2526 5891
Fixed Income/Derivatives +(85 2) 2526 5891

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