7 September 2009

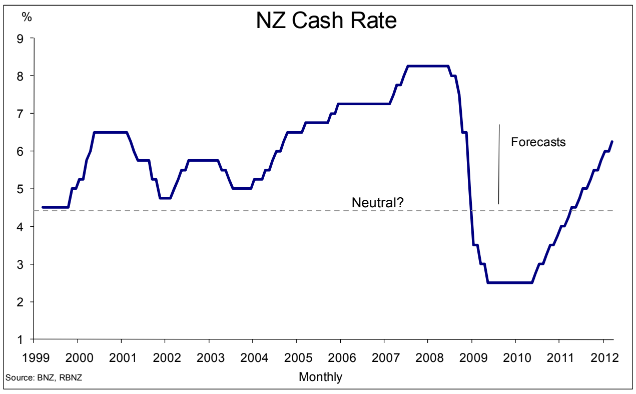
NZD An MPS Headache

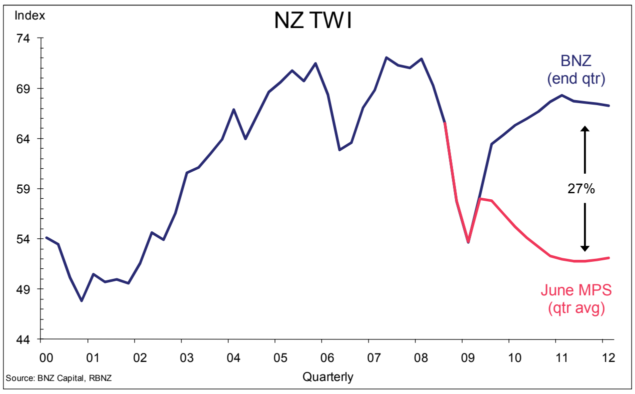
- Good news too good to ignore for RBNZ
- But recovery profile not without risks
- And elevated currency problematic
- MPS rate outlook to disappoint market expectations

The RBNZ will need to navigate some fairly treacherous waters at this week's meeting. While the volume of indicators pointing to a significant improvement in New Zealand's economy over the next 12 months is mounting, there remain a number of meaningful risks, not least of which are a troublesome NZD, an unbalanced growth profile and a still-uncertain global prognosis. At its heart, the Reserve Bank's view of the outlook – as encapsulated in Thursday's press release and accompanying Monetary Policy Statement – boils down to a finely-judged balancing act, as much now as ever.

To make it clear from the outset, we expect the OCR will be left unchanged, at 2.50%. A further cut, though not to be ruled out completely (we ascribe about 20% chance of such), would be to ignore the influx of good news since the previous OCR decision back at the end of July. Most notably, business confidence has improved massively, dairy prices have lifted over 20% (in NZD terms) and the housing market has picked up. That all provides enough reason for the Bank to stay on hold, we think.

The real question, rates-wise, then, is what the RBNZ has to say about the likely future path of interest rates. In this regard, it's not just the wording of the press release that will be crucial, but also the 90-day bank bill forecast included in the MPS. Money markets are hopeful for action sooner, rather than later, with current pricing consistent with a first hike in March; not that Dr Bollard places a great deal of weight on the thoughts of the





market, as he made apparent last week. Was this a shot across the bows from Dr Bollard? A hint, maybe, that the market might be expecting too much, too soon?

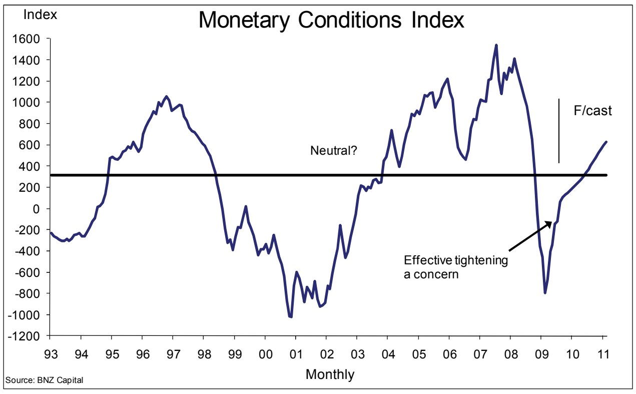
Perhaps. As it happens, we tend to the view that the market is a little ahead of the game. There's not much in it, to be fair, but our core view is that the first hike will come later, in June.

For us, the risks threatening the outlook are still too great to ignore – both in terms of likelihood and consequence – and will prevent the RBNZ from validating current market pricing. Chief amongst these worries must be the value of the NZD which, on a trade-weighted basis, has lifted about 25% from its early-March low.

As of the June MPS – the last time we were privy to the RBNZ's forecasts – a steadily depreciating TWI was presumed, to average a predicted 57.8 for the September quarter. Instead, the trade-weighted currency has averaged nearly 62.0 quarter-to-date, with a distinctly upward trend. Consequently, the MCI is rapidly closing in on neutral territory, and threatens to choke off the one source of growth that the RBNZ would most like to see prosper: exports.

In fact, if it were just the higher currency to consider, we'd be pushing for a further trimming in the OCR. Is it too often forgotten, but the Reserve Bank's mandated focus when setting monetary policy is inflation. The lower inflation outlook arising from the higher NZD would, all other things equal, prompt a further cut.

The RBNZ's likely to look through the impact of the currency, though, to the growth promised by the recent batch of positive forward looking indicators. Spare capacity will, eventually, be absorbed, providing a floor to inflation. That said, the gap between the



current level of the TWI, and the Reserve Bank's previous expectation of such, firmly forms the case against a hike in the OCR any time soon.

On this front, expect a substantially reworked currency track from the Bank, and much discussion of what that means for the outlook. Such was as much as promised in Dr Bollard's recent radio interview.

Not that it is just the currency that poses a threat to New Zealand's exporters. As the communiqué from the weekend's meeting of G20 finance ministers made clear, the risk of a double-dip recession, internationally, is still clear and present. As long as such risks remain meaningful, one suspects the RBNZ will be reluctant to prematurely unwind monetary policy settings.

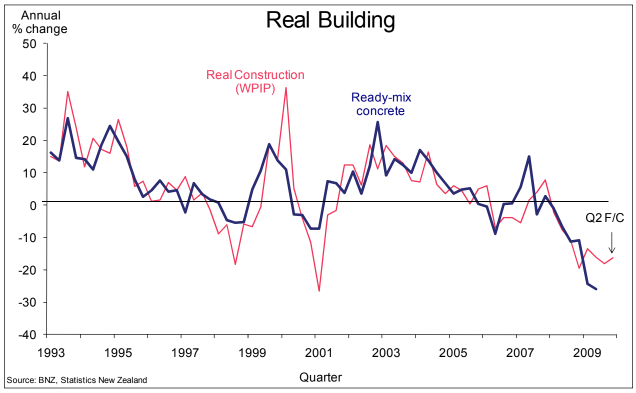
Domestically, for all that good news has trumped bad of late, the economic rebuild here is not as broadly based as either we, or the Reserve Bank, we suspect, would like. Despite an across-the-board improvement in firms' expectations of own activity – incidentally, a traditionally reliable indication of improving GDP – the housing sector is already threatening to have an undesirably large role in the recovery.

By contrast, a number of indicators for other sectors suggest activity is still very weak, even if improving. It's a levels versus a change thing. The Performance of Manufacturing Index, for instance, has lifted to within a whisker of 50, from 35 near the end of last year. That's a vast improvement but, nonetheless, depicts a sector that is still contracting. (August's reading, when it is released next week, could be the first to broach the expansionary mark of 50 since early 2008). Non-residential construction looks extremely shaky (and will likely remain that way until business profitability regains a firmer footing next year) and much of the services sector remains mired in gloom.

While the growth profile remains so mixed – and so heavily weighted toward a sector that generates so little bang for the buck for the remainder of the economy – the Reserve Bank is likely to remain fairly cautious about the outlook, we imagine. This, the higher-than-anticipated NZD and persistent uncertainties offshore collectively argue for the central bank to leave interest rates on hold until around mid-next year. If that's the way the MPS reads, on the basis of current pricing, markets will be disappointed.

Though not timely enough to have a major bearing on Thursday's decision, data this week – including the first of the 'hard' GDP indicators for the June quarter – will, nonetheless, be useful in establishing the base on which recovery must be founded. Such data should be a further reminder that the levels are as important as the growth.

In this context, one of the worst such indicators will surely be building work put in place, due tomorrow morning. In line with the collapse in the number of residential building consents during the first half of the year, and the parallel shrinkage in non-residential activity, we figure the volume of building work fell by 7.5% during the June quarter. As hefty as that drop is, risks are probably skewed to the downside, at least if the precipitous fall in concrete sales during the quarter is any indication. Such a result should help provide some context to the rebound in residential construction signalled in the business surveys.



Also due this week for the June quarter are the terms of trade, which we judge to be about flat for the quarter, with the steadily higher NZD likely a key driver in lower export and import prices, in roughly equal measure. As for volumes, we're expecting a positive result on the goods exports front (consistent with about 1.0% q/q in national accounts terms), courtesy of some solid performance for the primary sector. A jump in production from the Maari oil-field, strong Chinese demand for logs and sales out of dairy inventories should help underpin a seasonally adjusted lift in overall export volumes. Imports volumes, meanwhile, will likely look weaker, with investment, consumption and intermediate goods all down quarter-on-quarter, in line with the merchandise trade figures we've already seen.

Elsewhere this week, August's electronic card transactions provide the first hint of how spending fared in that month (and, incidentally, arrive ahead of July's retail trade figures, due next Monday, for which we expect +0.7% m/m). On face value, the extent of the pick-up in retailing confidence suggests another decent lift, following July's +1.2% m/m gain. Like the other monthly spending indicators, though, ECT data is prone to volatility, so we'll wait and see. Manpower's employment survey will like reflect the emerging sense of stability in the labour market, while falling short of signalling a return to net hiring, overall. And after yet another weather-induced price rise in vegetables during July, we look for a degree of downward price correction (we're looking for -0.3%) in August's food price update, due Friday.

All in all, it's likely to be a patchy week, data wise, much like the state of the economic recovery itself. As Dr Bollard, himself, put it recently, it's not enough that New Zealand's economic recovery is underway: the quality of that recovery is of utmost importance. The unevenness of the foundations of that recovery, thus far, and the risk posed by the value of the currency, could see the Reserve Bank maintain a cautious outlook, both in its commentary and forecasts. That may not see it step back from its clear easing bias entirely, but we suspect the Bank will look to maintain a steady-as-she-goes position.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates have continued to hold their recent ranges, with a small rally on the week largely the result of the RBA board meeting being seen as dovish. The market is pricing just a slight chance of a cut to the OCR in Thursday's Monetary Policy Statement, hikes are still priced to begin early in 2010 although the RBA announcement has meant the priced hikes are somewhat less aggressive.

The bond market followed the general trend and continued to be fairly well bid. One notable exception to this was Thursday's bond tender, where the 2017 bonds were underbid. This seemed to be the result of an overextension in the market and we now look for a pull back early in the week. The market will look to the MPS for direction later in the week.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
28-Aug-09	2.77%	4.04%	5.69%	4.15%	6.00%	185
4-Sep-09	2.74%	4.00%	5.64%	4.07%	5.94%	187
Change (bps)	**-3**	**-4**	**-5**	**-8**	**-6**	**2**

The swaps market has continued to hold its 4.20-4.00% range in 2yr and finished the week between these levels. This range seems unlikely to break before the MPS announcement, with offshore again providing the lead early in the week. The MPS should provide some impetus to the market that has been lacking direction for some time now.

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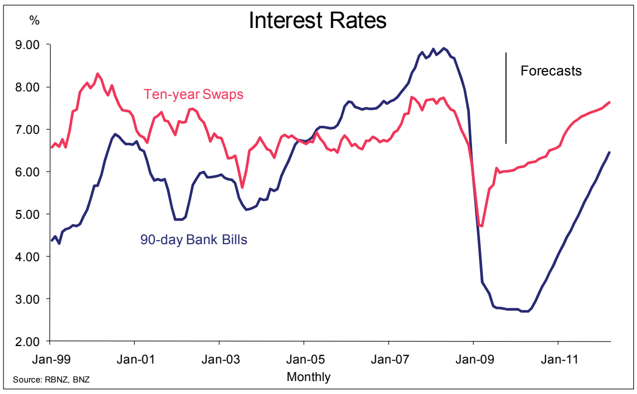

Interest Rate Technicals

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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 and we are very near that level now.

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. Should our support at +122 be broken this will be bought into question.

Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD/USD spent most of the past week trading in a 0.6700-0.6900 range. Early in the week, rumours Wells Fargo was in trouble reawakened fears about the financial sector, causing equity markets to plunge and denting risk appetite. With risk aversion hitting its highest level since early July, investors shunned growth sensitive currencies like NZD in favour of the relative safety of the USD and JPY. From around 0.6850 at the start of the week, NZD/USD briefly dipped below 0.6700.

However, for the rest of the week it was all one way traffic. Friday night's US non-farm payrolls data added to the growing belief that, at least technically, the US recession is bottoming out. And, combined with a solid performance across global equity markets, this saw risk appetite return, bolstering demand for the NZD. As a result, NZD/USD finished the week a shade below 0.6900, having once again failed to push through the rumoured option barrier.

For this week, local factors should play a more substantive role in dictating NZD sentiment. This key event will be the RBNZ Monetary Policy Statement (MPS) on Thursday. We think there's been enough good news over the past six weeks to keep the RBNZ from cutting the OCR. However, with the stronger NZD doing more than its fair share of returning monetary conditions towards more neutral settings, we suspect the RBNZ will remain content to keep rates on hold until mid next year.

Markets disagree. Current market pricing is consistent with the first 25bps hike coming in March and about 100bps of tightening over the next 12 months. Our official view has the first OCR hike coming in June with a further 100bps of tightening over the remainder of calendar 2010. If this week's MPS brings markets closer to our view, the associated drop in short-dated NZ interest rates and narrowing of NZ-US interest rate spreads would probably add some downside pressure to NZD/USD.

The improving global backdrop has seen the 'fair value' range (according to our short-term valuation model) edge higher over the past couple of weeks to around 0.6800-0.7000. However, we'd caution that this range is susceptible to a correction in NZ interest rates. Should NZ-US 3-year swap spreads contract 20-30 bps from the current 2.80% (possibly on a dovish MPS), this would lower our fair value estimate to around 0.6600-0.6800.

In the near-term, the rumoured 0.6900 barrier looms large for NZD/USD. If NZD/USD manages to break above this, we'd expect to see a pop higher towards 0.6950. However, ahead of the RBNZ decision on Thursday, we suspect the NZD/USD will struggle to hold-on to gains above 0.6900.

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Foreign Exchange Technicals

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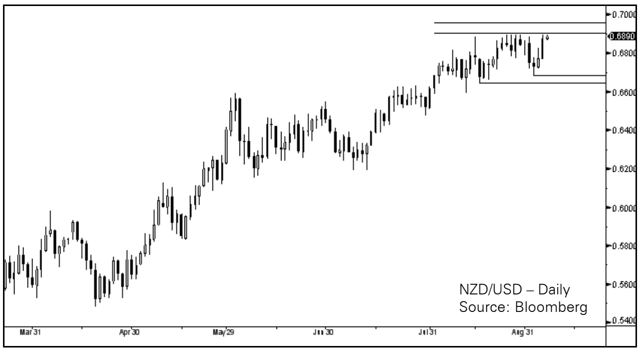
NZD/USD

Outlook:	Sell a failure
ST Resistance:	0.6900 (ahead of 0.6945)
ST Support:	0.6720 (ahead of 0.6645)

The currency is at an interesting juncture – either it breaks 0.6900 and spurts higher (towards 0.6950) or it fails to break 0.6900 suggestive of a correction lower.

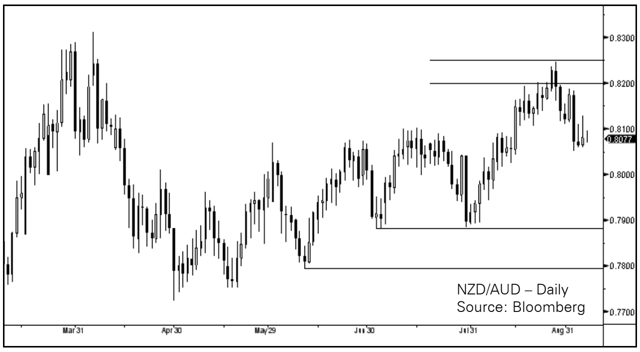


NZD/USD – Daily
Source: Bloomberg

NZD/AUD

Outlook:	Sell a rally
ST Resistance:	0.8195 (ahead of 0.8250)
ST Support:	0.7890 (ahead of 0.7790)

The failure to break above 0.8250 saw momentum indicators turn neutral and NZD/AUD drift lower. We think the downside has scope to run a little further yet and would wait for dips below 0.7900 before thinking about buying.



NZD/AUD – Daily
Source: Bloomberg

Key Upcoming Events

	Forecast	Median	Last
Monday 7 September			
Aus, Construction PMI (AiG), August			39.5
US, Holiday, Labor Day			
Germ, Factory Orders, July		+2.0%	+4.5%
Tuesday 8 September			
NZ, Bldg Work Put In Place, Q2 vol s.a.	-7.5%		-0.7%
Aus, NAB Business Survey, August			
Jpn, Eco Watchers Survey (outlook), August			44.9
UK, Industrial Production, July		+0.2%	+0.5%
UK, RICS Housing Survey, August		flat	-8%
UK, BRC Retail Sales Monitor, August			
Germ, Industrial Production, July		+1.6%	-0.1%
Germ, Trade Balance, July		+€11.3b	+€12.2b
Wednesday 9 September			
NZ, Electronic Card Transactions, August			+1.2%
NZ, Manpower Survey, Q4			-6
Aus, Housing Finance, July		-1.0%	+1.1%
Aus, Consumer Sentiment - Wpac, Sep			113.4
Aus, Retail Trade, July s.a.	+0.5%	+0.5%	-1.4%
UK, Trade Balance, July		-£2.0b	-£2.18b
US, Beige Book			
US, International Trade, July		-$27.4b	-$27.0b

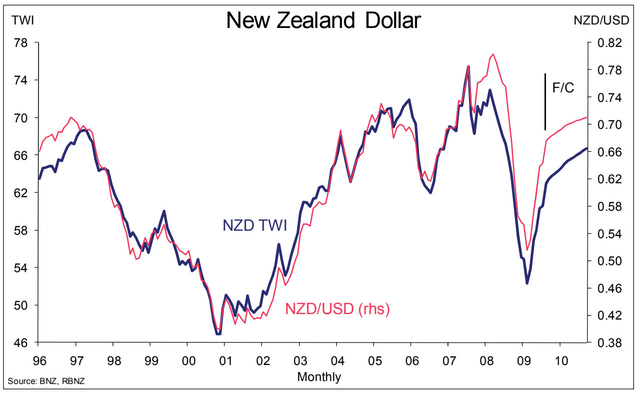
	Forecast	Median	Last
Thursday 10 September			
NZ, Terms of Trade, Q2	-0.1%	-2.5%	-3.0%
NZ, Monetary Policy Statement	2.50%	2.50%	2.50%
Aus, Unemployment Rate, July		5.9%	5.8%
Aus, Employment, July		-15k	+32k
Jpn, Machinery Orders, July		-3.1%	+9.7%
UK, BOE Policy Announcement	0.50%	0.50%	0.50%
Euro, ECB Monthly Bulletin			
US, Jobless Claims, week ended 05/09		560k	570k
Can, BOC Policy Announcement	0.25%	0.25%	0.25%
China, CPI, August y/y	-1.3%	-1.8%	
Friday 11 September			
NZ, Food Price Index, August	-0.3%		+0.6%
Jpn, GDP, Q2 2nd est		+0.9%P	+0.9%P
UK, PPI (core output), August y/y			+0.2%
US, Import Prices, August		+1.0%	-0.7%
US, Mich Cons Confidence, Sep 1st		67.5	65.7
US, Wholesale Inventories, July		-1.0%	-1.7%
China, Trade Balance ($US), August		+$13.60b	+$10.63b
China, Fixed Investment (Urban), Aug ytd y/y		+32.7%	+32.9%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call		2.50	2.50	8.00
1 mth		2.77	2.79	8.18
2 mth		2.78	2.79	8.14
3 mth		2.79	2.78	8.06
6 mth		2.85	2.82	8.01
GOVERNMENT STOCK				
11/11	4.00	4.05	3.94	6.00
04/13	4.84	4.92	4.92	5.95
04/15	5.27	5.34	5.43	5.96
12/17	5.64	5.70	5.90	5.95
05/21	6.04	6.11	6.53	-
CORPORATE BONDS				
BNZ 09/10	4.00	3.90	4.03	-
BNZ 05/15	6.68	6.68	7.05	-
GEN 03/14	6.76	6.82	4.70	-
GEN 03/16	7.25	7.31	7.84	-
TRP 12/10	4.65	4.67	6.97	7.44
TRP 06/20	7.58	7.78	7.44	7.44
SWAP RATES				
2 years	4.07	4.17	4.06	7.23
3 years	4.74	4.83	4.78	7.08
5 years	5.35	5.43	5.40	7.00
10 years	5.94	6.01	6.04	6.90

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6883	0.6842	0.6687	0.6832
NZD/AUD	0.8082	0.8126	0.8023	0.8211
NZD/JPY	64.05	63.88	65.27	74.46
NZD/EUR	0.4810	0.4781	0.4715	0.4749
NZD/GBP	0.4195	0.4206	0.4011	0.3829
NZD/CAD	0.7476	0.7467	0.7239	0.7219
TWI	63.62	63.45	62.62	64.74

NZD Outlook



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