Markets Outlook

bnz capital

14 September 2009

Retail Sales Take Backward Step

- July retail sales disappoint in falling 0.5% m/m
- Short-term disruption to retail recovery
- While median house prices improve further
- Q2 manufacturing, due tomorrow, important piece of GDP puzzle
- August PMI to crack 50?

Retail Trade			
July (nominal) %	**Actual**	Mkt Expected	June
Total m/m	**-0.5**	+0.5	**-0.1**
Total y/y	**-1.7**		**-1.8**
Ex-auto m/m	**-0.5**	+0.5	**-0.6**
Ex-auto y/y	**+1.9**		**+2.3**
All data seasonally adjusted			

Just as we thought the retail sector was regaining a sounder footing, the hefty 0.5% fall in July's sales, as reported this morning, has us re-examining that view. Not only was the result considerably worse than our (and market) expectations of a 0.5% gain, but it raises questions about the short-term recovery in the retail sector we believed was underway. Our relatively positive longer-term outlook remains unchanged, but July's data serve as a reminder that an improving housing market (as reaffirmed in REINZ figures also out today), and skyrocketing firm and consumer confidence may be good omens, but ultimately mean very little for retailers unless the cash registers are ringing.

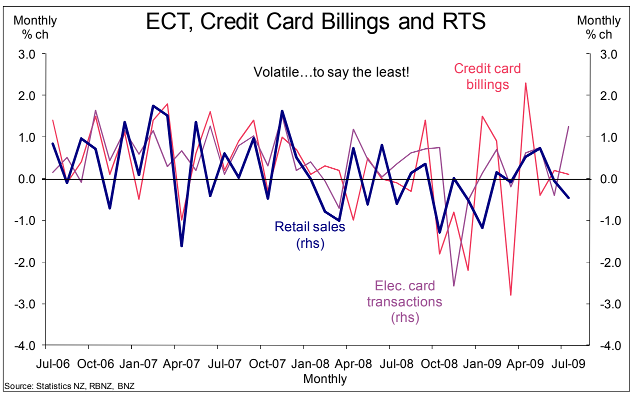
From what we can tell, this morning's result looks genuine enough. The core component also fell 0.5%, so the often-volatile automotive component can't be blamed for leading the headline astray. Incidentally, the softness in July's auto-related spending was in spite of a rebound in car sales, from the perilously low levels of earlier in the year.

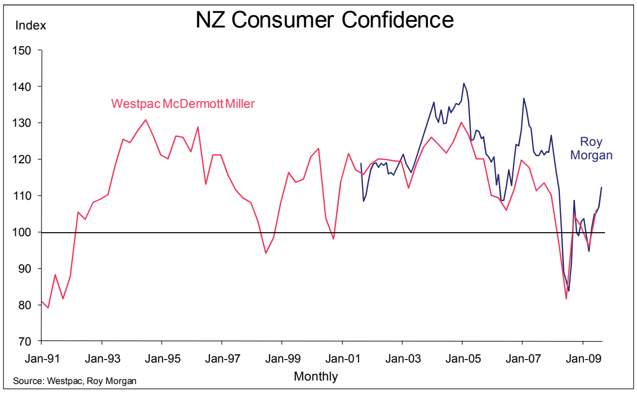
The composition of July's sales figures looks understandable, too; the weaker storetypes were some of those more cyclical in nature, in being concentrated in big-ticket items (department stores, appliance retailing) or exposed to the tourist market (cafes and restaurants). So there's nothing in the breakdown that stands out as being anomalous, rather it's simply a case of being weaker across-the-board than we expected.

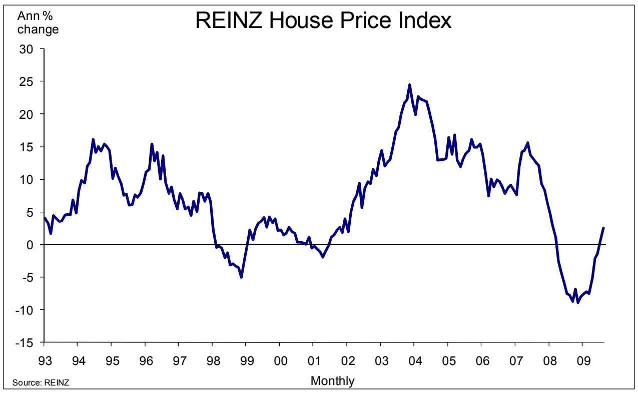
July's poor result may yet be seen to be a one-off disappointment. The clutch of monthly spending indicators suffers from significant volatility and, what's more, often fails to tell a consistent story. The fall in July's retail sales of 0.5%, for instance, compares to increases in both electronic card transactions and credit card billings of 1.2% and 0.1%, respectively.

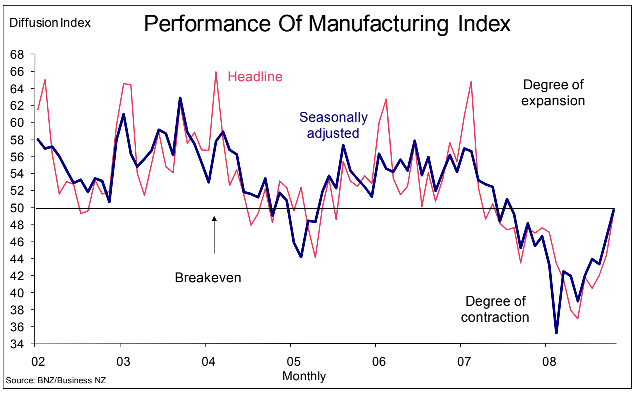
Heavy discounting may also have been a mitigating factor in keeping a lid on July's nominal turnover. Anecdotally, a portion of retailers – particularly those whose stock-in-trade is discretionary merchandise – are still being forced to clear goods at sale prices simply to preserve cashflow. As a survival strategy, it's perfectly understandable, but difficult, to maintain for an extended period of time.

The extent of discounting could be such, in fact, that the underlying real activity implied by July's nominal sales might not be quite as bad as the headline suggests, unless we're wildly askew with our CPI forecasts. However, it'll take a sizeable rebound in retail sales in August/September to prevent Q3 retail volumes from printing negative. We don't believe such a rebound is likely. August's lift in electronic card spending of 0.3% already points to only a modest gain, in that month, at least. Aforementioned issues with the partial spending indicators notwithstanding, the ECT and credit card data over the next couple of months will be useful for gauging the lay of the land. A decline in September quarter retail









volumes, as now seems the risk, would make June quarter's +0.4% "recovery" look short-lived – not to mention all the more reliant on the tax cuts implemented on 1 April.

For the near-term, though, July's retail dip is a reminder of the uncertain nature of things, still. Soaring household confidence is clearly no guarantee of increased spending and, of the two, it's the latter that the Reserve Bank will surely place more weight on.

August's housing market statistics, released by the Real Estate Institute this morning, will only provide further support to consumer confidence. The median price (per the new stratified methodology) lifted 1.2% during August, to extend its annual gain to 2.6% (from July's 0.9% y/y). And the median number of days to sell dropped to 33, seasonally adjusted, from 36 in July and a tragic 54 a year earlier.

Like the Reserve Bank, however, we harbour some reservations about the longevity of the recovery in house prices, also noting the relative shortage of listings at present. The likely lift in listings through spring, and into the peak sales period of February/March, will constrain price growth, we think. All the while, there is the fact that house prices remain very high in relation to incomes, even with their recent correction. It will take an awful lot to blow a bigger bubble from here.

With this morning's retail and housing statistics out of the way, the remainder of the week's data are almost exclusively devoted to manufacturing. June quarter's manufacturing statistics are due tomorrow, and will be as important for any information they yield about inventory draw-downs as sales activity. In printing much stronger than expected, last week's trade volume data left us with an expenditure measure of Q2 GDP considerably more robust than the corresponding production measure. Part of the solution, at least, will rely on the extent to which June quarter's exports were drawn from inventories (with the 24% q/q gain in dairy exports being the most prominent example of such). Tomorrow's manufacturing report will help, we hope, resolve that gap.

As for sales, we suspect these will print consistent with a decline in Q2 manufacturing GDP of around 2.0%. But we're also mindful of some potential for upside surprises, courtesy of wood, electricity and aluminium production.

Overall, tomorrow's manufacturing release will provide a major input into our Q2 GDP forecast. Currently, we anticipate a flat out-turn, with upside potential.

August's index of manufacturing performance is also due this week. After trending upwards since the beginning of the year, July's PMI came within a whisker of pushing through the 50-level that denotes expansion. The month-ago reading in the new orders sub-index, of 54.8, suggests that this upward trend in the headline PMI should be continued in August. If, indeed, it does lift above 50, August would be the first month in which the manufacturing sector expanded since last February. On the other hand, today's retail figures should serve as a reminder not to expect too much, too soon.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates had a widespread but moderate rally in last week. The primary driver was a Monetary Policy Statement that was widely considered to be highly dovish. An explicit easing bias was left in the statement, as well as a projected 90 day bill track which implied the first hikes to the Official Cash Rate starting as late as early 2011, nearly a full year after the market had been pricing.

However, despite the very clear guidance given by Dr Bollard, the market still fails to believe the RBNZ and the market continues to price a much less dovish track. The bank bills futures are pricing a hike around March next year and around 200 total basis points of hikes by the end of 2010, the point where the RBNZ sees the hiking cycle starting. Clearly the market believes that either the RBNZ is incorrect in its forecasts or is using the track to try and jawbone down longer dated rates.

The bond market saw a relatively quiet week, rallying along with the rest on the market on the MPS. The tender was very small relative to recent weeks with just $150m on offer, but it did see good bid to cover ratio and was well taken out. Offshore rates have been performing well which has helped to keep our market buoyant, but not busy.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
4-Sep-09	2.74%	4.00%	5.64%	4.07%	5.94%	187
11-Sep-09	2.76%	3.93%	5.55%	3.97%	5.86%	189
Change (bps)	**2**	**-7**	**-9**	**-10**	**-8**	**2**

The rally caused by the MPS has seen 2yr swap finally break its 4.20%-4.00% range, but it was with more of a whimper than a bang and we have failed to kick on strongly from there. We seem to still be in something of a holding pattern, with players unwilling to carry large postions and relatively small amounts of customer flow in the market. This week looks to be more of the same, with offshore moves likely to lead the kiwi market.

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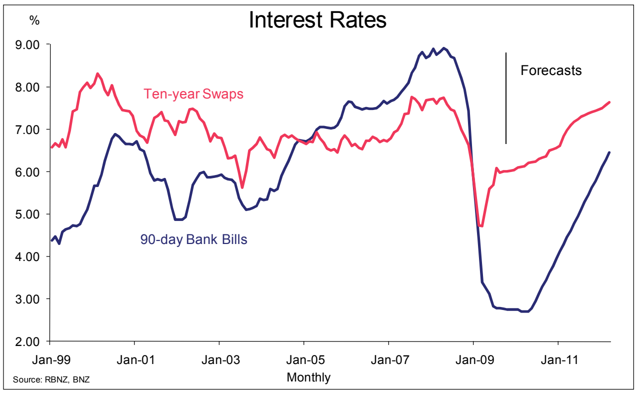

Interest Rate Technicals

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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, testing +122 but holding above. We therefore expect the steepening trend to continue. Should our support at +122 be solidly breached this will be the end of the steepening trend.

Foreign Exchange Market

Reuters pg BNZWFWDS

NZD/USD climbed markedly last week, from below 0.6900 to just under 0.7100 – its highest level in 13 months. Much of the recent strength in NZD/USD is attributable to broad-based USD weakness. Worries that Asian central banks may step-up the pace of reserve diversification and a decline in US bond yields saw the USD slide sharply last week. Improving Chinese data and solid risk appetite (our risk appetite index rose above its average of 50% for the first time in a year) also encouraged demand for growth sensitive currencies like NZD.

While most currencies climbed against the USD, the NZD had the dubious honour of being the strongest performing currency – despite the RBNZ's efforts to talk it lower.

The RBNZ left the OCR unchanged at 2.5% last week and reiterated its now long-held view that it expects "to keep the OCR at or below the current level through until the latter part of 2010". However, the market reaction suggested investors don't believe the RBNZ will be able to hold its line on interest rates for as long as it suggests. Market pricing is consistent with the first tightening coming in March (in contrast, our economists look for the first rate hike in June).

The Monetary Policy Statement (MPS) was also filled with concern about the recent strength in currency and the negative impact it might have on the NZ economy. Many investors are now wondering if the central bank will back up its currency concerns with action. While some passive "reserve building" may be seen from the RBNZ if the NZD continues to push higher, we don't think the conditions for active intervention have been met. For more on our intervention views, refer to last week's note *Huff and Puff Not Enough*.

Undeniably, NZ fundamentals have improved over recent months. And not only is our risk appetite index now sitting back around its long-term average, but NZ-US interest rate spreads have widened, while NZ commodity prices have recovered. Our short-term valuation model suggests a 'fair value' range for the NZD/USD of 0.6850-0.7050. This suggests there is no fundamental reason for NZD/USD to sustain bounces above 0.7050. In fact, if markets come around to our view on RBNZ policy, the downward pressure on NZ interest rates would likely see both NZ-US 3-year swap spreads contract 20-30bps. Everything else held equal, this would see 'fair value' drop to around 0.6600-0.6800.

While investors remain convinced the global economy is recovering, and that the NZ economy will grow at a faster than our trading partners in 2010, expect NZD/USD to gradually trend higher. That said, we can't help but think the NZD has got a bit ahead of itself and a correction may be in order in coming weeks. Some headwinds are expected ahead of 0.7090-0.7100, but a push towards 0.7150-0.7200 shouldn't be completely ruled out if the USD continues its broad-based decline this week. Initial support is expected ahead of 0.6990-0.7000, but we'll need to see a daily close below 0.6900 to suggest the uptrend is over and a deeper correction is on the cards.

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Foreign Exchange Technicals

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NZD/USD

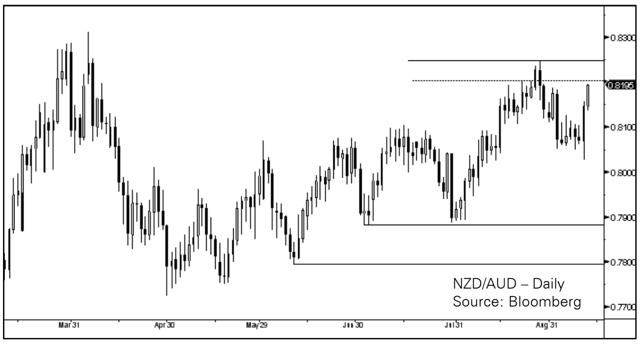
Outlook:	Sell a failure
ST Resistance:	0.7090 (ahead of 0.7155)
ST Support:	0.6990 (ahead of 0.6885)

Momentum indicators have turned positive, but with the daily RSI now in "over-bought" territory the risk of a correction is building. A daily close below 0.6900 is needed to suggest the uptrend has stalled.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8195 (ahead of 0.8250)
ST Support:	0.7890 (ahead of 0.7790)

Momentum indicators remain neutral and we'd view rallies towards 0.8250 as an opportunity to re-initiate short positions. We look for NZD/AUD to drift lower and would wait for dips towards 0.7900 before dip buying.



Key Upcoming Events

	Forecast	Median	Last
Monday 14 September			
NZ, Retail Trade, July	+0.7%	+0.5%	+0.1%
Jpn, Industrial Production, July 2nd est			+1.9%P
Euro, Industrial Production, July		-0.2%	-0.6%
Euro, EC GDP Forecasts			
Tuesday 15 September			
NZ, Manufacturing Sales, Q2 vol s.a.			+0.2%
Aus, RBA Minutes, 1 Sep Meeting			
Aus, Dwelling Commencements, Q2		+2.0%	-4.0%
UK, RICS Housing Survey, August		flat	-8%
UK, CPI, August y/y		+1.4%	+1.8%
Euro, Labour Costs, Q2 y/y			+3.7%
US, Business Inventories, July		-0.8%	-1.1%
US, Retail Sales, August		+2.0%	-0.1%
US, Empire Manufacturing, September		+14.0	+12.1
US, PPI ex-food/energy, August y/y		+2.2%	+2.6%
Germ, ZEW Sentiment, September			+56.1
Wednesday 16 September			
Aus, Westpac Leading Index, July			+0.7%
UK, Unemployment rate (ILO), July		7.9%	7.8%

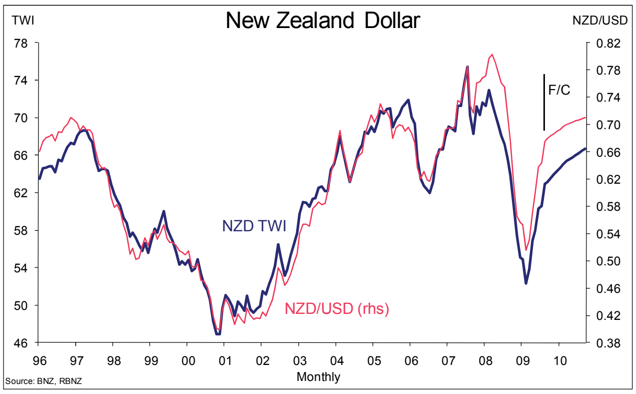
	Forecast	Median	Last
Wednesday 16 September *continued...*			
UK, Average Earnings, July 3m y/y		+2.0%	+2.5%
Euro, CPI, August y/y 2nd est		+0.2%	-0.2%P
US, NAHB Housing Index, September		19	18
US, Current Account, Q2 s.a.		-$92.0b	-$101.5b
US, Industrial Production, August		+0.6%	+0.5%
US, CPI ex food/energy, August y/y		+1.4%	+1.5%
Thursday 17 September			
NZ, BNZ PMI (Manufacturing), August s.a.			49.7
Jpn, BOJ Policy Announcement			0.10%
Jpn, Tertiary Industry Index, July			+0.1%
Jpn, MOF Business Survey, Q3			-22.4
UK, Retail Sales vol., August		+0.1%	+0.4%
Euro, Trade Balance, July (s.a.)		+€1.2b	+€1.0b
US, Housing Starts, August		590k	581k
US, Philly Fed Index, September		+6.0	+4.2
US, Jobless Claims, week ended 12/09		561k	550k
Friday 18 September			
Jpn, BOJ Monthly Report			
Germ, PPI, August y/y		-7.2%	-7.8%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	7.50
1 mth	2.80	2.77	2.80	7.92
2 mth	2.78	2.78	2.80	7.87
3 mth	2.78	2.77	2.73	7.74
6 mth	2.85	2.85	2.85	7.66
GOVERNMENT STOCK				
11/11	3.93	4.00	4.01	5.73
04/13	4.72	4.84	4.94	5.72
04/15	5.16	5.27	5.42	5.80
12/17	5.55	5.64	5.86	5.81
05/21	5.95	6.04	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.70	4.00	4.05	-
BNZ 05/15	6.52	6.68	6.91	-
GEN 03/14	6.55	6.76	6.85	-
GEN 03/16	7.05	7.25	7.33	-
TRP 12/10	4.45	4.65	4.72	7.06
TRP 06/20	7.38	7.58	7.83	7.27
SWAP RATES				
2 years	3.97	4.07	4.15	6.92
3 years	4.63	4.74	4.83	6.84
5 years	5.27	5.35	5.45	6.82
10 years	5.86	5.94	6.05	6.80

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7056	0.6883	0.6743	0.6659
NZD/AUD	0.8182	0.8082	0.8134	0.8148
NZD/JPY	63.78	64.05	63.84	70.56
NZD/EUR	0.4831	0.4810	0.4762	0.4658
NZD/GBP	0.4230	0.4195	0.4093	0.3701
NZD/CAD	0.7598	0.7476	0.7435	0.7088
TWI	64.31	63.62	63.00	63.13

NZD Outlook



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