

21 September 2009

Recovery, Slowly But Surely

- Week's data will underscore steady improvement
- Q2 GDP to herald end of recession?
- Confidence continues to front run activity
- But service sector looking better all the time
- And retail playing catch-up

One way or another, data this week will provide further evidence that the New Zealand economy is slowly, but surely, emerging from the economic gloom. The various monthly indicators on offer will continue their improving trend, we suspect, and June quarter GDP, due Wednesday, might even bring a technical end to the recession a quarter earlier than most expected. For all that, though, growth still has a long way to go before it catches up to the expectations implied by the ongoing surge in confidence.

Amongst the slew of releases on the week's calendar, it is Q2 GDP which looks to be the highlight. The tea leaves have been harder-than-normal to interpret this quarter, and we'll be keen to dig into the detail of Wednesday's release, as a result. But data releases tend to attract more attention at turning points in the business cycle, and GDP is no exception.

Formally, we've finalised our pick at -0.1% q/q (same as the RBNZ, coincidentally, and near the market's expectation of -0.2%), but only after a fair degree of to-ing and fro-ing, due to a mix of seemingly contradictory information amongst Q2's partial activity indicators. We suspect our lack of certainty around what June quarter partials all mean for GDP is shared by the market. The range of expectations, from -0.7% to +0.3%, certainly attests to such.

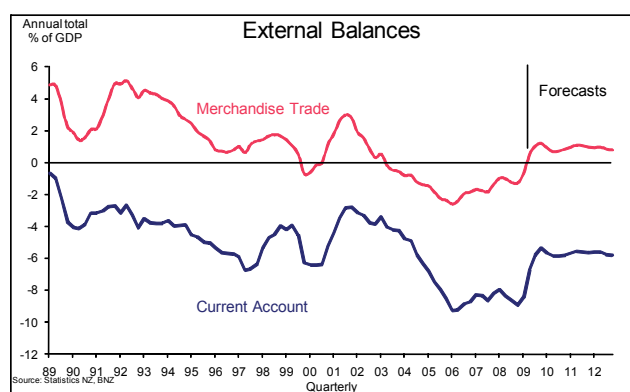
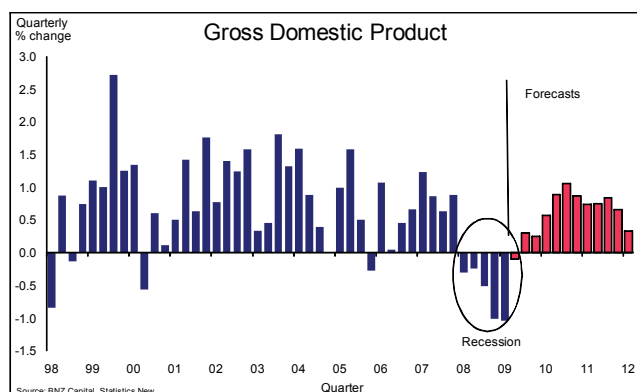
Indeed, that range probably provides a reasonable feel for the distribution of risks around the Q2 outturn. A number

of macro-type indicators – such as the number of hours worked (from the QES) and QSBO's trading activity – suggest something clearly negative is likely. In the slew of sector-specific data, however, are some unequivocally bullish reads at the industry level. Amongst these we count mining, forestry and electricity production, each of which looks to have experienced double-digit (or near to it) growth during June.

We also weren't helped by the various expenditure indicators (notably the overseas trade indexes) giving the impression of being much more robust than their production counterparts. The answer to part of this conundrum, at least, lies in inventories, for which we see very little concrete data ahead of the GDP release itself.

It is quarters like these where the art of forecasting is more clearly in evidence than the science. Our prognostications leave us at our expectation of -0.1% q/q but, importantly, we can't rule out a not insignificant chance of a positive GDP reading. If such transpired, it would signal that the New Zealand recession finished a quarter earlier than most had expected. And by virtue of being on the right side of zero, a positive growth read, even though not significantly different from expectations in absolute terms, will attract hefty media interest, we're sure. We can see the headlines now. Such would surely see the NZD push yet higher, from an already uncomfortably strong-looking starting point.

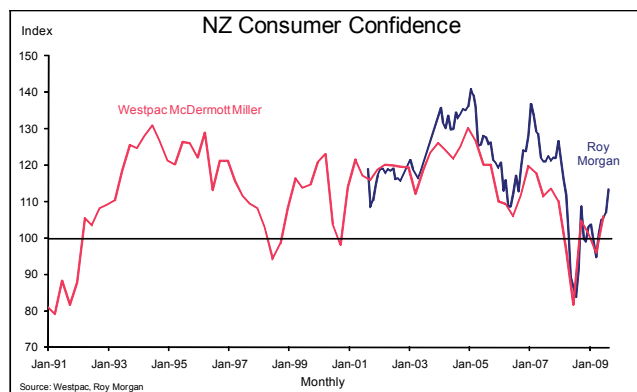
Nor is the Q2 current account deficit, due tomorrow, likely to deter fans of the NZD. We think the annual balance will improve to -\$12.1b, or around -6.7% of GDP, a touch better than the -\$13.0b/-7.1% the market is looking for. In either case, the inventory-drawn surge in merchandise exports during the June quarter will underpin a significant improvement in the deficit, from Q1's -8.5% of GDP.



That many of the structural issues plaguing the current account are only very slowly being remedied will be lost on currency markets, we suspect, particularly if the headline result prints closer to our expectation than that of the median.

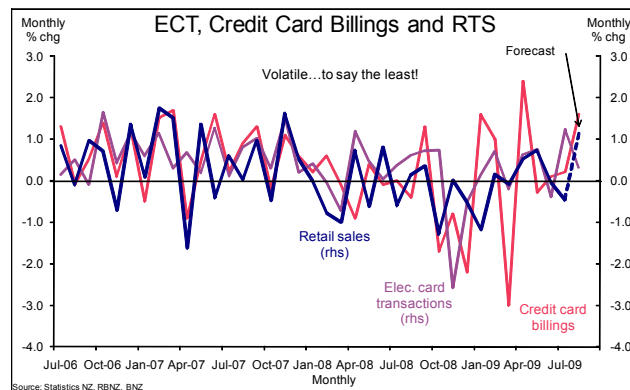
While we're on the trade front, August's merchandise figures will provide some idea of whether the strength supporting Q2's improving current account balance will stretch into the September quarter. We have significant doubts. For all that exports surged during the June quarter, the monthly trend of late has been of a distinct slowing. Simply put, drawing export sales from inventories can't be sustained indefinitely, and we believe August's trade figures, due Friday, will reaffirm as much. We're at the low end of market expectations, in picking a monthly goods shortfall of \$766m (median expectation is for a not quite-as-weak deficit of \$273m).

In these early, tentative stages of recovery, it is perhaps inevitable that confidence runs ahead of actual activity. This can only continue for so long, however, before one begins to question whether the expectations implied by soaring confidence will be met. We don't harbour such reservations just yet, but do note that these implied expectations will probably ratchet higher still, with the release of Westpac's consumer confidence index on Wednesday. Such was portended by the Roy Morgan poll, of late last week, which pushed up to 120, compared to the 114.5 of mid-August. That points to a lift in the Westpac index to somewhere around 115, from 106 a quarter earlier. A reading of 120, which isn't outside the realms of possibility, would be the strongest since 2005.



All the numbers aside, the big picture is that consumer confidence is on a distinctly upward track, and currently sits somewhere close to its average level of the past five years. For now, though, that improvement in consumer confidence has yet to translate consistently into the likes of retail spending, which is on a modest recovery track, at best. But while questions about the outlook of the labour market linger – and could yet threaten to dislodge consumer sentiment – we believe spending will gradually improve in a more robust fashion.

This afternoon's credit card spending figures, for August, provided extra weight for our view, in lifting a sizable 1.6%.



To be fair, that's a good deal stronger than the 0.3% growth seen in the already-released electronic card transactions data, and both series tend to be fairly volatile. Between them, however, they look consistent with our early take on the official retail sales measure (due mid-October), for which we've pencilled in +1.1% (and +0.6% ex-auto).

And it was even more heartening that August's Performance of Services Index improved to 51.3, from the 50.1 of July. That the services sector has expanded for two consecutive months is just the type of signal needed to suggest the recovery in the local economy has some genuine legs, particularly as the appreciating NZD poses an additional challenge to many firms. Even better news was that the PSI's forward looking new orders sub-index lifted to 57.6, giving us confidence our expectation of continued improvement in service sector activity is well founded.

Parts of the service sector are almost certainly benefiting from aspects of New Zealand's migration inflows. August migration figures, released this morning, pointed to continued strength in tourist flows from Australia (up 12% y/y), drawn here by superb skiing conditions, one supposes. No wonder, then, that service sector firms from Otago and Southland are by far the most upbeat about conditions.

Tourist flows from other countries aren't nearly as positive, unfortunately. Visitor numbers from Japan (-39% y/y) and Korea (-34%) are down sharply, and though arrivals from the US are up 7% compared to a year earlier, this only returns the number of visitors to 2007 levels. The bad news in all of this is that it tends to be these longer-haul tourists that spend the most on their travels.

As for permanent inflows, these remain robust though appear to be approaching a peak. Around 1600 net permanent arrivals touched down in August, somewhat weaker than the average monthly net inflow of the past six months of around 2000. Rather than genuine new arrivals from offshore, however, New Zealand's net inflow tally is dominated by a dearth of departures. As the number of Kiwis permanently departing these shores increases, as we expect it will, net migration will to slow. The annual net inflow will stabilise near current levels as a result.

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Domestic Interest Rates

New Zealand interest rates saw a moderate sell off across the curve over the previous week despite weaker than expected retail sales and PMI data. The market rung the risk of getting ahead of itself. As the RBNZ signalled in its last MPS, it is not yet convinced that a strong and sustained recovery will eventuate and the weaker data printed last week only serves to reinforce its easing bias. The market instead, continues to follow off shore moves particularly from a weaker Australian market. The bank bill futures are now pricing in a full 25 bps hike in March 2010 and 200 bps of hikes by the years end, compared to the RBNZ's 90-day bank bill projection of the first hike in late 2010.

The bond market saw a fairly quiet week with rates moving higher across the curve. Offshore markets have been performing well which has helped to keep our market buoyant. The initial bond tender was noticeably larger with \$450m on offer but still found a strong bid to cover ratio. Excess demand in the 11s saw the DMO issue

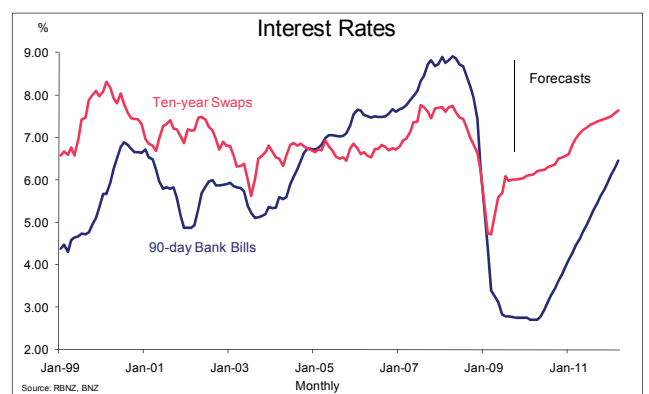
	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps (bps)
11-Sep-09	2.76%	3.93%	5.55%	3.97%	5.86%	189
18-Sep-09	2.78%	3.94%	5.625%	4.035%	5.93%	189.5
Change (bps)	2	1	7.5	6.5	7	0.5

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a further \$200m in a tap tender on Friday and that was easily absorbed also.

NZD interest rate swaps saw a decent sell-off across the curve, with very thin corporate flow and minuscule mortgage book paying. The market seems to be taking its lead from off shore. 2 year swap broke back within its previous range of 4.00%-4.20%. This week look for continued offshore influence supplemented by the Q2 current account and GDP data domestically.

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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.



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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

The NZD danced to a familiar beat last week. NZD/USD was one of the strongest performing currencies, benefiting from broad-based USD weakness and recovering risk appetite. As a result, NZD/USD reached a fresh 13-month high above 0.7150 during the week. However, it hasn't been all one-way traffic. Reservations about the speed and strength of the global recovery continue to flare up, causing volatility in currency markets.

The USD was under pressure most of last week on reduced "safe-haven" demand and worries that Asian central banks may be diversifying reserves out of US dollars. USD weakness has been 'floating all boats' lately and NZD/USD has been no exception. As an indication of the extent to which USD developments have been driving NZD gains lately, the NZ TWI has now risen around 25% from its March lows while the NZD/USD is up nearly 45%.

While global factors have played an important role in recent NZD gains, the currency has also benefited from a general sense the NZ economy has weathered the global recession in relatively good shape. This week will be particularly important in gauging just how quickly the NZ economy is recovering. Balance of payments, and consumer confidence data, are due to be released. But Q2 GDP will probably be the highlight. Our economists are expecting a small (0.1% q/q) fall (as is the RBNZ, coincidentally). However, given the inherent volatility in NZ's quarterly GDP numbers, a positive number is

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certainly not out of the question, and this sort of result would probably see the greatest reaction from the NZD.

Data developments aside, we wouldn't be surprised to see the market try and take NZD/USD higher this week, certainly if USD sentiment remains negative and risk appetite solid. Indeed, we think these two fundamental drivers will continue to exert a positive influence on the NZD/USD over the coming year. Nevertheless, the rapid gains in the currency over the past fortnight or so suggest the NZD has probably got a bit ahead of itself, and the case for a near-term correction is building. Our short-term valuation model suggests a 'fair value' range for the NZD/USD of 0.6750- 0.6950.

The rapid run-up in NZD/GBP has also been capturing the attention of many lately. GBP/USD has been the worst performing currency over the past month, propelling NZD/GBP to 12-year highs above 0.4300. GBP has been hit by ongoing banking sector concerns and sharp falls in interest rates, as central bank and government officials have intimated that official interest rates may need to be lowered (or even made negative). Barring further meltdown in the UK banking sector, we can't see a compelling reason for the NZD to continue to outperform GBP; we look for a correction back towards 0.4000 in coming weeks. Nonetheless, given upward momentum looks to be firmly entrenched for now, we may well see further NZD/GBP gains first.

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Foreign Exchange Technicals

NZD/USD

Outlook: Buy a dip
 ST Resistance: 0.7155 (ahead of 0.7250)
 ST Support: 0.6965 (ahead of 0.6885)

Momentum indicators remain positive, but with the daily RSI close to "over-bought" territory we'd wait for dips before buying. A daily close below 0.6900 will suggest the uptrend is 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.



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Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 21 September				Thursday 24 September continued...			
NZ, Credit Card Billings, August			+0.2%	Jpn, Merchandise Trade Balance, August			+Y380b
NZ, External Migration, August s.a.			+2,470	Jpn, All Industry Index, July			+0.1%
NZ, BNZ PSI (Services), August			50.1	US, Existing Home Sales, August			5.24m
US, Leading Indicator, August			+0.6%	US, Jobless Claims, week ended 19/09			545k
Euro, PMI Manufacturing (circa), September 1st est			48.2	Germ, IFO Index, September			90.5
Euro, PMI Services (circa), September 1st est			49.9	Friday 25 September			
Tuesday 22 September				NZ, Merchandise Trade, August	-\$767m	-\$273m	-\$163m
NZ, Balance of Payments, Q2	-6.7%	-7.2%	-8.5%	Jpn, BOJ Minutes, 10/11 Aug Meeting			
US, FOMC Policy Announcement			0.25%	UK, Business Investment, Q2 2nd est			-10.4%P
Wednesday 23 September				UK, CBI Dist Trade Survey (circa), September			-16
NZ, Wpac Consumer Confidence, Q3			106.0	UK, BOE Credit Conditions Survey (circa), Q3			
NZ, GDP, Q2	-0.1%	-0.2%	-1.0%	Euro, M3, August y/y			+3.0%
UK, BBA Home Loans, August			38k	US, Durables Orders, August			+4.9%
UK, BOE Minutes, 9/10 Sep Meeting				US, Shiller Home Price Index, June y/y		-16.4	-17.1%
Euro, Industrial Orders, July			+3.1%	US, New Home Sales, August			433k
Thursday 24 September				US, Mich Cons Confidence, September 2nd est			70.2
Aus, HIA Home Sales, August			+0.5%	Sunday 27 September			
				NZ, Daylight Saving Begins, +1hr to +13:00 GMT			

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	7.50	NZD/USD	0.7076	0.7056	0.6849	0.6906
1 mth	2.75	2.80	2.78	8.10	NZD/AUD	0.8168	0.8182	0.8169	0.8233
2 mth	2.82	2.78	2.80	7.95	NZD/JPY	64.66	63.78	64.63	73.76
3 mth	2.76	2.78	2.77	7.85	NZD/EUR	0.4814	0.4831	0.4774	0.4765
6 mth	2.85	2.85	2.85	7.63	NZD/GBP	0.4358	0.4230	0.4150	0.3763
GOVERNMENT STOCK					NZD/CAD	0.7573	0.7598	0.7392	0.7227
11/11	3.96	3.93	4.04	5.68	TWI	64.56	64.31	63.59	64.90
04/13	4.82	4.72	4.94	5.72	NZD Outlook				
04/15	5.26	5.16	5.40	5.76					
12/17	5.65	5.55	5.80	5.78	<p>Source: BNZ, RBNZ</p>				
05/21	6.05	5.95	6.53	-					
CORPORATE BONDS									
BNZ 09/10	3.82	3.70	3.84	-					
BNZ 05/15	6.68	6.52	6.71	-					
GEN 03/14	6.75	6.55	6.69	-					
GEN 03/16	7.25	7.05	7.18	-					
TRP 12/10	4.62	4.45	4.56	7.15					
TRP 06/20	7.59	7.38	7.67	7.23					
SWAP RATES									
2 years	4.05	3.97	4.08	6.96					
3 years	4.70	4.63	4.77	6.90					
5 years	5.35	5.27	5.40	6.87					
10 years	5.95	5.86	5.99	6.73					

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