5 October 2009

A "Far Out" Recovery

- Tuesday's QSBO will affirm NZ business recovery
- But will its nearer-focus match NBNZ one-year view?
- Dairy prices up, but remainder of export prices choppy
- We expect September's electronic transactions rose 0.8%
- Household credit, mortgage approvals, far from frothy
- OCR working more like a 4.50% than its actual 2.50%

"Far out" pertains to the distant horizon. It's also an exclamation of idle wonderment. Both seem relevant to the recent economic surveys – both here and abroad. Many of them are now promising a splendid recovery, for the coming year. But from present conditions the same surveys suggest are still problematic.

We have to ask: when dreams are free is reality biting?

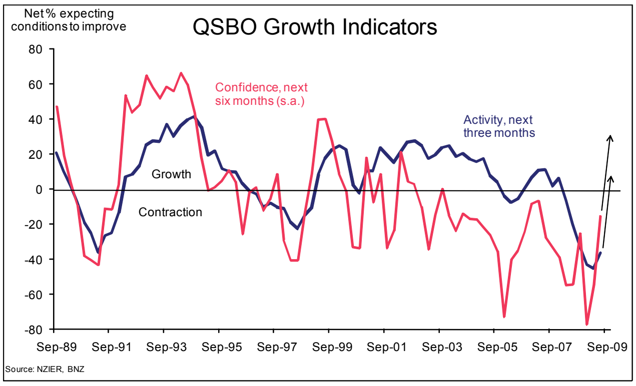
If we can believe the trend in the economic surveys, especially in sentiment, then the economic recovery we're projecting for 2010 may yet prove substantially underdone. However, if we put more store in the reports of what's actually occurring, up front, we might question whether the GDP pick up we presume is locked and loaded for the immediate term.

Of the many local examples, last week's Westpac Employment Confidence Index was the latest good one. While it jumped to 103.0 in September, from 96.3 in June, it was the net result of expectations blasting up to a stunning 122.1 while the present conditions index actually fell back to a poor 74.4. It's a massive gap between expectations and reality.

Of the foreign variety, US consumer confidence is one worth noting. It was bad enough that its headline reading tripped in September – albeit to remain in the broad zone of "just" a bad recession, rather than depression. But that its expectations component held up at 73.3 while its present-conditions index fell to a fresh all-time low of 22.7 certainly betrayed a sense of hope prevailing over bad experience.

Might we get another example when the NZ Institute of Economic Research publishes its latest Quarterly Survey of Business Opinion tomorrow?

To be sure, the QSBO, in general, will trumpet messages of a recovering business sector. That's to be welcomed. We detect improvement from our reconnaissance. And we know this from the various monthly business surveys of late, with last week's NBNZ edition the latest to press the case of a clear recovery in the offing.



However, it is also worth distinguishing some time frames here. The NBNZ survey enquires of respondents what they think things will do over the next twelve months. When times are tough, a year can afford reasonable time for any improvement – real or imagined.

The QSBO, in important contrast, tends to look out just three to six months in its various indicators (including its general business confidence), and with plenty of its other series informing on very recent history. By construction, then, it's less prone to wishful (one-year-ahead) thinking. Given this, it might not be quite as upbeat as the "far out" NBNZ survey was last week.

Another potential reason for the QSBO falling short of the NBNZ optimism, of course, is that the former does not directly survey farming folk, so will be missing the improvement in dairy prices.

With this in mind, the QSBO trading reports will be especially important to log. Recall, they were still in the rough in the June survey, albeit repaired from their deeper divots of March (when all-time lows were struck). For tomorrow's survey, reports from businesses about their trading over the past three months (Q3) need to buck up to about flat, from their terrible -36 (seasonally adjusted) of June. And the next-three-months view needs to shift up into the teens, from -10, in order to fit with the GDP recovery we, and the RBNZ, expect.

The other QSBO indicator on our checklist is the capacity utilisation measure, CUBO. It posted an unusual bounce in June – to an above-average 90.7%, from a below-average 86.3%. We still don't fully understand why (beyond unusually high meat processing in Q2). But we anticipate it has dipped back down in Q3, to square with the more general impressions we have of a substantial amount of idle capacity bedevilling the economy at present.

Related to this, we'll also be paying close attention to the QSBO reports of the relative difficulty of finding staff. If one aspect of the economy might be recuperating a little earlier and more clearly than we've expected it's the labour market. For the meantime, we're sticking with our view the unemployment rate is rising noticeably and will hit 7.5% by mid next year. But if the QSBO staffing indicators are not quite so soggy, then we'll certainly take note.

But that's not to overlook another "issue" of the economic surveys, including the QSBO. In being of the simple up-down-same genus, they are not well designed to capture degrees of change. It only takes the majority to turn to expecting just a small improvement for the net balance indices to surge. That few might expect a strong pick-up doesn't figure. Majority wins, not weightings or degree.

Normally, this isn't a big deal. Laws of large numbers will be as near as damn it, as we track the broad cycle. However, with a turning point not really in great dispute any longer, it's the extent of the "up" in prospect that is taking on prime importance. A GDP expansion of 3.0 to 4.0% over the coming year will mean something. Growth of just 1.5% will leave us cold and concerned.

Turning to the other domestic news of the week, dairy prices will surely inject a positive tone into September's commodity price indices, published by the ANZ this afternoon. They have certainly increased from August, even though the advances in the week-to-week dairy price measures we monitor have been losing much of their earlier strong momentum.

Tomorrow morning's very latest milk powder auction results will be an important cross-check in this respect. But that's not to overlook the likelihood that most other commodity export prices either lost upward force in September (watch aluminium and even forestry in this respect) or just plain backtracked (with meat prices on the chopping board this month).

What we know for sure is that the ever increasing NZ dollar continues to exert downward pressure on local commodity export returns. In this respect, pity those exporting to the United Kingdom, as the NZD soared a further 7% against the British pound last month. It's a reminder that the NZ dollar's recent strength is about much more than just US dollar weakness.

While we hope for a clear pick-up in New Zealand's commodity export prices, the fact is they are down about 20% on a year ago, whether expressed in US dollars, SDRs (a type of world currency unit) or NZ dollars.

The distinction between a better-looking future and a struggling reality is also germane to consumer spending. Despite the strong pick-up in consumer confidence over the last six months, a stabilising housing market, and less bad news from the labour market, the spending indicators have been decidedly disappointing.

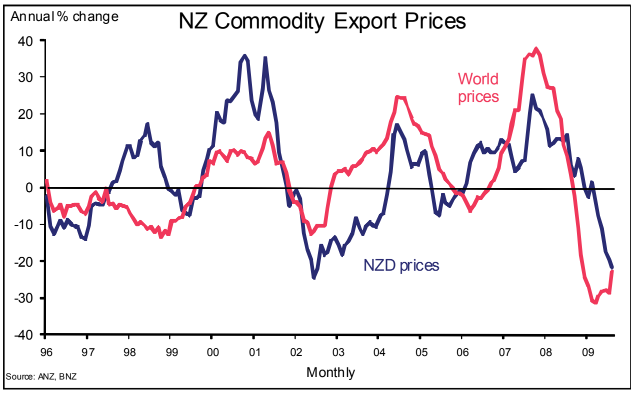
We saw this in July's retail trade drop. And nominal electronic card transactions (ECT) barely expanded on a trend basis the three months to August. We get September's ECT results this Friday. We expect them to expand in the region of 0.8% in order to fit with our expectations that a gradual recovery in consumer spending is, in fact, beginning to emerge.

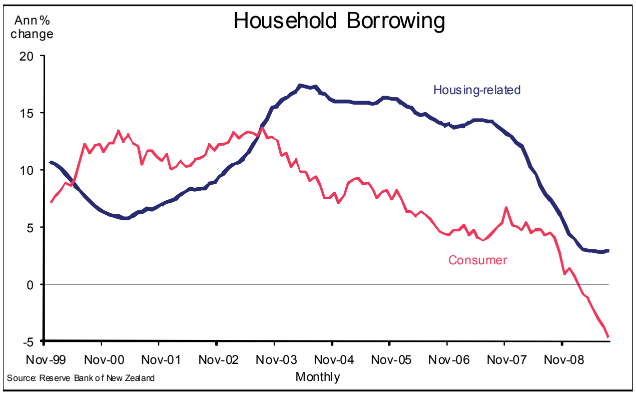
But if we don't see signs of a spark in consumer expenditure soon we'll have to start to wonder.

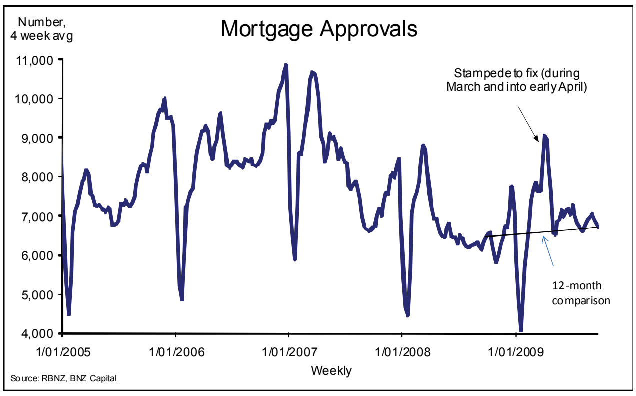
Perhaps the issues of flat wage growth, low savings rates and massive debt loads are the bigger ones to realise?

Speaking of which, we couldn't help but notice the flat results for last week's credit aggregates. Indeed, they've been dead flat all year, overall. While borrowing by agricultural businesses was simply expanding much less so in August, and other business borrowing was shrinking a bit, consumer finance dropped 4.6% over the twelve months.

The only real sign of life was in mortgage lending. Not that it was in any way strong, however. It expanded a seasonally adjusted 0.3% in August, matching July's increment. When it's cooking this variable rips along at more than 1.0% per month. The fact it's nowhere near this leaves us unconvinced the housing market is beginning to race away again (beyond its undeniable flurry of late, that is).







So too the latest mortgage approvals data leave us tepid. Yes, like a lot of the housing indicators, they are not nearly as weak as they were at their nadir. But they are far from frothy. Indeed, the weekly approval numbers are now beginning to fall short of year-ago levels (of late-September 2008, just after the Lehman Brothers collapse). On a 4-week moving average basis, mortgage approvals were just 2% higher than a year ago. This is not a signal of raging demand.

And nor is the current OCR, of 2.50%. To be sure, the markets are obviously getting nervous that New Zealand's cash rate is now too stimulative, given signs of recovery. But is it, really?

In crucial respect the current NZ OCR is working more like a 4.50% than a 2.50%. You see, normally, with a 2.50% we would expect short-term deposit rates to be around 2.00%. In fact, they're easily as much as 4.00% (a rate normally associated with an OCR of 4.50%).

The 200bps wedge (well-documented by the RBNZ in its September MPS, by the way) is being driven by a veritable battle for relatively scarce local funds, as banks reduce their degree of funding from abroad, especially the shorter-term part of it. This process has been egged on by recent Reserve Bank regulatory guidance for the NZ banking system. It's a very real tightening in monetary conditions, as it is maintaining upward pressure on bank funding costs, which is all the while radiating up into corporate and retail interest rates – the rates most relevant to the real economy and credit markets.

The point is: don't think the 2.50% OCR is all that low and stimulative, when, in effect, it's arguably acting more like a 4.50%.

If one accepts this, then one can also appreciate why the RBNZ can probably hold off lifting the OCR for as long as it has suggested.

By the same token, for the RBNZ to hike as much as the market is now pricing implies getting back to the "new neutral" for the OCR within nine months. That's pushing it – especially as it's likely to take the TWI with it, and alongside the big hole the NZ economy needs to grow its way out of in any case.

This is part of the reason we're still targeting mid-2010 as simply the start point for the tightening cycle, on the assumption the economy is expanding fast enough by then to be making genuine inroads into spare capacity, and the TWI isn't too much stronger than it already is.

So, while the "low" OCR and "far out" GDP expectations are all very well, we're just as mindful of how monetary conditions and the economy will play out, in effect, over the near term.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates were quite volatile over the past week, moving in line with offshore markets. Initially rates sold off on the back of a much weaker Aussie market pricing in more of a chance of an RBA hike this week. RBA Governor Glenn Stevens kicked things off, commenting on the need to ease stimulus spending and raising interest rates as the economy continues to recover. This was further emphasised by an article by Terry McCrann (noted RBA watcher) calling for hikes even sooner. On the data front, strong Aussie retail sales and NZ business confidence added to the positive sentiment and only compounded the momentum of the sell-off. We then rallied later in the week following a much more risk adverse US equity market heading into non-farm payrolls data. The overall effect left the curve a touch flatter with the long end rallying overall.

NZ government securities saw a strong flattening tone last week, with the longer dated bonds bid down, while short dated bonds were relatively unchanged. The 21s closed the week at new lows at 5.85%. The bond tender was once again successful with $350m on the offer, with noticeably quieter offshore demand after recent quarter-end and month-end buying. Local balance sheets picked up the slack and showed good interest in the nearer maturities.

NZD interest rate swaps were mainly driven by offshore moves last week, complemented by some small mortgage book paying and corporate flow. The call for RBA hikes sooner, strong Aussie retail sales data and a robust NZ business confidence survey helped drive yields to their highs of the week. The 2-year swap pushed all the way up to 4.31% while still trading within our perceived 4.20%-4.40% range. The curve ended the week a touch flatter with 2/10s closing at 168 bps. This week much of the attention will be focused on what the RBA does tomorrow, with many expecting them to hold at 3.00% with the possibility of hikes starting in November.

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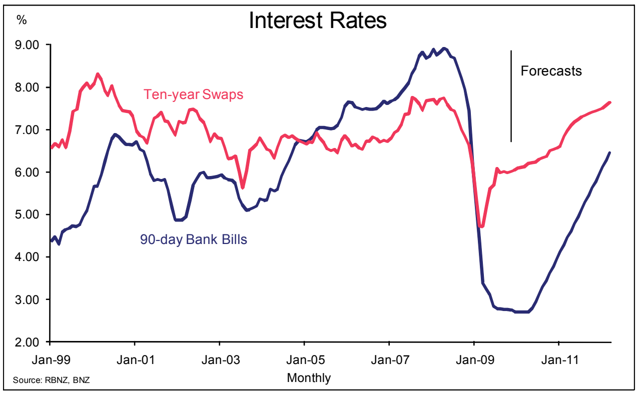
	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
25-Sep-09	2.79%	4.04%	5.59%	4.22%	5.98%	176
2-Oct-09	2.75%	4.07%	5.51%	4.22%	5.90%	168
Change (bps)	**-4**	**3**	**-8**	**0**	**-8**	**-8**



Interest Rate Technicals

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NZD 5yr Swap Rate

Outlook: Consolidation
ST Resistance: 5.50%
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: Flattening
ST Resistance: +122
ST Support: +98

A break of +122 has confirmed a new trend.
The flattening should continue initially targeting +98.

Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD/USD has spent the last week trading choppily in a 0.7080-0.7250 range.

Investors' risk appetite has come under renewed pressure over the past week or so, which has tended to halt further gains in "growth sensitive" currencies like the NZD. Our risk appetite index (which has a scale of 0-100%) has fallen to 44%, from 46% last week. Worries about the strength and timing of the anticipated global recovery had many investors questioning whether the recent equity market gains are sustainable. These fears were not helped by a string of weaker-than-expected data last week, including Chinese and UK PMIs, US consumer confidence, and non-farm payrolls. Reflecting the weaker data and more cautious mood, US equity markets posted a second consecutive weekly decline last week (the S&P500 fell 1.8%) and "safe-haven" demand underpinned both the USD and JPY.

The global outlook will be key to the fortunes of the NZD in the near-term. Investors have become quite optimistic on the global outlook over recent months, but are now starting to question whether or not this optimism is well-founded. The equity market rally that began in March this year has now extended its gains to over 60% and many equity markets are now looking stretched relative to valuations. For example, the P/E ratio of the S&P 500 is currently sitting close to 20 – the highest since early 2004.

The US corporate earnings season kicks off this week and if earnings fail to beat (relatively lofty) expectations, watch out for a correction in global equities and a tempering of risk appetite.

Clearly, the prospect of equity and/or commodity markets taking a "reality check" would pose some downside risks for the NZD. What's more, we do not expect USD weakness to continue at the same pace over the coming months. Officials are becoming increasingly vocal on the need for a strong dollar. Both ECB president Trichet and US Treasury Geithner were on the wires over the weekend expressing concern over recent USD weakness.

While the balance of these developments suggests the case for a near-term NZD/USD correction is building, it is important to note that any correction in the NZD/USD will be both short-term and shallow in nature. Indeed, NZ "fundamentals" remain NZD supportive on the whole. Our short-term valuation model suggests a fair value range for the NZD/USD is currently between 0.6950 and 0.7150 for the NZD/USD. This suggests that while NZ commodity prices continue to trend higher and NZ-US 3-year swap spreads remain above 3.00%, we'll need to see a material decline in risk appetite for NZD/USD to sustain dips below 0.6900.

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Foreign Exchange Technicals

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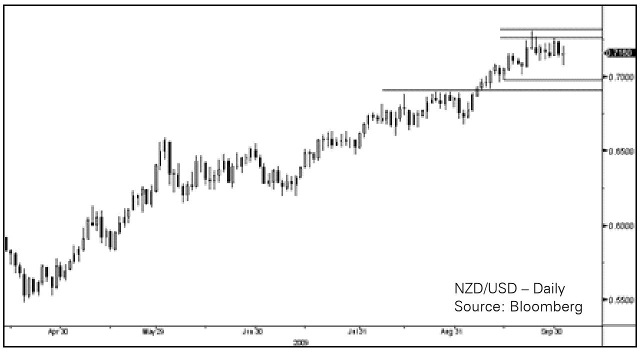
NZD/USD

Outlook:	Buy a dip
ST Resistance:	0.7275 (ahead of 0.7315)
ST Support:	0.6965 (ahead of 0.6890)

Momentum indicators remain positive, but the repeated failure to sustain bounces above 0.7250 suggests a near-term correction is likely. A daily close below 0.6900 is needed to suggest the uptrend has stalled.

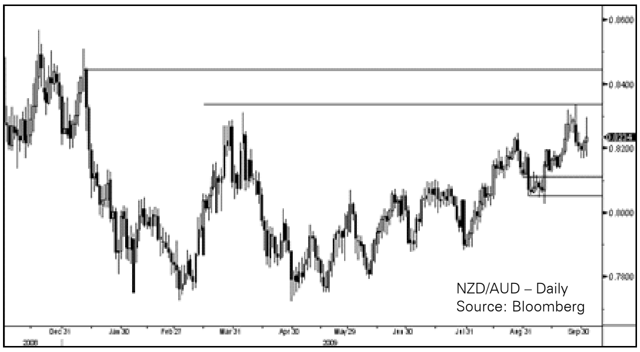


NZD/USD – Daily
Source: Bloomberg

NZD/AUD

Outlook:	Buy a dip
ST Resistance:	0.8340 (ahead of 0.8420)
ST Support:	0.8110 (ahead of 0.8080)

The break above 0.8250 has seen momentum indicators turn positive. However, with the market approaching "overbought" levels, we'd prefer to wait for dips before initiating long positions.



NZD/AUD – Daily
Source: Bloomberg

Key Upcoming Events

	Forecast	Median	Last
Monday 5 October			
NZ, ANZ Comdty Prices ($NZ), September			-0.7%
Aus, Services PMI (AiG), September			48.0
UK, CIPS Services, September		54.5	54.1
Euro, Retail Sales, August		-0.5%	-0.2%
Euro, PMI Services (circa), September 2nd		50.6	49.9
US, ISM Non-Manuf, September		50.0	48.4
Tuesday 6 October			
NZ, QSBO, Q3	+35		-25
Aus, RBA Policy Announcement	3.00%	3.00%	3.00%
Aus, International Trade, July	-$1200m	-$900m	-$441m
UK, Industrial Production, August		-0.2%	+0.5%
Wednesday 7 October			
Aus, Housing Finance, August	-2.0%	-1.0%	-2.0%
Aus, Construction PMI (AiG), September			42.4
Euro, GDP, Q2 3rd est		-0.1%	-0.1%P
Germ, Factory Orders, August			+3.5%
Thursday 8 October			
Aus, Employment, August	-10k	-10k	-27.1k
Aus, Unemployment Rate, August	5.9%	6.0%	5.8%
Jpn, Eco Watchers Survey (outlook),			44.0
UK, BOE Policy Announcement		0.50%	0.50%

	Forecast	Median	Last
Thursday 8 October *continued...*			
Euro, ECB Policy Announcement		1.00%	1.00%
Germ, Industrial Production, August			-0.9%
US, Jobless Claims, week ended 3/10			551k
US, Wholesale Inventories, August		-1.0%	-1.4%
Friday 9 October			
NZ, Electronic Card Transactions, Sep	+0.8		+0.3%
Jpn, Machinery Orders, August			-9.3%
UK, PPI (core output), September y/y			+0.7%
UK, Trade Balance, August			-£2.45b
US, International Trade, August		-$32.9b	-$32.0b
Germ, Trade Balance, August			+€12.4b

NZ only for following week

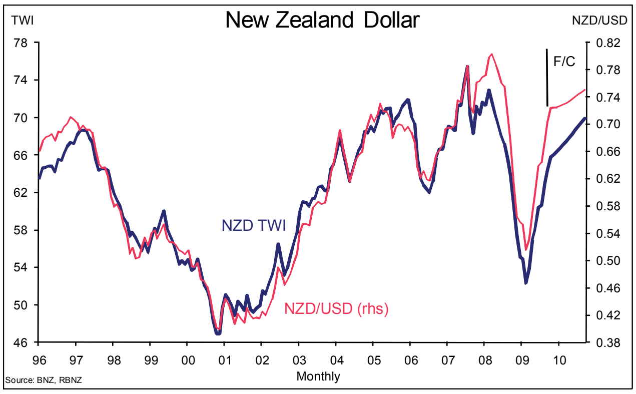
	Forecast	Median	Last
Tuesday 13 October			
NZ, Retail Trade, August	+1.1%		-0.5%
Wednesday 14 October			
NZ, Crown Financial Statements, June			
Thursday 15 October			
NZ, BNZ PMI (Manufacturing), September			48.7
NZ, CPI, Q3	+0.8%		+0.6%
NZ, Food Price Index, September	-0.5%		-0.9%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	7.50
1 mth	2.78	2.81	2.77	8.11
2 mth	2.78	2.80	2.78	8.11
3 mth	2.75	2.79	2.77	8.09
6 mth	2.90	2.90	2.85	7.64
GOVERNMENT STOCK				
11/11	4.07	4.04	4.00	5.50
04/13	4.83	4.85	4.84	5.56
04/15	5.22	5.26	5.27	5.67
12/17	5.51	5.59	5.64	5.68
05/21	5.85	5.95	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.81	3.81	4.00	-
BNZ 05/15	6.57	6.63	6.68	-
GEN 03/14	6.57	6.57	6.76	-
GEN 03/16	6.97	6.89	7.25	-
TRP 12/10	4.34	4.44	4.65	7.00
TRP 06/20	7.22	7.30	7.58	7.24
SWAP RATES				
2 years	4.22	4.22	4.07	6.83
3 years	4.82	4.84	4.74	6.80
5 years	5.39	5.44	5.35	6.79
10 years	5.90	5.98	5.94	6.73

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7166	0.7177	0.6883	0.6587
NZD/AUD	0.8260	0.8262	0.8082	0.8548
NZD/JPY	63.96	64.27	64.05	69.11
NZD/EUR	0.4901	0.4877	0.4810	0.4818
NZD/GBP	0.4491	0.4491	0.4195	0.3724
NZD/CAD	0.7733	0.7828	0.7476	0.7133
TWI	65.33	65.32	63.62	63.88

NZD Outlook



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