9 November 2009

Dairy Dollars a Welcome Boost

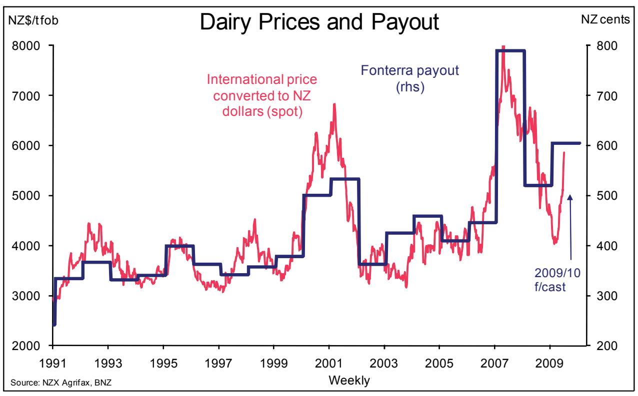
- Fonterra boosts payout on stellar price rises
- Farmers' prospects looking better all the time
- Retail volumes to look weak in Q3
- Manufacturing hanging in there, just, we think
- RBNZ report to highlight increased funding costs

Fonterra upped the ante again, this morning, in lifting its payout forecast for the current season to $6.05/kg milksolid. That's a massive lift from the previously anticipated $5.10/kg, announced only six weeks ago. The season opening $4.55/kg is now nothing but a distant memory.

That Fonterra has been able to ramp up its payout so forcefully, and so rapidly, is testament to how much the global dairy situation has improved in recent months. Since July, when things were at their worst, skim and whole milk powder prices have leapt around 75%, in US dollar terms. Butter has looked even better, up over 90%. Even the soaring kiwi has done little more than slow down the dairy juggernaut. On average, NZD dairy prices are up about 50% since early July.

The payout upgrade also represents a huge vote of confidence by Fonterra in the outlook. It may even instil a modicum of optimism amongst dairy farmers.

Sure, farming input costs are still high. Depending on whom you believe, breakeven for dairy farmers is somewhere in the vicinity of $4.50 to $5.50/kg, including debt servicing (but before drawings). So even the previous forecast for the season (of $5.10/kg) had left many farmers wondering how they would make ends meet. At $6.05/kg, the revised payout provides much-needed breathing space.

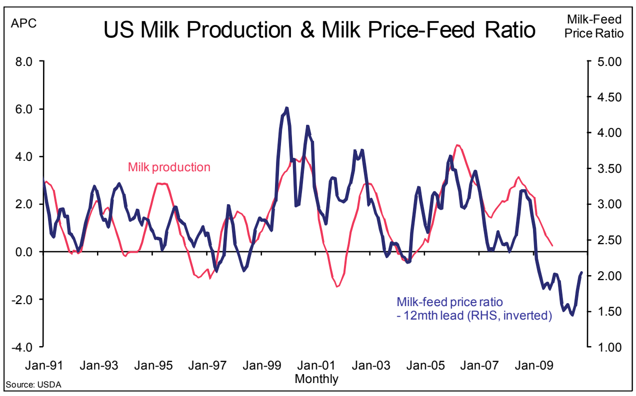


The dairying margin should improve still further over the course of the season. Prices for key material inputs are falling, encouraged by the high NZD and the lagged pass-through from global price declines. And wage growth will slow a good deal further over the next six months or so, we suspect, in line with a further deterioration in the labour market more generally.

A further lift in Fonterra's payout also can't be ruled out, given the clear positive momentum behind global dairy prices. At the very least, cheese and casein still have some way to go to catch up to the percentage increases already seen in milk powder prices, which tend to lead the pack. And of the latter, there's been little (if any) sign to date that the rate of their increase is abating.

We don't know to what extent Fonterra may have built these expected lifts into today's announcement, of course. Reading between the lines of Fonterra's statement, however, we suspect the dairy giant is reacting to events as they happen, rather than getting too far ahead of itself. Sir Henry van der Heyden continues to warn of the volatility in global markets and the frustratingly-high NZD, and there is still a long way to go before the end of the season. Banking on not-yet-realised gains would be foolhardy in such circumstances, if only because of the farmer backlash that would undoubtedly follow a payout downgrade.

There's also the risk of a global supply response, as noted in Fonterra's statement. Specifically, that response is most likely to come from the US, given the sheer size of its dairy industry and the strength of its infrastructure. To date, though, any US supply response still looks many months off, with dairy farmers there still buckling under the weight of comparatively high feed costs.



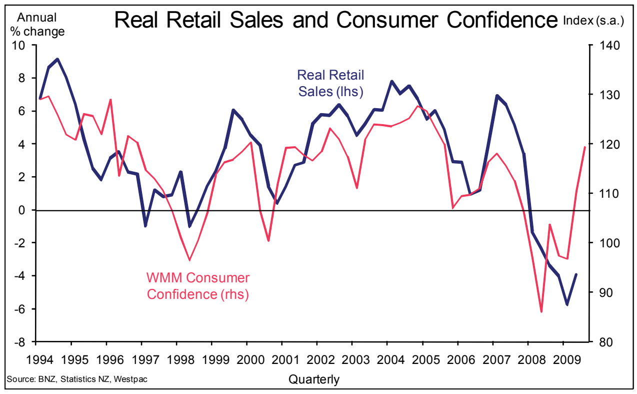
Fonterra's latest forecast certainly looks achievable, therefore, with upside risk if anything. The lift from $5.10/kg is roughly worth an additional $1.25b to aggregate dairy farming incomes, with obvious benefits to the wider New Zealand economy. Those flow-on benefits are likely to be more muted than we've become used to, with business-folk, including farmers, now considerably more cautious about their level and quality of spending. Even so, rural retailers will likely embrace any windfall gains, however watered down they might be, given the way the retail sector, in general, continues to struggle.

Data this week look likely to reinforce this story, with both Q3 retail volumes and September's nominal monthly sales on offer, on Thursday. For the latter we expect a continuation of the weakly positive trend in evidence now for some months. Formally, we're looking for a seasonally adjusted 0.4% m/m lift in September (and +0.1% excluding the volatile automotive component). That would see nominal sales lift around 0.6% for the quarter.

As for the quarterly volumes, we're not so sure, with much depending on what happened to retail prices during the three months to September. A combination of anecdote, observation and common sense suggests that retail pricing remains under considerable pressure, with consumer demand insufficiently robust to support any great price increases. We would have thought that discounting, rather than hiking prices, was the more likely option.

Yet the retail components of the Q3 CPI, like the headline index, pointed to strength in surprising areas, with increasing used cars prices a good example. There's not a one-to-one translation between the CPI components and the actual retail price deflators, to be sure, so there's a fair bit of uncertainty about precisely what that means, but we judge retail prices lifted by over 1.0% during the September quarter (compared with the overall CPI result of +1.3%). That leaves us with a Q3 retail volume expectation of -0.6%. Ex-auto will look not so bad, we think, at -0.1%.

While we've placed our faith in the figures in settling our formal expectations, our instincts tell us the risk lies in results that are not quite so negative. The market's



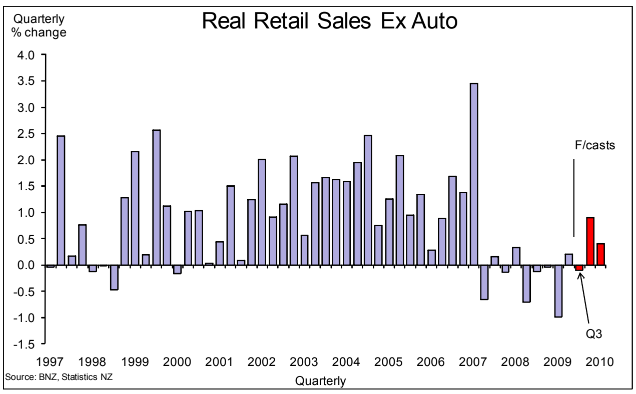
median expectation, of a flat result for total retail volumes, points in that direction, too.

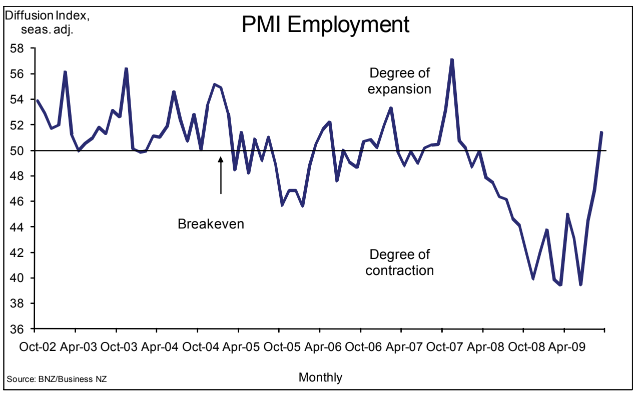
Mechanics aside, though, it looks as if the retail sector struggled throughout the September quarter, despite the rapid improvement in consumer confidence. We expect the rise in confidence to begin translating into a much healthier looking retail sector from the December quarter. The first hint of this will be provided by October's electronic card transactions, due Tuesday.

This week also sees the release of October's food prices. After two consecutive months of food price declines (in turn correcting hefty weather-related increases), we're looking for something closer to trend, so around 0.4% for the month.

The update of the BNZ-Business NZ Performance of Manufacturing Index, due Thursday, will provide fresh insight into how the manufacturing sector fared during October. If firm expectations gathered via other surveys are to be believed, a further lift in the headline PMI reading, from September's 51.2, is on the cards. All the same, offshore PMIs have looked a mixed bag of late, with a number seeming to falter after clearing the 50-point hurdle that indicates expansion.

In any case, it will arguably be the PMI's sub-indexes that will be of interest. We'll have an eye out for the employment reading, in particular, for clues it might offer on the future direction of the labour market (especially following the softness we saw in last week's Q3 Household Labour Force Survey).





Also, the Reserve Bank releases its six-monthly Financial Stability Report (FSR) on Wednesday morning. Though not offering much in the way of direct insight into monetary policy, it typically makes for interesting reading nonetheless. Since the previous, May, report conditions in financial markets, both locally and overseas, have improved considerably. Private savings rates are also lifting in New Zealand (albeit as the Government's fiscal situation deteriorates), something which will likely get a thumbs up.

One topic we suspect will get particular attention in the FSR is the impact higher bank funding costs are having on retail and corporate lending rates. Though conditions in offshore wholesale money markets are worlds better than they were during the financial crisis, New Zealand banks have spread their funding base, tapping more into local depositors' funds and lengthening funding maturities from offshore. Given the limited (notwithstanding higher savings rates) pool of local deposits, and upward sloping yield curves globally, both of these options – encouraged by the RBNZ, incidentally – are lifting the average cost of funding for the banking system. These increases are being passed on to borrowers. Indeed, at current levels, mortgage rates are indicative of an OCR something closer to 4.50%, rather than the 2.50% actually in place. This gives the impression of an effective tightening in financial conditions, even with no change in underlying monetary policy. It also provides a key reason why the RBNZ will be in no hurry to lift the OCR.

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Domestic Interest Rates

NZD interest rates have seen a relatively quiet week as the market continued to digest the dovish OCR commentary. The 3-month bank bill continues to trade in a tight range around 2.80%, with no significant change in bank bill margins yet evident. This is notable because in Australia the spread between their bank bills and OIS curve has pushed out by around 15 points recently. Market pricing for the OCR is broadly unchanged, with the first 25bp hike priced for March next year.

The bond market was also quiet on the week with muted interest seen through the curve. The Australian market struggled somewhat and the New Zealand market followed along. Offshore demand continues to be light and as a result the bond market is largely following offshore leads. The swaps market is the dominant driver in short end bonds, while the Australian market seems to be driving long-end yields.

The swaps market followed along with the general theme and saw relatively little activity. We seem to have fallen into a rough range in 2yr around 4.50%, with payers lurking below this level and receivers around at a little above. The curve has steepened somewhat in the past week despite significant profit taking on existing positions in the market. We still feel the steepener is a good trade to hold, with the current curve still pricing hikes too aggressively and the attractive carry in the position. With this week's data relatively light it's likely the market will be pushed by flow and offshore moves.

Reuters pgs BNZL BNZM

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
30-Oct-09	2.79%	4.32%	5.72%	4.53%	6.18%	165
6-Nov-09	2.80%	4.29%	5.75%	4.50%	6.23%	173
Change (bps)	**1**	**-3**	**3**	**-3**	**5**	**8**

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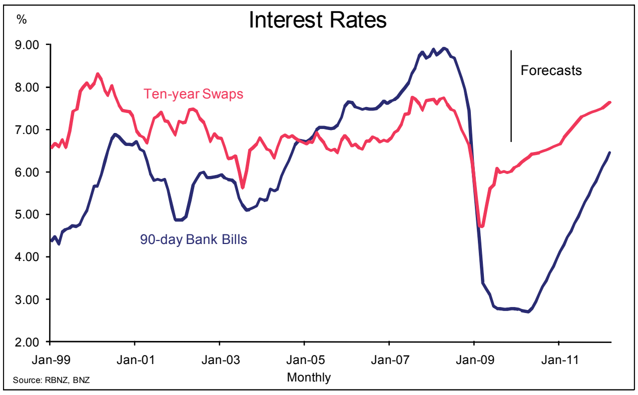

Interest Rate Technicals

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NZD 5yr Swap Rate

Outlook: Consolidation
ST Resistance: 5.95%
ST Support: 5.50%

The previous break above 5.50% proved important. The market is now trending higher with next level 5.95%. Any rallies should be limited to 5.50%.

NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Flattening
MT Resistance: +122
MT Support: +61

The +122 level continues to hold. We expect the +122/+98 range with an eventual break of +98 targeted and trend support at +61.

Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD spent most of last week licking its wounds following its fall from grace the week before. Having started the week close to 0.7150, a steady recovery in investors' risk appetite saw NZD/USD grind up to around 0.7250 by the end of the week.

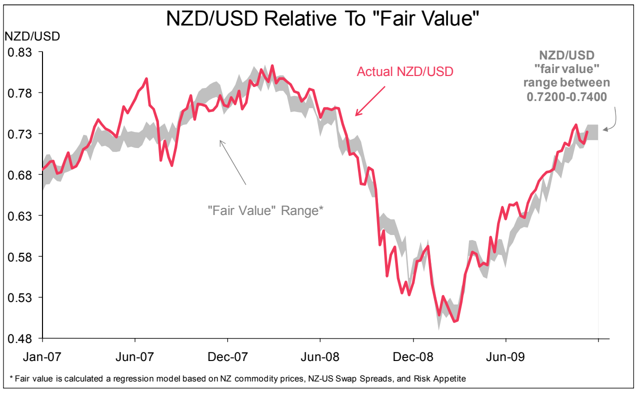
Last week's local news wasn't particularly inspiring. The HLFS showed September quarter employment fell 0.8%q/q, which saw the unemployment rise to 6.5%.

Governor Bollard was also on the news wires warning folk about the fragility of NZ's economic recovery. However, it wasn't all bad news on the local front. Last week's online auction showed wholesale milk powder prices have risen 87% over the past five months. Strong gains in dairy prices are providing something of a buffer against the high NZD for some NZ exporters. In fact, Fonterra has just announced an upward revision to its 2009/10 dairy payout, from NZ$5.10/kg to NZ$6.05/kg.

The NZD also found support from an improvement in offshore sentiment. US equities bounced strongly (the S&P500 rose 3.2% for the week), which helped risk appetite recover, withdrawing some 'safe-haven' support for the USD. Our risk appetite index is currently sitting at 50%, well above the 39.5% low seen on 30 October.

Looking ahead, we suspect the USD will start the week on a fragile footing. Indeed, the absence of supportive USD comments from the weekend's G20 meeting, combined with last week's Fed commitment to keep rates lows for "an extended period", may well be setting the USD up for further weakness this week – provided equity markets and risk appetite remains buoyant.

In the absence of any notable local events (Q3 retail sales, due Thursday, will probably be the highlight), a weaker USD should keep NZD/USD well supported on dips towards 0.7150 this week. On a short-term valuation basis, the NZD/USD also looks 'cheap' below 0.7200. Our model suggests the NZD/USD is 'fairly' valued between 0.7200 and 0.7400. Fair value has crept up in recent weeks in line with the recovery in risk appetite, improving global data and higher NZ commodity prices.



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Foreign Exchange Technicals

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NZD/USD

Outlook: Buy a dip
ST Resistance: 0.7375 (ahead of 0.7450)
ST Support: 0.7050 (ahead of 0.7000)

The failure to break convincingly below 0.7100 suggests the downward momentum has stalled. We'd view dips towards 0.7100 as a buying opportunity.

NZD/AUD

Outlook: Buy a dip
ST Resistance: 0.8080 (ahead of 0.8130)
ST Support: 0.7885 (ahead of 0.7800)

The market is close to a critical juncture. A convincing break below 0.7885 would suggest a deeper correction towards 0.7800 is on the cards. But a failure to break below 0.7885 would be consistent with a rebound back towards 0.8100.

Key Upcoming Events

	Forecast	Median	Last
Monday 9 November			
Aus, Housing Finance, September	+4.0%	+3.0%	-0.6%
Germ, Industrial Production, September		+1.0%	+1.7%
Germ, Trade Balance, September		+€11.3b	+€8.1b
Tuesday 10 November			
NZ, Electronic Card Transactions, October			+0.4%
Aus, NAB Business Survey, October			
Jpn, Eco Watchers Survey (outlook),			44.5
UK, BRC Retail Sales Monitor, October y/y			+2.8%
UK, Trade Balance, September		-£2.2b	-£2.3b
UK, RICS Housing Survey, October		+28%	+22%
Germ, ZEW Sentiment, November		+55.0	+56.0
Wednesday 11 November			
NZ, Food Price Index, October	+0.4%		-0.7%
NZ, RBNZ Fin. Stabilty Report			
Aus, Consumer Sentiment - Wpac, October			121
Jpn, Machinery Orders, September		+4.1%	+0.5%
UK, Average Earnings, September 3m y/y		+1.4%	+1.6%
UK, Unemployment rate (ILO), September		8.0%	7.9%
UK, BOE Inflation Report			

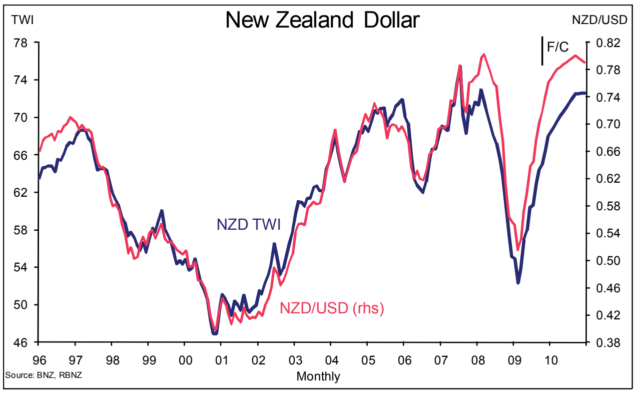
	Forecast	Median	Last
Wednesday 11 November *continued...*			
China, Trade Balance ($US), October		+$19.1b	+$12.9b
China, Industrial Production, October y/y		+15.5%	+13.9%
China, CPI, November y/y		-0.4%	-0.8%
China, Fixed Investment (Urban), Oct ytd y/y		+33.5%	+33.3%
China, Retail Sales, October y/y		+15.2%	+15.5%
Thursday 12 November			
NZ, BNZ PMI (Manufacturing), October s.a.			51.2
NZ, Retail Trade, Q3 vol s.a.	-0.6%	flat	+0.4%
NZ, Retail Trade, September	+0.4%	+0.3%	+1.2%
Aus, Employment, October	-10k	-10k	+41k
Aus, Unemployment Rate, October	5.8%	5.8%	5.7%
Euro, ECB Monthly Bulletin			
Euro, Industrial Production, September		+0.5%	+0.9%
US, Jobless Claims, week ended 7/11		510k	512k
Friday 13 November			
Euro, GDP, Q3 1st est		+0.5%	-0.2%
US, International Trade, September		-$31.8b	-$30.7b
US, Mich Cons Confidence, November 1st		71.0	70.6

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	6.50
1 mth	2.78	2.82	2.78	7.15
2 mth	2.78	2.84	2.78	6.74
3 mth	2.82	2.78	2.82	6.65
6 mth	2.94	2.94	2.90	6.33
GOVERNMENT STOCK				
11/11	4.33	4.30	4.15	5.72
04/13	5.10	5.08	4.93	5.86
04/15	5.51	5.47	5.29	6.01
12/17	5.77	5.70	5.54	6.04
05/21	6.07	6.00	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.94	3.95	3.89	-
BNZ 05/15	6.86	6.83	6.63	-
GEN 03/14	6.85	6.84	6.65	-
GEN 03/16	7.29	7.26	7.02	-
TRP 12/10	4.41	4.42	4.42	6.18
TRP 06/20	7.58	7.52	7.26	7.00
SWAP RATES				
2 years	4.53	4.50	4.38	6.34
3 years	5.11	5.07	4.95	6.40
5 years	5.70	5.63	5.45	6.44
10 years	6.26	6.15	5.91	6.50

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7333	0.7143	0.7327	0.5846
NZD/AUD	0.7952	0.7955	0.8106	0.8754
NZD/JPY	65.98	64.12	65.61	57.65
NZD/EUR	0.4925	0.4854	0.4978	0.4585
NZD/GBP	0.4400	0.4349	0.4627	0.3634
NZD/CAD	0.7873	0.7747	0.7644	0.7072
TWI	65.55	64.47	66.18	59.18

NZD Outlook



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