16 November 2009

PPI Data Affirm Melting Inflation Core

- Q3 PPI further evidence of waning inflation
- Housing inflation unsustainable
- Higher dairy payout unlikely to restore farm prices
- Thursday's household savings rate: improving?
- October's credit card billings to affirm subdued spending
- As BNZ PSI warns of slow recovery

This morning's economy-wide producer price data were not deflationary, as their headline results suggested – with output prices diving 1.4% in Q3 and inputs dipping 1.1%. However, they certainly affirmed falling inflation, as a general rule, and to scant, even negative, rates in some key respects.

The latest PPI news thus fits with the range of other indicators that we've seen as being inflation benign, and another reason to discount the supposedly "strong" Q3 CPI result that got the markets all excited about rate hikes.

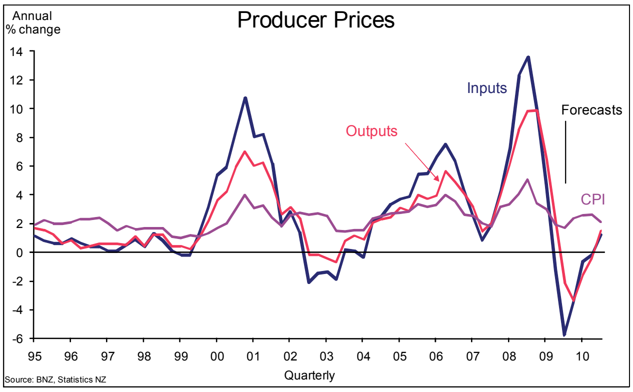
To be clear, there were some big downward distortions to the Q3 producer prices, courtesy of the dairy industry. This reflected the step-wise way in which Statistics NZ measures the dairy payout, with the September quarter being the one to fully reflect dairy payout relevant to the lead-in June-year farm production season.

And so the Q3 output PPI suffered the square-up to last season's lower diary payout to dairy farmers – of $5.20, from the booming $7.90 result "paid in full" in 2008 Q3. By the same token, today's input PPI was hit by a step-shift downwards in the payment dairy manufacturers (read: Fonterra) made to farmers for their raw milk-solids, according to Statistics NZ methods.

With this inherent jumpiness, it's no great surprise that our statistical office has today announced it intends to move away from this method of recording the dairy payout in the producer prices. From the December quarter onwards it will try to blend it in over the four quarters. This will go at least some way to minimising the inherent volatility in New Zealand's producer prices.

For the September quarter just gone, however, there has been a major distortion – in the order of 20 to 25% falls to the dairy price components concerned. Without these, the headline producer prices would probably have been closer to flat than the clear negatives they registered.

We also note that the rising exchange rate would have helped to suppress the Q3 producer price results. It's a



reminder that the trade-weighted exchange rate has strengthened by more than a quarter since early this year –point to point - with the Q3 TWI averaging about 7% more than it did in Q2.

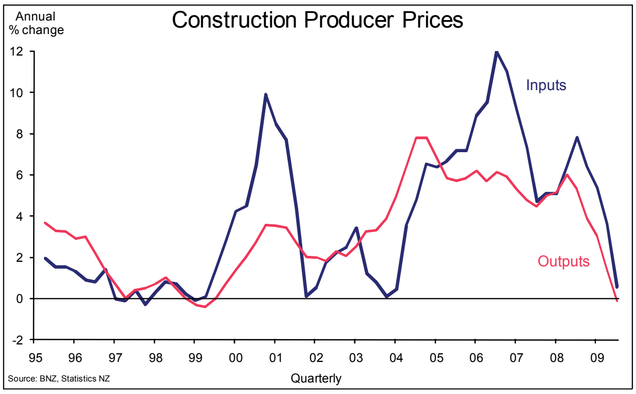
This is undoubtedly why the export-oriented categories of today's PPI report saw either subdued gains, or outright falls.

The log export market was a good example in this respect. While volumes have clearly been booming, mainly to China, prices in NZ dollar terms tailed off a bit further in the September quarter, according to the producer prices.

Still, exchange rate and dairy price influences aside, the PPI data gave a strong sense that inflation was being suppressed in a core sense too.

One of the key categories in this regard was construction. Here, inflation has died a death. Its output price slipped 0.2% for the second quarter running, to be down 0.1% on a year ago. It was only mid last year that it was storming at 6% y/y. Construction input prices weren't quite as weak, but expanded a bare 0.1% in Q3, to be 0.5% higher than the corresponding period in 2008 (as a sign the sector's margins remain under pressure).

And this morning's Capital Goods Price Index (CGPI) highlighted the weakest bits. While its price index for new residential buildings slipped 0.4% (-1.0% y/y) that for non-residential structures retreated 1.3%, to be down 3.4% on a year ago. And even though the "other" construction category of the CGPI – which includes infrastructure-type work – registered annual inflation of 4.0%, its quarterly advance, of 0.5%, was the slowest since mid-2007, and 2003 before that.



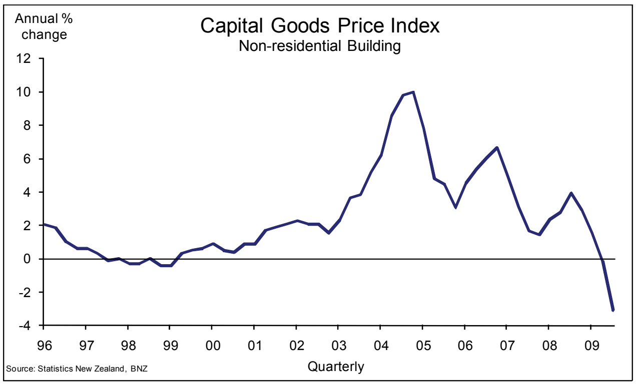
The other example of domestically-fading inflation that caught our eye was in business services. Even up until early this year it was ramping up its prices and fees, seemingly at will. But its PPI index has all of a sudden fallen by 0.7% and 0.5% over the last couple of quarters respectively.

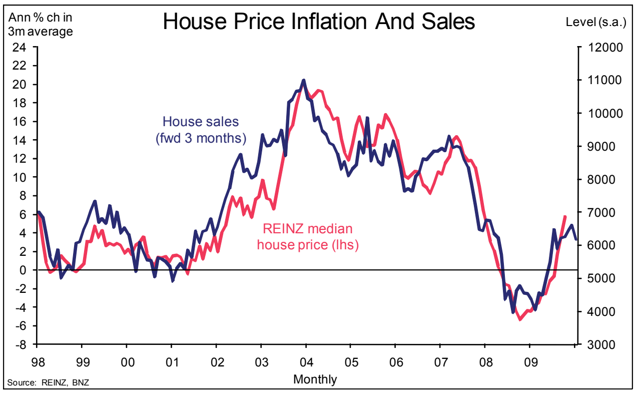
With so many signs of falling inflation, to low levels, what, then, of the housing market? While much has been made of the price pressure, we're not convinced it can last. We side with the RBNZ on this, in seeing starting valuations as already pushing the envelope, and with impending supply and eventual interest rate responses also something to bear in mind. Then there are the proposed tax changes for the sector.

As for last week's REINZ report for October, it confirmed the housing market is finding its feet but did nothing to suggest things are getting out of hand (also the message from the latest mortgage approvals, into mid-November, by the way).

The REINZ Stratified House Price Index rose 1.3% for the month to be up 5.0% for the year. (Unadjusted the movements were 1.4% and 6.0% respectively). Days to sell also showed a strengthening market, in dropping from 33 to 31.

However, turnover, while well up on year earlier levels (36.3%) fell around 6.0% for the month on a seasonally adjusted basis. This may have been weather related, as this October was one of the coldest in decades.





Nonetheless, the recent trend in sales suggests that house price inflation may be approaching a peak.

Specifically, with mortgage rates about as low as they are going to go and net migration inflows close to as high as they will probably go, there is growing doubt as to the sustainability of current house price pressures.

Nonetheless, there is substantial evidence that there is a shortage of new supply in central city areas and we will be watching closely for a construction sector response to keep pricing in check.

As for the rural property market, October's prices, published over the weekend, gave little away in respect of a response to the higher payout Fonterra announced just a couple of weeks ago. In obvious ways, this is because of lags. Even so, it's clear from still-subdued rural sales and farm prices in October that it will take a lot to reverse the big drops in farm prices we've seen, across the board, over the past twelve months.

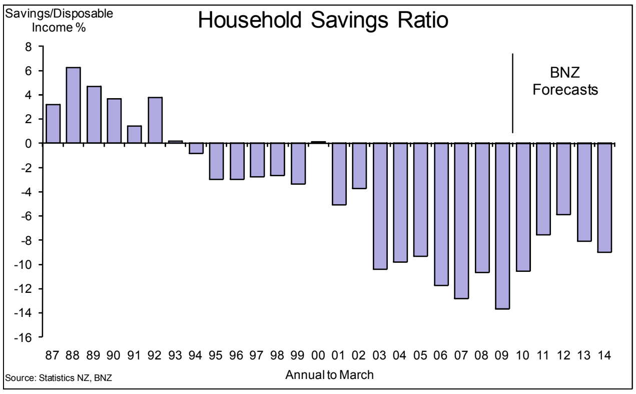
Importantly, this drop has probably reflected a wholesale reassessment of the underlying valuations of farming enterprises, in relation to net income, as it has just the recent lows in the dairy payout.

The real test of how everything is settling will be how the coming months of rural sales and prices look.

Local news for the remainder of the week is not expected to be earth shattering.

Thursday morning's GDP accounts are the very historical (year to March 2009) version. The only news in these National Accounts will thus be strictly for the analysts, not the markets.

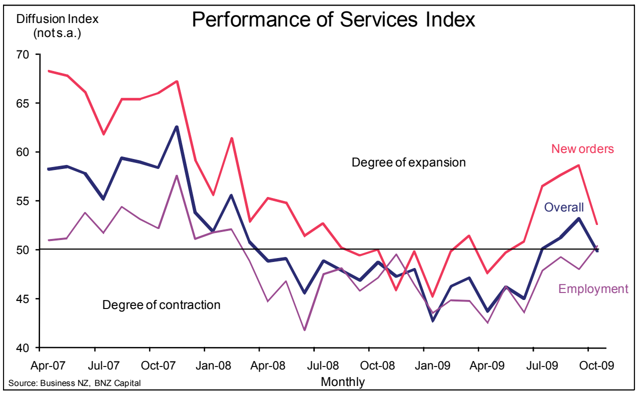
If anything does make it to the wires from these accounts it will be the latest personal savings rate, as will be printed in the annexed Household Income and Outlay Account. Yes, we know this is not perfect as a measure of household savings. But there are dangers in throwing this baby out when its bathwater warns that, whatever the best measure of household savings, there's little denying



it has weakened to unsustainably low levels since about the year 2003.

Thursday afternoon we get the Q3 NBNZ Regional Trends survey. It will provide its usual very vague clues on GDP. So we would be surprised to see it either very strong or very weak, given we're looking for a 0.2% increase in Q3 GDP.

The local data week draws to a conclusion with Friday afternoon's credit card billings, for October, as published by the RBNZ. For these, only a huge rebound from their September weakness would question our expectation of a scant increase in October's retail sales, based on the flattish electronic card transactions we've already seen for the month.



And we say this re-iterating that our Performance of Services Index (PSI), published earlier today, lost momentum in October (especially when one considers this unadjusted index should probably be getting a seasonal boost about now, as we head into the usual festive-season pick-up). In this sense, the PSI mirrored the slower tones in last week's seasonally adjusted Performance of Manufacturing Index.

To be sure, we still believe the trends are positive, such that expansion will become apparent in the December quarter. However, there are also warnings in this of not presuming too strong a recovery, too soon.

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Domestic Interest Rates

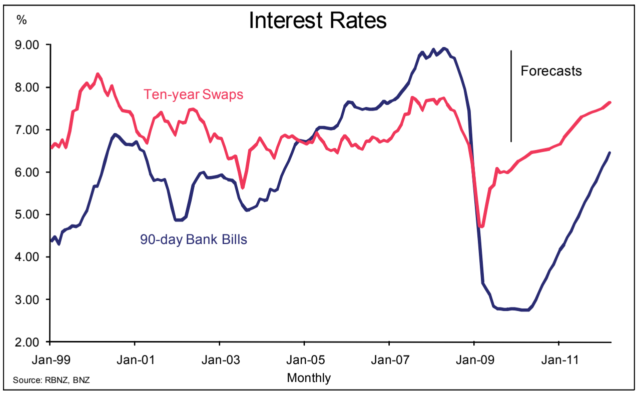
Reuters pgs BNZL BNZM

NZD interest rates saw a generally quiet week with relatively little movement. The front of the curve has been broadly unchanged with the bank bill margin in New Zealand still holding around the same level, despite the blowout in the equivalent spread in Australia. While the futures curve has rallied slightly in the past week, the general theme is largely unchanged, the first hike is priced for March next year with aggressive hikes priced from around the middle of 2010.

The government bond market has seen reasonable two way flow with the front bonds well bid on the spread to swap, but supply continues to weigh on the market and the back end underperformed relative to swap yields or offshore moves. We feel these themes are likely to continue in the coming week, with the short end tracking fairly closely to the swap market and the back end following offshore moves.

The swaps market saw flattening pressure and a sell off earlier last week before recovering ground as the week continued. Receivers were seen in 2-yr swap around 4.65% and we feel payers are lurking towards 4.40%. With data flow relatively light on the week it's likely we'll play within this range in the near future. While the curve has flattened over the past week, we still believe that fundamentals support the steepener and the carry on this position remains highly attractive.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
6-Nov-09	2.80%	4.29%	5.75%	4.50%	6.23%	173
13-Nov-09	2.81%	4.34%	5.78%	4.54%	6.17%	173
Change (bps)	**1**	**5**	**3**	**4**	**-6**	**0**



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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 the next key level at 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 to hold, near term, but with an eventual break of +98 targeted and trend support at +61.

Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD/USD spent most of last week in a 0.7300-0.7450 range.

The NZD started the week on a firm footing following Fonterra's upward revision to its 2009/10 dairy payout (from NZ$5.10/kg to NZ$6.05/kg). This announcement tended to overshadow generally mixed reports on the NZ retail sector later in the week, and set the scene for a stronger NZD.

The NZD also found support from the global backdrop. US stocks rose 2.3% over the week, which encouraged investors' risk appetite and buoyed demand for 'growth-sensitive' currencies like the NZD. News the Eurozone economy formally exited recession in September helped allay fears about the outlook for the global economy, further supporting investors' appetite for risk. At the same time, the Fed's commitment to keep rates low for an "extended period" and the IMF's comment that the USD is still "on the strong side", helped maintain downward pressure on the USD. As a result, the NZD/USD pressed nearly 2.5% higher over the week. But gains were not only relative to the weakening USD. On a trade-weighed basis, the NZD increased 2%.

Looking ahead, this week is relatively light on the data front, with only second tier data due for release. As such, direction will be largely dictated by fluctuations in risk appetite and sentiment in offshore equity markets. With risk appetite still on a generally improving trend and the Fed likely to remain on hold for "an extended period", the USD will likely remain heavy in the short-term. And with local fundamentals still supportive, we suspect further modest gains in the NZD/USD may be in store.

Our short-term valuation model suggests a 'fair value' range in the NZD/USD of 0.7350-0.7550. Fair value has been driven higher by a combination of factors in recent weeks; recovering risk appetite, higher NZ commodity prices and widening NZ-US interest rate spreads. Our risk appetite index (which has a scale of 0-100%) is now back above the long-term average of 50%, having dipped below 40% a fortnight ago. Meanwhile, Fonterra's payout revision and accelerating Asian growth are indicative of a generally positive outlook for NZ's commodity export prices.

All up, these factors suggest dips below 0.7300 in NZD/USD are unlikely to be sustained, in the absence of a fresh wave of negative global news. We look for a push back towards 0.7500-0.7550 in coming weeks.

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Foreign Exchange Technicals

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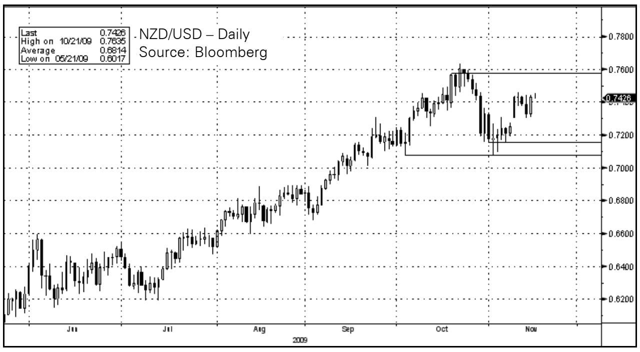
NZD/USD

Outlook:	Consolidation
ST Resistance:	0.7460 (ahead of 0.7570)
ST Support:	0.7155 (ahead of 0.7100)

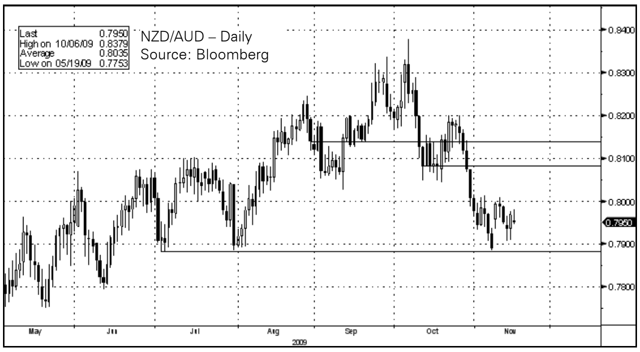
Momentum indicators have turned neutral but are not yet positive. Solid support is expected to emerge on dips towards 0.7155.



NZD/AUD

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

The failure to break convincingly below 0.7885 suggests downward momentum has stalled. As a result, a rebound back towards 0.8100 is now on the cards. Dips below 0.7900 should be viewed as buying opportunities.



Key Upcoming Events

	Forecast	Median	Last
Monday 16 November			
NZ, Capital Goods Price Index, Q3 y/y			+4.1%
NZ, PPI Outputs, Q3 y/y	-0.9%	-0.4%	+2.3%
NZ, PPI Inputs, Q3 y/y	-4.5%	-4.6%	-1.2%
NZ, BNZ PSI (Services), October			53.2
Jpn, GDP, Q3 1st est		+0.7%	+0.6%
Euro, CPI, Oct y/y 2nd est		-0.1%	-0.1%P
US, Business Inventories, September		-0.7%	-1.5%
US, Empire Manufacturing, November		+30.0	+34.6
US, Retail Sales, October		+0.9%	-1.5%
Tuesday 17 November			
Aus, RBA Minutes, 3 Nov Meeting			
Jpn, Tertiary Industry Index, September		+0.1%	+0.3%
UK, CPI, October y/y			+1.1%
US, PPI ex-food/energy, October y/y		+1.4%	+1.8%
US, NAHB Housing Index, November		19	18
US, Industrial Production, October		+0.4%	+0.7%
Euro, Trade Balance, September (s.a.)			+€1.0b

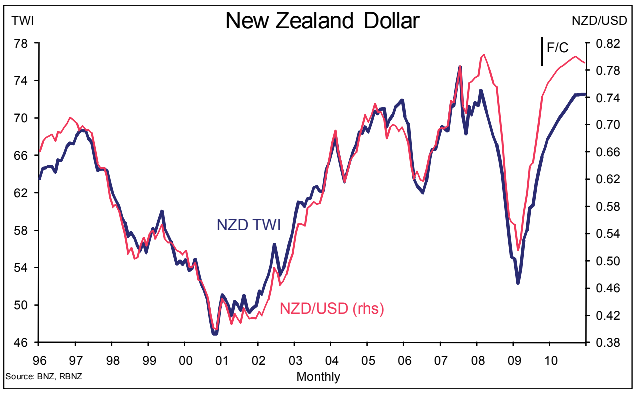
	Forecast	Median	Last
Wednesday 18 November			
Aus, RBA's Debelle Speaks, Securitisation			
Aus, Labour Price Index, Q3	+0.7%	+0.7%	+0.8%
Aus, Westpac Leading Index, September			+1.1%
UK, BOE Minutes, 4/5 Nov Meeting			
UK, CBI Industrial Trends, November			-51
US, CPI ex food/energy, October		+1.6%	+1.5%
US, Housing Starts, October		600k	590k
Thursday 19 November			
NZ, National Accounts, Year-end March 2009			
NZ, NBNZ Regional Trends, Q3			+0.4%
UK, Retail Sales vol., October			flat
US, Leading Indicator, October		+0.4%	+1.0%
US, Jobless Claims, week ended 14/11		505k	502k
US, Philly Fed Index, November		+12.0	+11.5
Friday 20 November			
NZ, Credit Card Billings, October			-1.0%
Jpn, BOJ Policy Announcement		0.1%	0.1%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	6.50
1 mth	2.80	2.78	2.80	6.76
2 mth	2.79	2.78	2.78	6.43
3 mth	2.78	2.82	2.82	6.14
6 mth	2.90	2.94	2.99	5.85
GOVERNMENT STOCK				
11/11	4.34	4.33	4.38	5.44
04/13	5.08	5.10	5.16	5.66
04/15	5.52	5.51	5.52	5.85
12/17	5.78	5.77	5.74	5.90
05/21	6.08	6.07	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.90	3.94	4.13	-
BNZ 05/15	6.82	6.86	6.77	-
GEN 03/14	6.83	6.85	6.87	-
GEN 03/16	7.24	7.29	7.20	-
TRP 12/10	4.39	4.41	4.72	5.84
TRP 06/20	7.50	7.58	7.37	6.81
SWAP RATES				
2 years	4.54	4.53	4.66	5.60
3 years	5.10	5.11	5.19	5.79
5 years	5.66	5.70	5.63	6.00
10 years	6.17	6.26	6.02	6.24

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7430	0.7333	0.7385	0.5513
NZD/AUD	0.7955	0.7952	0.8075	0.8525
NZD/JPY	66.60	65.98	67.17	52.95
NZD/EUR	0.4975	0.4925	0.4958	0.4390
NZD/GBP	0.4444	0.4400	0.4525	0.3760
NZD/CAD	0.7828	0.7873	0.7673	0.6823
TWI	66.15	65.55	66.32	56.53

NZD Outlook



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