

7 December 2009

Looking Forward to Higher Interest Rates?

- Further recovery will bring stimulus removal
- RBNZ simply to flesh out recent messages
- MPS to mostly question market's April start-point to hiking
- This week's Q3 GDP indicators likely mixed-to-stable
- Q4 potential better, but will November's ECT data play ball?

The more obvious an economic recovery looks, the closer the removal of policy stimulus becomes. This equation went a long way to explaining the more significant reaction in the US bond market, than in equities, to the not-so-bad news on the US labour market over the weekend.

It's a reminder that the international economic news over the last twelve months or so, as favourable as it's been, and further it might go yet, has been fuelled by monumental policy stimulus, rather than its own steam.

The trouble, of course, is that the stimulus can't last. It's far too expensive, for one thing. By far the most costly the planet has ever seen, in fact. We need only look at the sky-rocketing path of public debt to get a sense of this. And policy stimulus can create as many new addicts as it is trying to help get through, especially when it is so generous and widespread.

To carry on with the analogy, only when the policy drugs are being withdrawn from the system will we get a clear idea of the underlying health of the patient (the global economy). We're not there yet. But the bettering economic news would seem to be bringing the days of reckoning into sharper focus.

For the sake of truth, we're tempted to say, bring it on (including a reinstatement of mark-to-market "asset" valuation, while we're at it, now that prices can no longer be described as distressed).

As this happens, however, the patient might well confess to being not that healthy, after all, especially knowing the size of the bill it will get upon check out, for the treatment it has received.

This global analogy, of course, extends to New Zealand. Except here the patient was never quite as bad as to be admitted to intensive care, and relied on much less, and much less expensive, medication to see it through.

In this context, Thursday's Monetary Policy Statement (MPS) seems bound to keep signalling the RBNZ has time

up its sleeve before any reversal of policy stimulus becomes imperative.

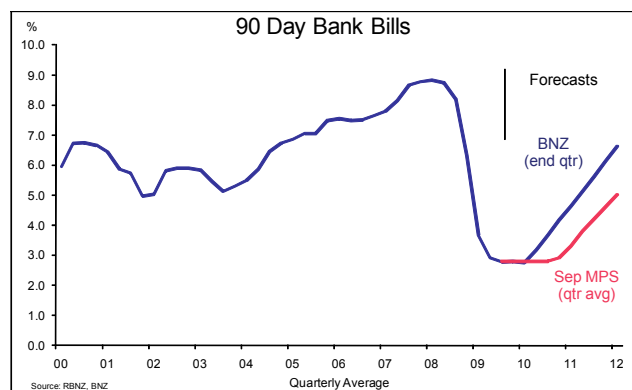
To be sure, the ongoing rebound in dairy prices and recovery in house prices will have caught the Bank's attention, as a reminder of the dangers in keeping policy too loose for too long. However, by and large, the news has been of a GDP pick-up no stronger than the RBNZ already anticipated. And so the task of Thursday's MPS is simply to elaborate on October's steady-as-she-goes commentary, while avoiding any bold statements that might be misconstrued by the markets.

This very much includes the view on the Official Cash Rate. The Bank has done a great job in leaning against over-excited market expectations over the last many months. We believe it will continue to do so on Thursday, as it should.

In being an MPS, it will, of course, make explicit the Bank's forecast for 90-day bank bill yields. We believe this will imply a first OCR hike around Q3 of next year. While closer than the very end-2010 mark the Bank indicated in its September MPS, it is still well beyond the April start-point the market fully expects.

Issues of timing extend to later down the track, although these seem much less stark now, given the big rally in NZ debt markets since the 29 October OCR review. Following this, the markets are now pricing an OCR of around 4.25 to 4.50% for end-2010, and something closer to 5.00% by mid-2011.

This view does not look to be under great threat. After all, the September MPS implied an OCR of just above 4.00% toward the end of next year, and closer to 5.00% by mid the following one, and we know the economic information



over the last three months has been just a bit stronger than the Bank anticipated.

Still, it will be interesting to note the Reserve Bank's medium-term forecasts for 90-day bank bill yields in Thursday's MPS.

All the while, we'll just keep monitoring the marginal information to see if it's faster, or slower, than the RBNZ would seem to presume. In this respect, this week sees a clutch of Q3 economic indicators that may prove important for our final GDP estimate.

This morning's nominal wholesale trade figures, in slipping just 0.8% in seasonally adjusted terms, appeared to fit with our expectation of stabilising activity in this sector in Q3, following sizable contraction through the length of the recession.

We expect similar conclusions from tomorrow morning's manufacturing survey for the September quarter. It, like the wholesale trade survey, can be difficult to translate into the GDP accounts – as they both record sales and stocks, rather than production per se. However, we've certainly been getting hints of stability in the monthly Performance of Manufacturing Index of late (with November's edition due Thursday). And agricultural processing should be providing as much stability as international demand is now exhibiting.

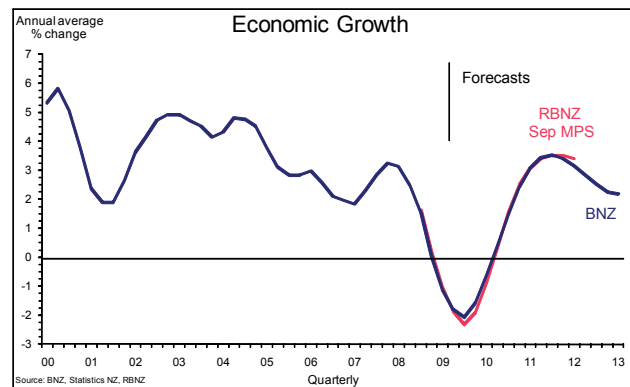
On the other hand, local construction still looked to be struggling in Q3. We expect Tuesday morning's Building Work Put in Place figures to affirm this. Formally, we're looking for a 3% real fall. But we wouldn't be surprised to see a bigger decline, mainly as residential construction registers a larger lagged hit to the earlier housing correction while non-residential work struggles to hold recent levels.

Of course, housing construction looks set to pick up from this point, and strongly so if building consents are any guide. However, consents also portend a weakening in non-residential construction over the coming period. How this nets out for the building sector will be interesting to see.

The other GDP indicator of the week, albeit a looser one, is Thursday's Overseas Trade Indexes. While there is bound to be some good news in these, they won't be without their weak spots.

On the positive side, the terms of trade are likely to recover part of Q2's hit, albeit mainly on the back of recovering dairy prices. We're looking for a 3.0% bounce, compared to 0.5%, the market's median expectation.

On the volume side, we should see a modest fall in export volumes, seasonally adjusted, mainly as the one-off factors that boosted Q2 wash out.



On the imports side, we'll simply scour the OTI results for clues on domestic demand and the (recently volatile) inventory cycle, which may yet prove important to Q3 GDP calculations.

By the end of the week, we'll have a better steer on Q3 GDP. Our final calculation, however, will have to wait for the quarterly energy production statistics, which tend to be released later in the piece these days, now that the Ministry of Economic Development has assumed responsibility for publishing them. Our current estimate for Q3 GDP is still for a gain of 0.2%.

As for how Q4 is shaping up, we already have some positive backgrounders in the form of much improved business and consumer expectations. But, as for the specifics, we're still lacking.

That's where Wednesday's electronic card transactions, for November, could be important. A solid increase will probably be enough to shake its recent trend of torpor. However, any fall in November's ECT data would set a sour tone going into the all-important festive season. And we say this having heard more in the way of downbeat, rather than upbeat, anecdote of late.

The other couple of local economic reports worth mentioning are Wednesday morning's Manpower survey, which will probably fit with the many other signs of a stabilising employment outlook, and Friday's Food Price Index, for which we expect a 0.8% bounce from October's second successive monthly drop of large proportion.

The big question, of course, is the extent to which the economy is recovering from recession. In New Zealand's case, we'd say gradually, as for the international economy, overall. So policy officials should not feel rushed. Should the bounce-back be stronger than anticipated, this will simply bring forward the withdrawal of the policy super-stimulus upon which much of the recovery to date has depended on. It's what we have to look forward to, as the patient's true health is put to the test.

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Domestic Interest Rates

NZD interest rates were relatively quiet over the past week as the market generally consolidated prior to a likely busy week ahead. The biggest move over the week followed the RBA's decision to hike by 25 basis points, despite this being in line with expectations. The Australian rates market initially rallied on the decision but followed that up with a significant sell off. NZD swap rates outperformed on that sell off leaving the curve roughly in the same place as it started, albeit slightly flatter.

The bond market largely followed the swap market and, similarly, outperformed Australia, as our market largely held its ground.

From here, the immediate pressure on rates is largely upward as the domestic market digests the implications of the stronger-than-expected US non-farm payrolls data. Once this is past, direction will be dominated by the revelations of Thursday's MPS. We feel that the

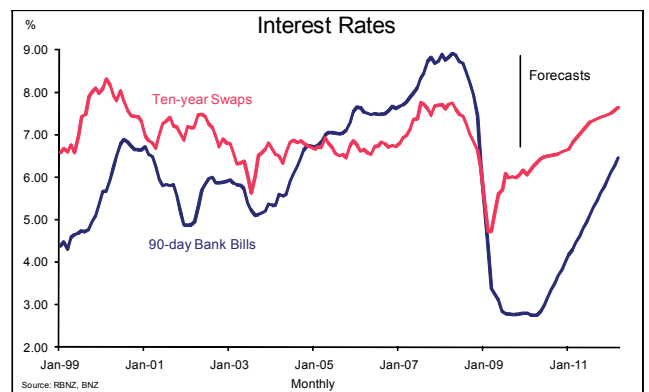
	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
27-Nov-09	2.81%	4.02%	5.60%	4.30%	5.98%	168
4-Dec-09	2.78%	4.05%	5.65%	4.33%	6.00%	167
Change (bps)	-3	3	5	3	2	-1

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RBNZ will hold its relatively dovish line, but the market will likely be expecting this so any ensuing rally may be relatively contained.

Currently, the futures curve continues to price roughly a 50% chance of a hike at the time of the March MPS followed by significant hikes through the second half of 2010. We remain of the view that such pricing is a little aggressive.

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Interest Rate Technicals

NZD 5yr Swap Rate

Outlook: Consolidation
 LT Resistance: 5.95%
 LT Support: 5.14%

The close below 5.50% was significant. Expect us to move lower towards the next support at 5.14%.

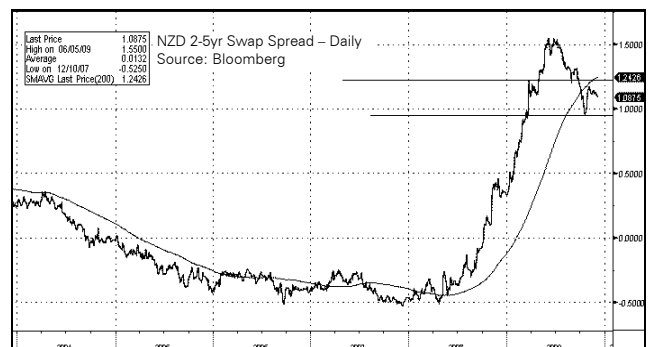


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NZ 2yr-5yr Swap Spread (yield curve)

Outlook: Flattening
 MT Resistance: +122
 MT Support: +95

The +122 level continues to hold. We expect the +122/+98 range to be sustained, near term, but with an eventual break of +98 targeted. Trend support comes in at +61.



Foreign Exchange Market

The NZD/USD spent most of last week trading choppy within a 0.7100-0.7300 range.

Global financial markets managed to shrug off the Dubai debt default worries and both equity markets and risk appetite recovered. The more stable global backdrop, combined with positive gains in NZ commodity prices, saw NZD/USD flirt with the 0.7300 level. However, this didn't last. A surprisingly strong US employment report (non-farm payrolls fell just 11,000 in November, well below the 125,000 drop forecast) triggered a sharp rise in US interest rates as investors brought forward the timing of anticipated Fed rate hikes. The hawkish shift in Fed expectations sparked a sharp rebound in the USD and NZD/USD finished the week closer to 0.7150.

The moves seen in currencies last week suggest the correlation between the USD and risk appetite may be fading: USD/JPY gained some 4% after the Bank of Japan expanded its quantitative easing program (and Japanese interest rates fell) in its emergency special meeting; EUR/USD struggled to make further headway after ECB President Trichet hosed down near-term tightening expectations by describing Eurozone rates as "appropriate"; and Friday's stronger-than-expected US non-farm payrolls and hawkish shift in Fed expectations, supported the USD. We suspect that relative growth prospects and diverging economic fundamentals will have a greater role to play in driving currencies in 2010. This means we may actually start to see the USD benefit

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from upside surprises in US data rather than falling due to rising risk appetite.

Locally, the key focus is Thursday's RBNZ decision. With things progressing broadly in line with its expectations, we suspect the RBNZ will remain comfortable reiterating that the OCR will remain at 2.50% until the second half of next year. Specifically, we look for the 90-day track to imply a probable first hike in Q3. A "steady she goes" attitude from the RBNZ will starkly contrast market participants' expectations for Fed policy (market pricing is now consistent with a Fed Funds rate close to 1.00% by the end of 2010). NZ-US 3-year swap spreads narrowed 27bps to 3.14% last week and further compression is likely to undermine the NZD/USD.

The implied 'fair value' range for NZD/USD (according to our short-term valuation model) has fallen from 0.7300-0.7500 to 0.7150-0.7350 over the past week, as the sharp narrowing in NZ-US 3-year swap spreads has more than offset the positive effect of rising NZ commodity prices and improving risk appetite.

For the week ahead, we suspect we're in for more NZD/USD range trading. A generally firmer USD and the RBNZ's "steady as she goes" approach to the cash rate will likely see NZD/USD struggle towards 0.7300. However, underlying optimism about the global recovery and still-firm NZ commodity prices should encourage demand on dips below 0.7100.

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Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
 ST Resistance: 0.7290 (ahead of 0.7335)
 ST Support: 0.7080 (ahead of 0.7010)

The dip below 0.7080 saw momentum indicators turn negative, but the failure to sustain dips below 0.7100 suggests the downtrend is stalling. Fade strength on bounces towards 0.7300.

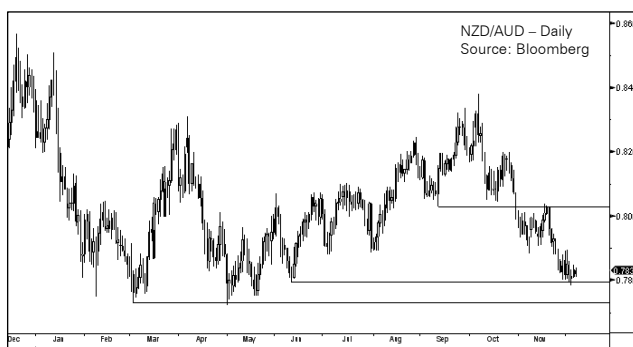


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NZD/AUD

Outlook: Consolidation
 ST Resistance: 0.8030 (ahead of 0.8080)
 ST Support: 0.7800 (ahead of 0.7730)

The move below 0.7885 saw momentum indicators turn negative but the failure to break below 0.7800 suggests the downtrend has stalled, at least for now. Another failure to break this level would pave the way for a move back towards 0.8030.



Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 7 December				Thursday 10 December			
US, Bernanke Speaks, Economic Club of NY				NZ, Monetary Policy Statement	2.50%	2.50%	2.50%
Germ, Factory Orders, October		+0.8%	+0.9%	NZ, BNZ PMI (Manufacturing), Nov			50.6
Tuesday 8 December				NZ, Terms of Trade, Q3	+3.0%	+0.5%	-9.0%
NZ, Manufacturing Sales, Q3 vol s.a.			+1.8%	Aus, Employment, November	flat	+5k	+24k
NZ, Bldg Work Put In Place, Q3 vol s.a.	-3.0%		-4.5%	Aus, RBA's Debelle Speaks			
Aus, NAB Business Survey, November				Jpn, Machinery Orders, October		-4.5%	+10.5%
Aus, Stevens Speaks, ABE Dinner Address				UK, BOE Policy Announcement	0.50%	0.50%	0.50%
Aus, Current Account, Q3	-\$15.4b	-\$16.8b	-\$13.35b	Euro, ECB Monthly Bulletin			
Jpn, Eco Watchers Survey (outlook),			42.8	US, International Trade, October		-\$37.0b	-\$36.5b
UK, Industrial Production, October		+0.5%	+1.6%	Friday 11 December			
Germ, Industrial Production, October		+1.0%	+2.7%	UK, PPI (core output), November y/y		+2.1%	+2.0%
Wednesday 9 December				US, Mich Cons Confidence, December 1st est		69.0	67.4
NZ, Electronic Card Transactions, November			+0.2%	US, Retail Sales, November		+0.7%	+1.4%
NZ, Manpower Survey, Q1			+1	US, Business Inventories, October		-0.2%	-0.4%
Aus, Consumer Sentiment - Wpac, December			118	China, CPI, November y/y		+0.5%	-0.5%
Aus, Housing Finance, October	-3.0%	-2.0%	+5.1%	China, Fixed Investment (Urban), Nov ytd y/y		+33.0%	+33.1%
Aus, International Trade, October	-\$1.70b	-\$1.70b	-\$1.85b	China, Retail Sales, November y/y		+16.5%	+16.2%
Jpn, GDP, Q3 2nd est		+0.7%	+1.2%P	China, Trade Balance (\$US), November		+\$24.0b	+\$24.0b
UK, Trade Balance, October		-£3.2b	-£3.5b	China, Industrial Production, November y/y		+18.0%	+16.1%
Germ, Trade Balance, October s.a.		+€10.5b	+€9.9b				

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	5.00	NZD/USD	0.7150	0.7167	0.7333	0.5332
1 mth	2.77	2.77	2.78	5.48	NZD/AUD	0.7818	0.7814	0.7952	0.8251
2 mth	2.77	2.77	2.78	5.45	NZD/JPY	64.59	62.29	65.98	49.47
3 mth	2.77	2.80	2.82	5.36	NZD/EUR	0.4811	0.4768	0.4925	0.4190
6 mth	2.93	2.91	2.94	5.10	NZD/GBP	0.4351	0.4326	0.4400	0.3614
GOVERNMENT STOCK					NZD/CAD	0.7547	0.7578	0.7873	0.6754
11/11	4.11	4.03	4.33	4.50	TWI	64.18	63.68	65.55	54.07
04/13	4.83	4.74	5.10	4.55	NZD Outlook				
04/15	5.37	5.28	5.51	4.70					
12/17	5.71	5.61	5.77	4.80	<p>Source: BNZ, RBNZ</p>				
05/21	6.00	5.90	6.53	-					
CORPORATE BONDS									
BNZ 09/10	3.79	3.80	3.94	-					
BNZ 05/15	6.60	6.63	6.86	-					
GEN 03/14	6.58	7.25	6.85	-					
GEN 03/16	7.02	7.65	7.29	-					
TRP 12/10	4.22	4.24	4.41	5.64					
TRP 06/20	7.31	7.33	7.58	6.15					
SWAP RATES									
2 years	4.38	4.31	4.53	4.78					
3 years	4.95	4.88	5.11	4.95					
5 years	5.49	5.44	5.70	5.10					
10 years	6.04	5.99	6.26	5.34					

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