18 January 2010

(Mis)Reading Inflation Concerns

- Q4 CPI expected higher than RBNZ estimated
- Headline CPI upside could accumulate into 2010
- But core inflation pressures look modest
- As housing recovery starts to look shaky
- Retail sales, PMI, consumer confidence expected positive

With New Zealand's gradual GDP recovery broadly on track, some attention has turned to the inflation angle of the Reserve Bank's job. The Bank itself raised a couple of small flags on the subject, at its December Monetary Policy Statement (MPS).

So the potential for Wednesday's Q4 CPI result to (over)excite the market looms large. Even though the polls are looking for a flat result for the quarter (for 2.1% y/y), the context is that the RBNZ has estimated a fall of 0.2%. We're looking for a 0.1% rise in the Q4 CPI.

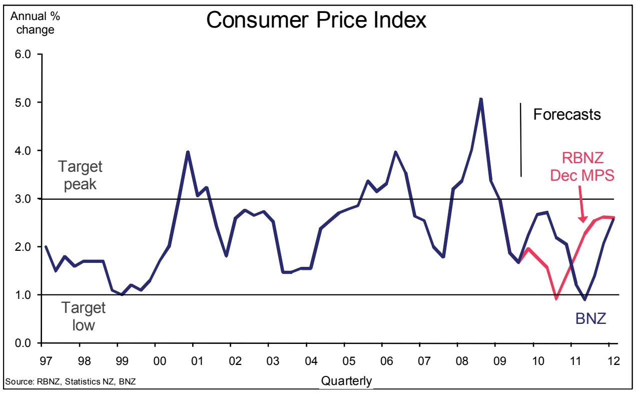
What's more, it looks as though the RBNZ could be even lighter on it expectations for inflation going into the start of 2010, in thinking the annual CPI pace will be just 1.8% in Q1. We figure on something around 2.7%. That's a big gap.

It's also worth remembering the last MPS did not build in any upward CPI impacts over the next couple of years from the impending Emissions Trading Scheme.

Then there are the recent jumps in commodity prices to bear in mind. These also threaten to make the headline CPI a headache for the RBNZ, especially with the potential for an exchange rate correction lingering in the background.

Of course, central banks these days are charged with preventing any inflation from taking root, even if it's principally a psychological phenomenon (which is essentially what the US Federal Reserve officials have been on about over recent weeks; managing expectations).

Yet we struggle to believe the NZ economy has any fundamental inflation problem. Who would be confident of hiking prices on the presumption of excess domestic demand, for example? And who would be sure in securing a plump salary or wage increase this year, with the labour market still relatively slack (albeit not getting any worse now, or so it would seem).



Meanwhile, many of the drivers of headline CPI remind us of the false inflation the Bank was right not to react to during 2008 (indeed, it was cutting its cash rate while headline inflation was high).

Rising petrol prices are a good example. This is part of what's inflaming the near-term NZ CPI. But it's basically a force of disinflation locally, in that it crimps purchasing power.

On commodity prices, we simply note many of them look very strong relative to global growth, just as they did over 2007/08. In this respect, it was interesting to note that the NZ exporters currently seeing price jumps have themselves expressed caution about the sustainability of it all. And that's not to forget the many exports who aren't experiencing world price rebounds, but a strong exchange rate nonetheless. Meat producers are but one example.

These are all reasons to be careful of over-reacting to any upside surprises to headline CPI inflation, when the drivers and details promise to be the most important thing to note and understand. This pertains to Wednesday's CPI data as much as any.

In this spirit, the housing market is also instructive in the inflation debate. While home prices, in trending higher again, have been catching the Reserve Bank's attention, we remain unconvinced it will be sustained. We just don't have the once-in-a-lifetime confluence of macro-economic drivers we had over the bubbly period of 2003-2007. Not even close. Starting-point issues of over-valuation, alone, leave us nervous.

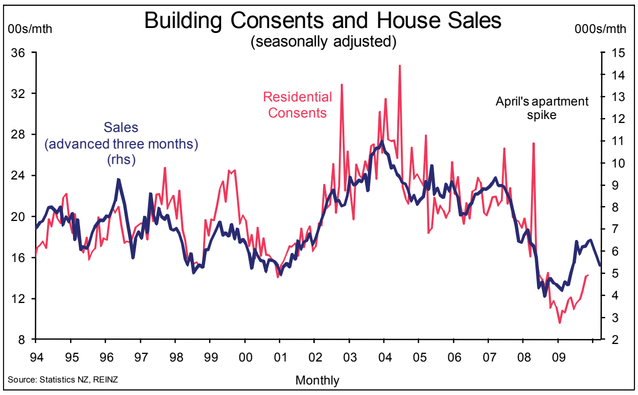
So the negative undertones in the nation's latest housing data, published this morning, were very interesting to behold. Sure, the median house price looked strong, up another $5k, to $360,000. But – as was the case in the Auckland-based Barfoot and Thompson data – the sale price figure was flattered by a shift to higher-end properties. To account for such things, it's better to look at the Stratified Index of the raw REINZ data, as constructed nowadays by the RBNZ. This index fell 0.9% in December.

The real warning of a stalling recovery, however, came from December's home sales. Granted, their 18% fall in the month reflected the usual seasonal dip just ahead of the festive season. However, even seasonally adjusted sales dropped a noticeable 7%, on our estimates. That makes it the third fall in as many months, to trim home sales about 20% from their September 2009 peak.

This is important stuff. It warns not just that home prices look vulnerable, but also that the home-building rebound might fail to push on much further than recent building consents have portrayed.

For the remainder of the week's economic data, following Wednesday's CPI report there is a congregation for Thursday.

The most anticipated of those will be November's retail trade. The market is looking for an increase of 0.5%, overall, and 0.2% on an ex-auto basis. We are pretty close to these medians, with 0.4% and 0.1% respectively. Whatever the actual results are – whether a positive or negative surprise – it's worth noting that electronic card

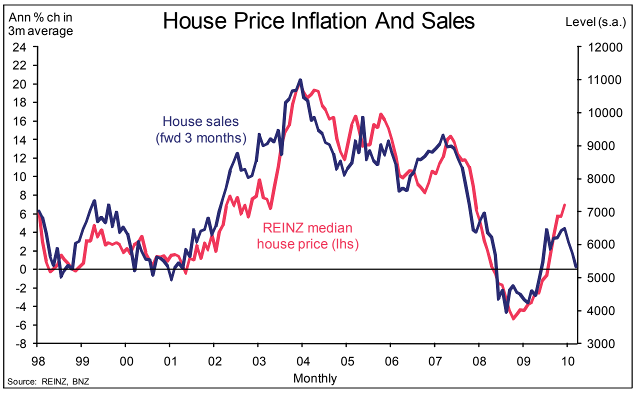


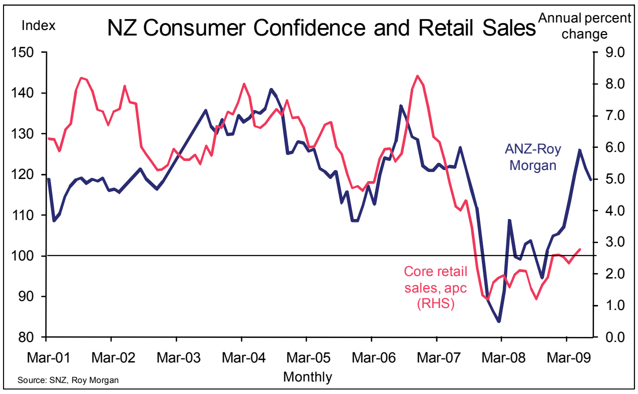
transactions maintained a gentle recovery in the month of December. That's the way we'll keep playing it, until we see any good reason to shift up, or down, any gears.

Thursday morning also sees December's Performance of Manufacturing Index. This will be compared to its reasonable 51.8 result of November, seasonally adjusted.

Thursday then serves up, in the afternoon, the latest Roy Morgan consumer confidence poll result – now sponsored and published by ANZ Bank. While this index has recovered to a robust level since the first half of 2009, it had dribbled off a bit in November and December, to 118.6. It will be interesting to see which way it went in January, let alone by how much.

craig_ebert@bnz.co.nz





Domestic Interest Rates

Reuters pgs BNZL BNZM

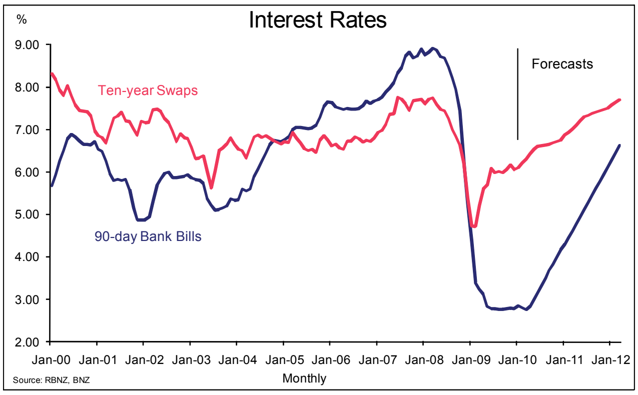
NZD interest rates continued their generally very quiet start to the year in the past week, with the only significant move a rally to the back end of the curve. The 3-mth bank bills continue to trade a very tight range and have not sold off yet, despite the 3m OIS contract starting to up the odds of a hike at the March meeting. The futures strip remains broadly unchanged, pricing around a 50% chance of a hike in March, then hikes through the middle of the year which total more than 25 basis points per meeting.

The bond market meanwhile, followed offshore moves and flattened significantly. Both the US and Australian markets saw good bids to their longer dated bonds and this flowed through to the NZ market. The bond tender was well received, albeit with only shorter dates on offer, with the 2015 maturities seeing the most interest. The market this week will continue to take its lead from offshore, with Wednesday's NZ CPI release the most important data to watch.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
8-Jan-10	2.78%	4.22%	5.78%	4.57%	6.08%	151
15-Jan-10	2.78%	4.21%	5.71%	4.57%	5.98%	141
Change (bps)	**0**	**-1**	**-7**	**0**	**-10**	**-10**

The swaps market also remains very quiet with 2-yr trading in the 4.50's throughout the week. There was some receiving interest on the back of Uridashi flow to the mid-curve, however, which combined with a bid to long-end bonds caused a flattening of the curve. It will likely take a significant surprise in the CPI or a major offshore move for the front end to break these ranges in the coming week.

nick_webb@bnz.co.nz



Interest Rate Technicals

pete_mason@bnz.co.nz

NZD 5yr Swap Rate

Outlook: Neutral
LT Resistance: 5.90%
LT Support: 5.09%

Yields have fallen to initial support at 5.40%. If this level is broken, then we may head towards the LT support at 5.09%. Overall, the market is range trading and does not look like breaking out in the near term.

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

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

The curve flattened during the past week and the previous target of +61 still looks likely to be achieved.

Foreign Exchange Market

Reuters pg BNZWFWDS

It was hard to get overly excited about currencies last week. NZD/USD spent all of last week within a relatively tight 0.7350-0.7450 range.

Hopes about robust economic growth in the antipodean economies provided a bit of support for both the AUD and NZD last week. In NZ, the Quarterly Survey of Business Opinion was consistent with NZ economic growth returning to trend in 2010. Across the Tasman, the Australian employment report was just another indicator suggesting the Australian economy is going from strength to strength. Market pricing is now consistent with about a 75% chance of the RBA hiking rates 25bps in February.

However, fading risk appetite and soft global equities helped limit the gains in NZD/USD. Last week's US corporate earnings reports were a bit of a mixed bag. While Intel surprised on the upside, JP Morgan's larger-than-expected loan losses raised concerns about bank profitability. Worries about Greece's sovereign solvency and China's efforts to slow sectors of the economy also took a toll. The S&P500 fell 1.08% on Friday to finish the week down 0.8%.

Looking ahead, we suspect the USD will continue to shuffle sideways this week. The US corporate reporting season will gather pace this week, but with US interest rates steadily falling (US 2-year government bond yields have fallen 25bps this year as investors have delayed the anticipated timing of the Fed's first rate hike) we doubt earnings disappointments (and risk aversion) will result in a persistently stronger USD.

It's worth noting, the recent decline in US interest rates have increased the yield advantage of the NZD. NZ-US 3-year swap spreads have widened out to around 325 bps, from closer to 310bps at the start of the year. This has pushed up the NZD/USD 'fair-value' range implied by our short-term valuation model to 0.7400-0.7600.

Locally, there's plenty to watch this week. With the RBNZ expecting a soft Q4 CPI (-0.2%), Wednesday's release has the potential to over-excite the market. We're expecting a 0.1% rise, which would set annual inflation at 2.2%. On Thursday, we'll get November's retail sales, December's Performance of Manufacturing Index and January's ANZ-Roy Morgan consumer confidence reading.

All up, it will probably be another range bound week for NZD/USD. While weaker global equities and disappointing corporate earnings may provide some weight early in the week, we expect dips will be limited to the 0.7280-0.7300 region.

danica_hampton@bnz.co.nz

Foreign Exchange Technicals

danica_hampton@bnz.co.nz

NZD/USD

Outlook:	Buy a dip
ST Resistance:	0.7440 (ahead of 0.7500)
ST Support:	0.7350 (ahead of 0.7280)

While momentum indicators remain positive, we expect dips below 0.7300 to be short-lived.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8040 (ahead of 0.8110)
ST Support:	0.7940 (ahead of 0.7790)

The failure to break convincingly above 0.8100 suggests the uptrend has stalled for now. However, momentum indicators remain will remain positive, as long as the currency trades above 0.7935.

Key Upcoming Events

	Forecast	Median	Last
Monday 18 January			
Aus, TD Inflation Gauge, December y/y			+2.1%
Jpn, Industrial Production, November 2nd est			+2.6%P
US, Holiday, Martin Luther King			
Tuesday 19 January			
UK, CPI, December y/y		+2.6%	+1.9%
US, NAHB Housing Index, January		17	16
Germ, ZEW Sentiment, January		+50.0	+50.4
Can, BOC Policy Announcement			0.25%
Wednesday 20 January			
NZ, Food Price Index, December	+0.7%		-0.3%
NZ, CPI, Q4	+0.1%	flat	+1.3%
Aus, Consumer Sentiment - Wpac, January			113.8
Jpn, Tertiary Industry Index, November		-0.2%	+0.5%
UK, BOE Minutes, 6/7 Jan Meeting			
UK, Unemployment rate (ILO), November		8.0%	7.9%
US, Housing Starts, December		575k	574k
US, PPI ex-food/energy, December y/y		+1.0%	+1.2%
Germ, PPI, December y/y		-5.1%	-5.9%

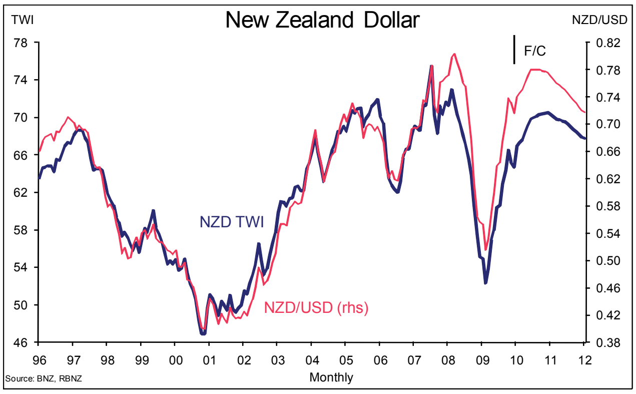
	Forecast	Median	Last
Thursday 21 January			
NZ, ANZ-RM Consumer Confidence, January			118.6
NZ, Retail Trade, November	+0.4%	+0.5%	flat
NZ, BNZ PMI (Manufacturing), December			51.8
Euro, PMI Services, January 1st est		53.8	53.7
Euro, PMI Manufacturing, January 1st est		51.9	51.6
US, Philly Fed Index, January		+19.4	+20.4
US, Jobless Claims, week ended 16/01		440k	444k
US, Leading Indicator, December		+0.7%	+0.9%
Can, BOC Qtly Policy Report			
China, CPI, December y/y		+1.4%	+0.6%
China, Retail Sales, December y/y		+16.3%	+15.8%
China, Fixed Investment (Urban), Dec ytd y/y		+31.5%	+32.1%
China, Industrial Production, December y/y		+19.6%	+19.2%
China, GDP, Q4 y/y		+10.5%	+8.9%
Friday 22 January			
Aus, Terms of Trade, Q4		-1.5%	-7.4%
UK, Retail Sales vol., December		+1.1%	-0.3%
Euro, Industrial Orders, December		+0.5%	-2.2%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	5.00
1 mth	2.75	2.73	2.72	5.18
2 mth	2.76	2.75	2.74	4.97
3 mth	2.77	2.76	2.76	4.61
6 mth	3.05	3.03	2.95	4.43
GOVERNMENT STOCK				
11/11	4.20	4.21	4.22	4.17
04/13	4.87	4.94	4.93	4.36
04/15	5.36	5.43	5.40	4.60
12/17	5.70	5.77	5.71	4.71
05/21	5.97	6.05	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.86	3.88	3.87	-
BNZ 05/15	6.59	6.68	6.71	-
GEN 03/14	6.60	6.69	6.77	-
GEN 03/16	7.05	7.14	7.16	-
TRP 12/10	4.35	4.36	4.40	4.64
TRP 06/20	7.30	7.39	7.37	5.82
SWAP RATES				
2 years	4.57	4.56	4.50	4.25
3 years	5.01	5.07	5.02	4.46
5 years	5.43	5.52	5.49	4.65
10 years	5.98	6.07	6.00	4.99

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7345	0.7387	0.7109	0.5879
NZD/AUD	0.7977	0.7957	0.7978	0.8400
NZD/JPY	66.65	68.24	64.26	52.98
NZD/EUR	0.5118	0.5115	0.4975	0.4360
NZD/GBP	0.4518	0.4596	0.4410	0.3881
NZD/CAD	0.7568	0.7602	0.7581	0.6983
TWI	66.54	66.90	64.93	57.59

NZD Outlook



Contact Details

BNZ

Stephen Toplis	**Craig Ebert**	**Danica Hampton**	**Mike Jones**
Head of Research	Senior Economist	Senior Strategist	Strategist
+(64 4) 474 6905	+(64 4) 474 6799	+(64 4) 472 4767	+(64 4) 472 4767

Main Offices

Wellington	**Auckland**	**Christchurch**
1 Willis Street	80 Queen Street	129 Hereford Street
PO Box 2392	Private Bag 92208	PO Box 1461
Wellington 6140	Auckland 1142	Christchurch 8140
New Zealand	New Zealand	New Zealand
Phone: +(64 4) 474 6145	Phone: +(64 9) 976 5762	Phone: +(64 3) 353 2219
FI: 0800 283 269	Toll Free: 0800 081 167	Toll Free: 0800 854 854
Fax: +(64 4) 474 6266		

National Australia Bank

Peter Jolly	**Alan Oster**	**Rob Henderson**	**John Kyriakopoulos**
Head of Research	Group Chief Economist	Chief Economist, Markets	Currency Strategist
+(61 2) 9295 1199	+(61 3) 8634 2927	+(61 2) 9237 1836	+(61 2) 9237 1903

Wellington		**New York**	
Foreign Exchange	+800 642 222	Foreign Exchange	+1 800 125 602
Fixed Income/Derivatives	+800 283 269	Fixed Income/Derivatives	+1877 377 5480
Sydney		**Hong Kong**	
Foreign Exchange	+800 9295 1100	Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(61 2) 9295 1166	Fixed Income/Derivatives	+(85 2) 2526 5891
London			
Foreign Exchange	+800 333 00 333		
Fixed Income/Derivatives	+(44 20) 7796 4761		

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