

26 January 2010

# **RBNZ** on Track for Mid-Year Tightening

- Bollard to repeat December MPS themes, Thursday
- · Of cautious recovery, mid-year start to tightening
- Data mostly positive, but not without soft spots
- · Consumer spending improving, but rural sector not
- · Friday's building consents/int'l trade likely mixed
- · Bollard also speaking to business group, Friday

We expect Governor Bollard will be requisitely boring at Thursday's OCR review. While the economic information has certainly retained momentum, the bulk of it has not been materially different to what the RBNZ implied in its December Monetary Policy Statement (MPS).

Even the threat of sparks in last week's Q4 CPI report proved a damp squib, which left the headlines as tame as the underlying pulse of inflation itself.

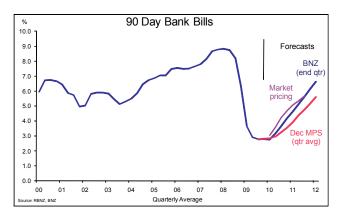
So there's every reason to believe Bollard, in the few paragraphs of text he has to play with at this week's announcement, will simply reiterate the themes of the December MPS. This, recall, entails a gradually strengthening economic recovery and a probable mid-year start to bumping up the Official Cash Rate.

This very much coincides with the view we've held for a good while now. Relative to this, the markets are still aggressive on the OCR outlook (albeit less gung-ho than they were).

Still, the risks around the Bank's core view are widely fanned. Conditionality still reigns – a message from December's MPS that seemed lost on some. The Bank moving as early as April is possible, but would take a surge in the data and/or, as a sidewinder, a slump in the NZ dollar for no real reason. Conversely, any loss of momentum in the economic recovery, and/or renewed global ructions, would have the Bank on the sidelines past mid-year, presumably.

So the news will remain crucial for scoring the Reserve Bank's policy path. For the moment the data retains a positive bias, although not compellingly so, and not entirely.

On the plus side, we've seen the likes of further improvement in Monday's Performance of Services Index. While its headline December reading of 54.4 might have been flattered by the time of year, it still looked positive in an underlying sense, especially with its forward-looking components, such as new orders, that much stronger.



In this sense, the latest PSI aligns with the positive messages from the Performance of Manufacturing Index, as we saw from last week.

There have also been signs consumers are loading more into their shopping baskets. Part of this would seem to reflect discounts, in part afforded by the high NZ dollar. But there is also a more gkeneral lift in consumer spirits coming through, evident in the way the ANZ Roy Morgan confidence index pushed to a relatively high level in January. In this vein, this afternoon's credit card billings will be notable for which way they go.

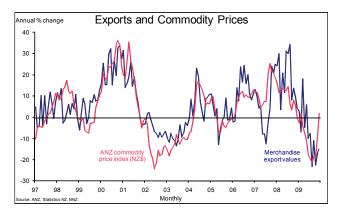
With the perkier signs around consumer spending and confidence it's been a little strange, then, to see home sales and mortgage approvals continuing to fall, to relatively weak levels, with even like-for-like home prices slipping in December.

Mixed messages are also likely to be evident in Friday morning's building consents, for December. For residential consents, we're looking for another increase, as they continue to shunt off recent acute lows. But on the non-residential side of things, consents are likely to keep coming off the boil, especially once the recent buttress from mainly public-sponsored projects is taken into account.

Not that December's merchandise trade figures, published at the same time as building consents, will give any clearer steer. While there might be signs of stability on the imports side, there may well be suggestions export volumes continued to struggle in the closing months of 2009, on balance.

As for December's nominal trade balance, we're essentially looking for a flat outturn – based on exports of \$3,263m (-15% y/y) and imports of \$3,260m (-22% y/y).

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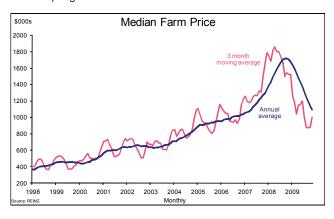


This would be enough to keep the underlying trade gains in place, however, thus supporting the case for further contraction in the current account deficit.

In the context of external trade, however, we should also note New Zealand's farming sector would seem to be doing it tough, still. This was certainly the message from December's REINZ rural real estate report, in any case.

This showed, for example, that dairy farm sales over the three months to December 2009 were just 30, down from the 43 a year prior. Notably, dairy farm sale prices equated to about \$35 per kilogram of milk-solids, down about a third from the \$52 peak over the second half of 2008. This is interesting, as it implies there has not been any material bounce-back in dairy farm prices, even with the avoidance of the terrible (sub-\$5) payouts that were looking possible during the first half of 2009. Balance sheets must be smarting from this.

And it doesn't look as though the rest of the rural sector is faring that much better. This is partly because its property prices tended to follow the dairy bubble (so will probably do so the bust, to some extent) but also because we know local meat price schedules are still well down from 2007/08 highs, viticulture has certainly experienced a correction around land prices and cash-flow, while the whole of the rural sector is obviously struggling with the relatively high NZ dollar.



Over recent months there's also been the drought that has been tightening its grip over the top half of the North Island, where about half the nation's dairy farms reside (the supply ramifications of which may well be a supporting factor in global dairy prices – as was definitely the case during the early-2008 drought).

But it's not just the variegated economic news (including globally) that will be making Bollard's deliberations difficult, probably arguing for more time. So too some domestic policy issues around taxation reform, as recommended by the Tax Working Group last Wednesday.

Limiting the tax deductibility of losses made by landlords (which seems the norm) would appear to be the front-runner on the housing front, with a land tax, while theoretically appealing, likely to cause specific problems, in practice.

A capital gains tax, even outside owner-occupier status, looks to be an even knottier candidate, in effect, with the added disadvantage of being lumpy in its returns to government revenue (and perhaps thin for a while anyway, on the assumption we won't be seeing another housing boom any time soon).

As for regular tax rates, aligning personal, trust, and PIE rates might fly at some stage but would not be cheap, and would surely be unaffordable if they were all expected to follow any further reduction in the corporate tax rate on the grounds of international competitiveness. A rise in GST seems a line-ball call, but would seem important for affording the degree of tax rate abatement being touted.

These are big issues to weigh – including accounting wise, at a time when the Government is facing significant deficits to begin with, let's not forget. So we don't imagine we'll be getting any decisions on tax reform in the immediate term. More likely, they will be "leaked" in the lead-up to the May Budget. The RBNZ will surely want to see the details of this (and not just the taxation bits) before making any major moves of its own.

It's one of many things arguing for the RBNZ to not rush into any tightening cycle. It can afford to wait, gather more information, and signal. We expect this will be the message of Thursday's OCR review.

For more on the Bank's thinking, also note Governor Bollard is delivering his customary speech to the Canterbury Employers' Chamber of Commerce on Friday. This will be an opportunity for him to flesh out the mere paragraphs he has at his disposal at Thursday's announcement.

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### **Domestic Interest Rates**

NZD interest rates saw a reasonable rally over the past week on the back of a weak CPI number (-0.2% vs a market expectation of flat). This caused the market to largely price out the chance of a hike in the March meeting, with hikes now priced from April and slightly more than 25bp per meeting from there to the end of 2010. Further clarification to the hiking cycle may be provided by the OCR review on Thursday, although we expect that more explicit signalling likely won't come until the March Monetary Policy Statement.

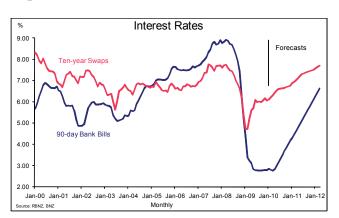
The rally from the CPI followed through into the bond market, with the short end yields dragged down by the swap market and the long end supported by a strong week offshore. The coming week will be dominated by the OCR statement, with further direction provided by offshore moves. The bond tender will be on Friday and there still seems to be good domestic demand for short end bonds so expect this to be well supported.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
15-Jan-10	2.78%	4.21%	5.71%	4.57%	5.98%	141
22-Jan-10	2.77%	4.05%	5.65%	4.43%	5.91%	148
Change (bps)	-1	-16	-6	-14	-7	7

#### Reuters pgs BNZL BNZM

The swaps market had a good rally in the short end on the back of the CPI number, with some steepening following through on the curve. The market continues to be quiet and illiquid, but a reasonable bid was seen around 4.40%, which was a level that saw reasonable support on the upside. Direction for the week will come from the OCR review on Thursday, we feel that in the short end there is probably more room to move on the upside than to rally further from here.

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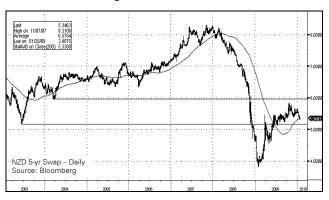


#### **Interest Rate Technicals**

#### **NZD 5yr Swap Rate**

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

The 5.40% level has been breached and so the swap rate should head towards LT support at 5.09%. Overall, however, the market is range trading and does not look like breaking out in the near term.



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

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

The curve flattening is still in place and the previous target of +61 still looks likely to be achieved.



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## Foreign Exchange Market

The NZD was the worst performing currency last week. It fell about 4% against the USD, from above 0.7400 to below 0.7100.

The NZD seemed to be hit by the perfect storm last week. Globally, investors became increasingly risk averse amid worries about European sovereign solvency and China's attempts to slow growth. Lacklustre US corporate earnings and Obama's plans to curb bank speculation also weighed heavily on equity markets. The S&P500 fell nearly 4% last week and our risk appetite index (which has a scale of 0-100%) fell from 69% to 48%. Against this backdrop, investors ditched growth sensitive currencies like the NZD in favour of the relative safety of the USD.

The local news simply added to the weight on the currency. Yes, November's retail sales printed on the stronger side of expectations. However, the REINZ data suggested housing market activity is slowing and Q4 CPI showed that inflation pressures remain benign. All in all, it aligned with our view that the RBNZ can wait until mid-year to begin tightening – a message we expect the RBNZ to reiterate at this Thursday's OCR review.

After finishing last week around 0.7100, the NZD/USD rebounded a little on Monday, with markets managing to shrug off Friday's fragility. Investor sentiment was cheered by rumours Bernanke would likely be reappointed as Fed Chairman and news reports suggesting President Obama will detail new stimulus measures (aimed at helping middle class families) in this week's State of the Union address.

#### Reuters pg BNZWFWDS

The coming week is packed full of event risk, which should help provide direction for currency markets. The Senate is expected to vote on whether to reappoint Bernanke for a second term and Obama will give his State of the Union speech on Thursday. We're also slap bang in the middle of the US corporate earnings season (companies like Apple, Amazon, Boeing and Microsoft are all reporting this week). However, the key event will probably be the FOMC meeting, which should set the USD's direction. The Fed is widely expected to leave both policy unchanged and maintain the "extended period" line in describing how long they will keep rates at accommodative levels. Given the labour market remains weak and inflation pressures benign, we suspect those looking for hints as to when the Fed will start to tighten policy will be disappointed. As such, we wouldn't be surprised to see a bout of USD weakness towards the end of the week

While worries about the global outlook may keep the NZD/USD fragile early in the week, we continue to think that dips below 0.7000 will be short-lived. Certainly, there are some tentative indicators that the pace of NZ's recovery will slow in coming months. However, the NZ economy is still on track to grow at an annual average pace of 2.5% in 2010 and this stacks up favourably relative to our trading partners. Likewise, the RBNZ is likely to hose down expectations for near-term rate hikes at Thursday's OCR Review. However, we are expecting the RBNZ to start raising rates at some point this year (and sooner than the Fed, ECB and Bank of England).

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#### **Foreign Exchange Technicals**

#### NZD/USD

Outlook: Consolidation

ST Resistance: 0.7290 (ahead of 0.7335) ST Support: 0.7075 (ahead of 0.6990)

Momentum indicators shifted from bullish to neutral following the break below 0.7280. However, the failure to close below 0.7075 casts doubts over whether the downtrend can be sustained.



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#### NZD/AUD

Outlook: Consolidation

ST Resistance: 0.8040 (ahead of 0.8080 ST Support: 0.7850 (ahead of 0.7790)

The break below 0.7905 saw momentum indicators turn negative, but solid support is expected below 0.7800.



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# **Key Upcoming Events**

	Forecast	Median	Last Last	Forecast	Median	Last			
Tuesday 26 January				Thursday 28 January continued					
NZ, Credit Card Billings, December			+0.8%	US, Jobless Claims, week ended 23/01	450k	482k			
UK, GDP, Q4 1st est		+0.4%	-0.2%	US, Durables Orders, December	+2.0%	+0.2%			
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%	Germ, Unemployment, January sa	8.2%	8.1%			
US, Shiller Home Price Index, Nove	-5.0%	-7.3%	Friday 29 January						
US, Consumer Confidence, January	53.5	52.9	NZ, Crown Financial Statements, November						
Germ, IFO Index, January	95.1	94.7	NZ, Building Consents, December (res, #)		+1.2%				
Wednesday 27 January			NZ, Merchandise Trade, December flat	-\$139m	-\$269m				
Aus, Westpac Leading Index, November +0.4%				NZ, Bollard Speaks, Chamber of Commerce					
Aus, CPI, Q4	+0.5%	+0.4%	+1.0%	Aus, Private Sector Credit, December +0.1%	+0.1%	+0.1%			
Jpn, BOJ Economic Report				Jpn, Unemployment Rate, December	5.3%	5.2%			
Jpn, Merchandise Trade Balance, December +¥610			+¥371b	Jpn, CPI, December y/y	-1.7%	-1.9%			
UK, CBI Dist Trade Survey, January	•		+13	Jpn, Industrial Production, December 1st est	+2.5%	+2.2%			
US, FOMC Policy Announcement	0.25%	0.25%	0.25%	Euro, CPI, Jan y/y 1st est	+1.2%	+0.9%			
US, New Home Sales, December		368k	355k	Euro, M3, December y/y	-0.5%	-0.2%			
Thursday 28 January				Euro, Unemployment Rate, December	10.1%	10.0%			
NZ, OCR Review	2.50%	2.50%	2.50%	US, Fed's Kohn Speaks, Interest Rate Risk					
NZ, Household Credit, December y/	y		+2.8%	US, GDP, Q1 saar 1st est	+4.6%	+2.2%			
Jpn, Retail Trade, December y/y		+0.3%	-1.0%	US, Chicago PMI, January	57.0	58.7			
Euro, Economic Confidence, Januar	'n	92.3	91.3	US, Mich Cons Confidence, January 2nd est	73.0	72.8P			

Year Ago

0.5299

0.8058

0.4082

0.3842

0.6526

53.37

NZD/USD 0.82

> 0.74 0.70 0.66 0.62 0.58 0.54 0.50 0.46

0.42

0.38

12

04 05 06 07 08 09 10 11 Monthly

47.04

## **Historical Data**

5.33

5.90

5.43

5.98

5.54

6.07

5 years

10 years

Today	Week Ago	Month Ago	Year Ago		Today	Week Ago	Month Ago
BILLS				FOREIGN E	XCHANGE		
2.50	2.50	2.50	5.00	NZD/USD	0.7140	0.7345	0.7080
2.71	2.75	2.72	4.61	NZD/AUD	0.7889	0.7977	0.7982
2.75	2.76	2.74	4.33	NZD/JPY	64.43	66.65	64.87
2.77	2.77	2.81	4.14	NZD/EUR	0.5045	0.5118	0.4923
3.01	3.05	2.95	3.73	NZD/GBP	0.4397	0.4518	0.4424
г ѕтоск				NZD/CAD	0.7554	0.7568	0.7382
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