1 February 2010

More to Keep RBNZ Cautious

- RBNZ expects a 6.6% jobless rate for Q4 HLFS
- We're looking for 6.9%, on 0.3% dip in jobs
- With LCI/QES wage growth slackening as well
- Tourist arrivals firm, but immigration peaking
- As further signs of housing hesitancy emerge
- With RBNZ surely wary of May Budget restraint too

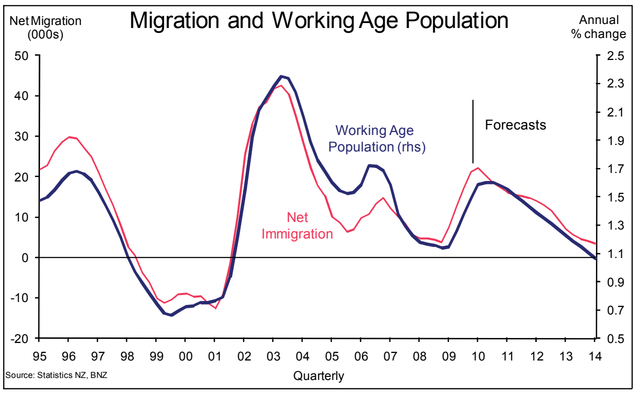
With the upcoming data important for scoring RBNZ policy, we believe this week's batch, by and large, will keep the Bank cautious. And waiting until mid-year before tightening seems all the more advisable given the Bank will probably want to see the details of May's surely-restrained Budget.

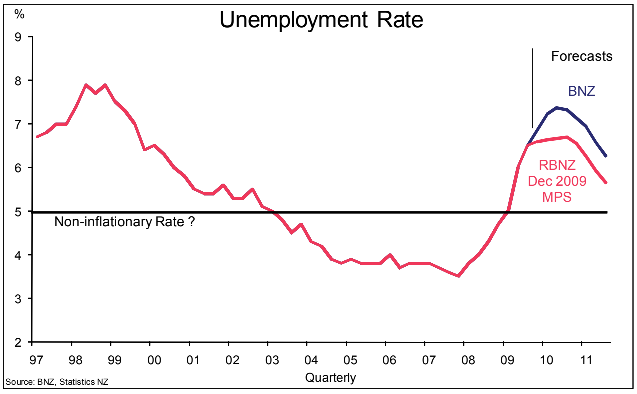
As for the data, Thursday's Q4 Household Labour Force Survey will be the big test of this week. December's Monetary Policy Statement – which Governor Alan Bollard last week said remained on track – estimated a strong sense of stability in this respect. It had the jobless rate ticking up just a notch, to 6.6%, from 6.5%, on a steady employment reading for the quarter.

The market is not quite as confident, in being centred on 6.8% for the jobless rate and a 0.1% dip in employment.

We believe even more of a hangover is due. Formally, we are looking for a clear jump in the Q4 unemployment rate, to 6.9%, based on employment falling a further 0.3% and the participation rate easing 0.2 points, to 67.8%.

But our view of upside pressure to the unemployment rate goes beyond Q4 of 2009. Granted, staffing intentions are beginning to turn positive, even sooner than we imagined. Still, it will probably take a little while before for these are acted upon. All the while, the supply of labour continues to expand, partly reflecting higher net immigration. To the extent this is not absorbed, the jobless rate will rise.





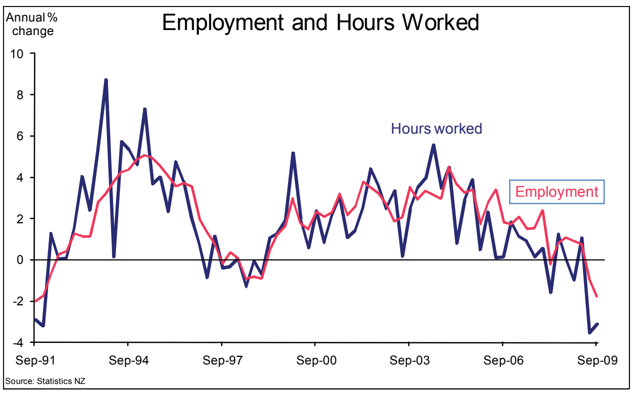
The other reason to wonder about further upside in the unemployment rate is that any pick up in economic activity will probably be met, in the first instance, with increased hours of existing employees rather than new hires.

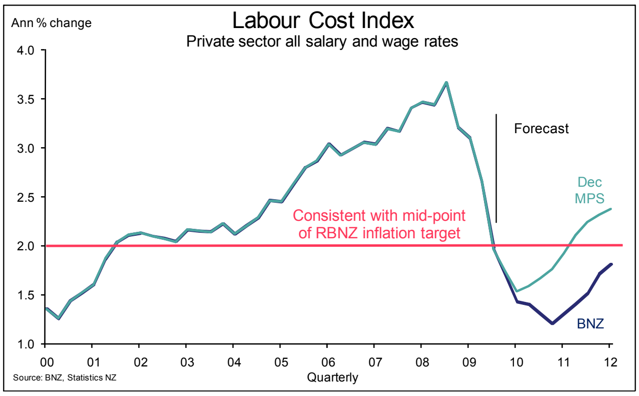
This is a reminder of the way hours have been cut back to the bone through the recession. While this has helped spread the pain amongst the workforce it has also been important in avoiding a bigger hit to the number of outright job losses.

With this in mind, it will be important to note the full-time, part-time, split in the HLFS jobs tally, and how total hours-worked performed in relation to total headcount.

Ahead of the HLFS, Tuesday's Q4 Labour Cost Indexes and Quarterly Employment Survey (QES) should confirm weaker wage growth continues to dribble through.

As usual, we'll put the most faith in the LCI readings, the private-sector version of which we expect increased 0.4% in the quarter (in line with the market). This would lower the annual pace to 1.6%, from 1.9%. As a proxy for unit





labour costs, this is effectively a bit below the Bank's implied mid-point target (something also depicted in the core CPI readings of late).

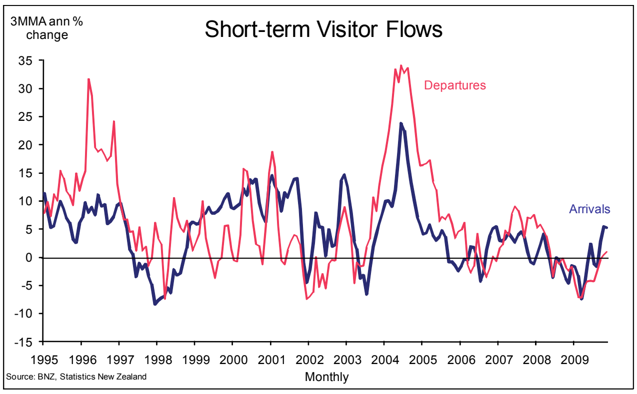
Tomorrow's QES will also have important insights into Q4 staffing, in its filled-jobs series. We anticipate this to be in the range of 1.675 to 1.685 million to be consistent with what we expect for Thursday's HLFS employment.

Also watch the QES details on paid hours, and full-time/part-time employment, for further insight into overall economic activity through the December quarter of 2009 and the way in which this is affecting labour input.

As for Friday's migration report, its most notable feature might well be another solid increase in short-term visitor arrivals for December. We'd guess an annual increase of around 5% – albeit still largely hinged on strong gains in visitors from Australia, and with more general signs that most tourists are staying and spending a bit less when they get here.

Short-term visits abroad by NZ residents, however, looked a bit soggy all 'round in December.

In respect of net immigration, we expect December's result to be another reasonable one, although peaking more generally. It's one of many factors that would appear



to have reached its maximum impulse, including for the housing market – not that any of them became strong in any way to start with.

This is why we're not too surprised to see further evidence of hesitation in the local housing market. This time it's in the form of the January's housing statistics, as published by website realestate.co.nz this morning. It reported that while new listings weakened, inventory rose noticeably, as underlying buyer demand backed off. This extends the downward trend we've noted in other housing activity indicators over recent months.

Similarly, asking prices were also still moderating, according to the real estate website.

These are signs the housing market might well be choking on its own hubris again already.

No wonder, then, that the RBNZ didn't make a big deal of the housing market at last week's OCR review. Indeed, Governor Alan Bollard didn't even care to mention it.

This brings to mind something else, which, if nothing else, argues for the markets to be careful in the tightening cycle they still see as starting earlier, and being more aggressive, than the Bank is strictly outlining. That something is May's Budget.

Specifically, this stands a good chance of announcing tax policy changes that will be detrimental to those landlords who are in it simply for the leveraged tax write-offs, and perceived capital gain, rather than long-term yield. Let's just say the policy changes could well improve home affordability rather noticeably.

Of course, May's Budget could also harbour policy that offsets any damage that it might wrought through housing – for example by way of personal tax cuts. Nonetheless, the general theme must surely be of the Government needing to be restrained, given the outlook of clear deficits and sharply rising debt (just a bit less awful than previously seen). This means fiscal policy is bound to be a net drag on economic growth for the foreseeable future – something the RBNZ implied, again, at last week's OCR review.

The fiscal and policy prognosis is another reason we remain comfortable with the idea of June being the most likely start point to any OCR increase, with the May Budget a focal point in all of this. Surely the Bank would rather know the details of it, before implementing any tightening of its own?

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates saw a gentle rally on the week, largely driven by offshore rallies. The OCR statement was very short and contained litle new information, leading to a muted response from the market. The futures strip is now largely pricing out the chance of a March hike to the OCR with the first hike now priced for April.

From there the market is pricing just slightly more than 25bps per meeting to the end of the year. While we fundamentally stil believe the markets are too aggressive on their OCR path, we feel Governor Bollard's comments in his speech on Friday, with "…it is possible there could be some meaty chunks to the upside", potentially show some value in a bills steepener around here, buying June futures contract to sell the September or December contracts.

The Australian rates market was buoyant as speculation the RBA won't hike as aggressively as expected combined with general skittishness in equities. This didn't feed through to the kiwi market as much as you might expect and NZ bonds underperformed markedly on the week. Last week's tender was well supported but the DMO chose to only issue 2011 and 2013 maturity bonds, not issuing the 2021s on offer. With our underperformance recently, don't be surprised if we outperform over the next week if offshore rates sell off.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
22-Jan-10	2.77%	4.05%	5.65%	4.43%	5.91%	148
29-Jan-10	2.76%	3.99%	5.62%	4.38%	5.88%	150
Change (bps)	-1	-6	-3	-5	-3	2

Similarly, the swaps market underperformed on the week with good paying interest for 2-yr below 4.40%. We did manage to eke out a small rally, however, and feel the curve is good value to pay to most maturities, near term. The natural payside interest in the kiwi market has been somewhat suppressed by a large scale move to floating rates, a move that could reverse in a hurry if the market gets spooked by a signal that higher short term rates are coming. A move like this caused a big spike in yields in March 2009 and while it isn't necessarily imminent here, the risk of a repeat move bears thinking about.

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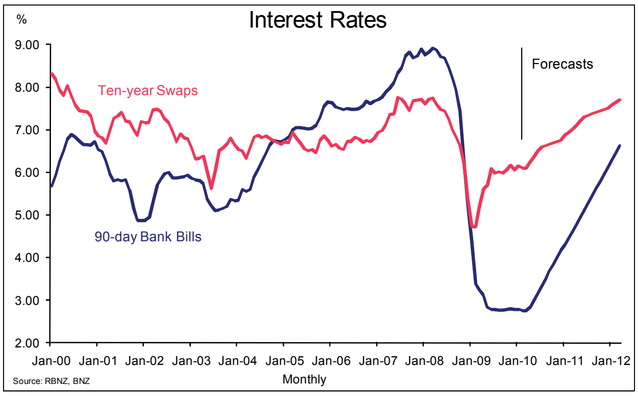

Interest Rate Technicals

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NZD 5yr Swap Rate

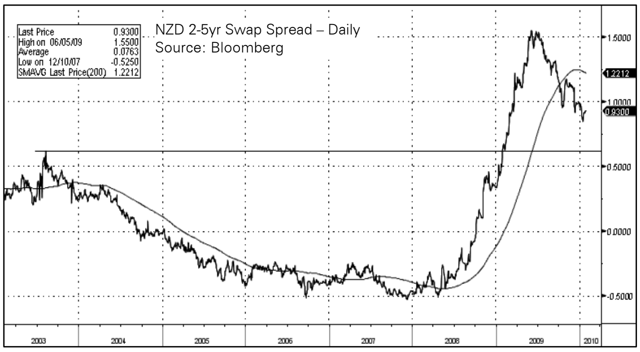
Outlook: Neutral
LT Resistance: 5.90%
LT Support: 5.09%

We continue to track towards LT support at 5.09%. Overall, however, 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 flattening is still in place and the previous target of +61 still looks likely to be achieved.



Foreign Exchange Market

Reuters pg BNZWFWDS

It was a bumpy ride in the NZD last week. After pushing above 0.7150 early in the week, NZD/USD later succumbed to rising European credit fears, and finished the week closer to 0.7000.

Last week's local news was relatively unexciting. Data developments were a little mixed, with Friday's surprisingly good trade balance offset to some extent by an unexpected drop in December's building permits. Meanwhile, the RBNZ's January OCR review was admirably boring and commendably short. As widely expected, Governor Alan Bollard stuck fast to December's script (while keeping the OCR at 2.50%, for the record).

As such, it was really offshore factors that set the direction for the NZD last week. News China is beginning to clamp down on excessive credit growth raised fears a slowing in Chinese growth could derail the global recovery. And an escalation of the fiscal crises in Spain, Portugal and particularly Greece reinforced wider credit concerns for the European region, knocking back investors' risk appetite. Our index of risk appetite (which has a scale of 0-100%) fell to 48%, from above 58% at the start of January. Not surprisingly, the resurgence in sovereign credit fears took the biggest toll on EUR; EUR/USD fell to 6-month lows below 1.3900. But NZD/USD didn't escape unscathed. The combination of lower risk appetite and 'safe-haven' support for the USD saw NZD/USD fall 1.2% to nearly 0.7000.

Despite this, it's worth noting that, on a trade-weighed basis, the NZD finished the week pretty much unchanged. NZD/EUR found clear support from the sliding EUR.

Meanwhile, creeping uncertainty about the likelihood of another 25bps hike from the RBA on Tuesday ensured any losses in NZD/AUD were limited to 0.7850. Current market pricing implies a roughly 60% chance of an RBA hike. If we are right and the RBA does hike its cash rate 25bps on Tuesday, the NZD/AUD will likely again test the bottom end of its recent 0.7850-0.8000 range.

After an encouraging start to the year, sentiment and risk appetite have taken a clear turn for the worse in recent weeks. We suspect the precondition for a recovery in risk appetite and 'growth-sensitive' currencies will be a stabilisation in the debt crisis in Greece (and to a lesser extent Spain and Portugal). In the absence of such, we're likely to see further modest gains in the USD this week.

For the NZD, we believe the fundamental outlook is still sound, which should lead to a resumption of the uptrend in coming weeks. Indeed, according to our short-term valuation model the combination of NZ-US swap spreads, risk appetite, and NZ commodity prices are consistent with a NZD/USD of 0.7150-0.7350. However, while heightened credit fears and worries about the global outlook continue to hang over markets, we suspect the NZD/USD will struggle towards 0.7150 this week. This is particularly so given the clear jump we are expecting in Thursday's Q4 unemployment rate (to 6.9%, well above the 6.6% the RBNZ expects). Initial support on NZD/USD is seen towards December's low of 0.6970. A convincing break through this level would pave the way for a deeper correction.

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Foreign Exchange Technicals

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NZD/USD

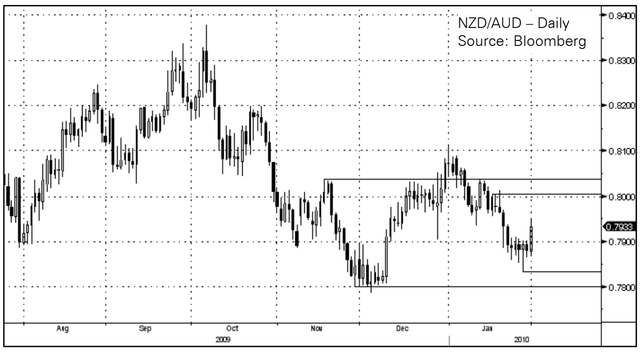
Outlook: Consolidation
ST Resistance: 0.7170 (ahead of 0.7290)
ST Support: 0.6970 (ahead of 0.6890)

The break below 0.7070 saw momentum indicators turn negative. A daily close below the December low of 0.6970 is needed to confirm the downtrend.

NZD/AUD

Outlook: Consolidation
ST Resistance: 0.8000 (ahead of 0.8040)
ST Support: 0.7830 (ahead of 0.7790)

The failure to sustain dips below 0.7850 suggests the downtrend has stalled for now. With the daily RSI at broadly neutral levels we expect more range-trading in the near-term.



Key Upcoming Events

	Forecast	Median	Last
Monday 1 February			
Aus, House Prices, Q4	+3.0%	+3.5%	+4.2%
Aus, TD Inflation Gauge, January y/y			+2.6%
UK, CIPS Manuf Survey, December		53.9	54.1
US, Construction Spending, December		-0.5%	-0.6%
US, Personal Spending, December		+0.3%	+0.5%
US, ISM Manufacturing, January		55.5	55.9
China, PMI (NBS), January		56.5	56.6
Tuesday 2 February			
NZ, LCI Priv Ord Wages, Q4 y/y	+1.6%	+1.6%	+1.9%
Aus, NAB Business Survey, December			
Aus, RBA Policy Announcement	4.00%	4.00%	3.75%
US, Pending Home Sales, December		+1.0%	-16.0%
Germ, Retail Sales - vol, December		+0.9%	-1.1%
Wednesday 3 February			
Aus, International Trade, December	-$2.60b	-$2.40b	-$1.70b
UK, CIPS Services, January		56.5	56.8
Euro, Retail Sales, December		+0.4%	-1.2%
US, ADP Employment, January		-40k	-84k

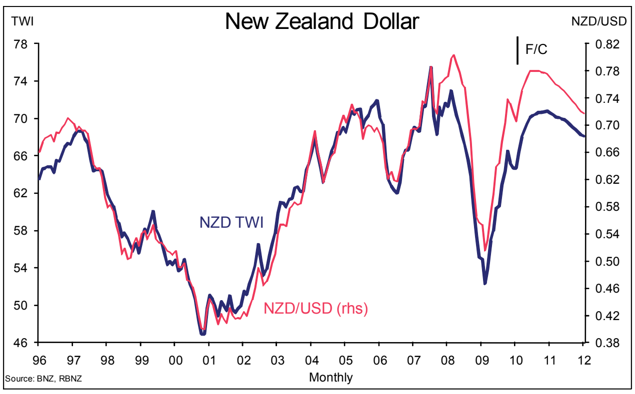
	Forecast	Median	Last
Wednesday 3 February *continued...*			
US, ISM Non-Manuf, January		51.0	50.1
Thursday 4 February			
NZ, HLFS Employment, Q4	-0.3%	-0.1%	-0.8%
NZ, External Migration, December s.a.			+1,780
NZ, HLFS Unemployment Rate, Q4	6.9%	6.8%	6.5%
Aus, Retail Trade, December s.a.	-0.5%	+0.2%	+1.4%
Aus, Building Approvals, December	-1.3%	flat	+5.9%
UK, BOE Policy Announcement	0.50%	0.50%	0.50%
Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
US, Factory Orders, December		+0.5%	+1.1%
US, Jobless Claims, week ended 30/01		455k	470k
US, Productivity (non-farm), Q4 saar 1st est		+6.0%	+8.1%
Germ, Factory Orders, December		+0.2%	+2.8%
Friday 5 February			
Aus, RBA Quarterly Statement			
UK, PPI (core output), January y/y		+2.6%	+2.6%
US, Non-Farm Payrolls, January		+13k	-85k
Germ, Industrial Production, December		+0.6%	+0.7%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	3.50
1 mth	2.72	2.71	2.72	3.90
2 mth	2.75	2.75	2.74	3.73
3 mth	2.75	2.77	2.81	3.46
6 mth	3.01	3.01	2.95	3.17
GOVERNMENT STOCK				
11/11	3.99	4.05	4.27	3.34
04/13	4.70	4.74	4.99	3.69
04/15	5.18	5.22	5.47	4.03
12/17	5.62	5.65	5.79	4.32
05/21	5.93	5.95	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.76	3.79	3.93	-
BNZ 05/15	6.49	6.58	6.79	-
GEN 03/14	7.25	6.60	6.85	-
GEN 03/16	7.65	7.27	7.25	-
TRP 12/10	7.00	4.23	4.39	3.95
TRP 06/20	6.95	7.24	7.48	5.74
SWAP RATES				
2 years	4.38	4.42	4.56	3.25
3 years	4.84	4.87	5.08	3.54
5 years	5.30	5.33	5.54	3.87
10 years	5.88	5.90	6.07	4.48

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7002	0.7140	0.7080	0.5066
NZD/AUD	0.7958	0.7889	0.7982	0.7980
NZD/JPY	63.00	64.43	64.87	45.60
NZD/EUR	0.5053	0.5045	0.4923	0.3965
NZD/GBP	0.4390	0.4397	0.4424	0.3500
NZD/CAD	0.7502	0.7554	0.7382	0.6220
TWI	64.69	65.11	64.74	51.55

NZD Outlook



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