8 February 2010

Taxing Issues for the "House" of Parliament

- Government to outline (tax) policy agenda, Tuesday
- Friday's REINZ data to show further housing slowing
- Q4 retail sales likely solid, December the real test
- With January's ECT data an important adjunct
- January's PMI looks to beat December's goodly 52.9
- Bollard sounds reasonably cautious in TV interview

RBNZ Governor, Alan Bollard, sounded reasonably cautious on a TV interview over the weekend. And we have a number of noteworthy data releases this week, following last week's soft labour market statistics. But the biggest news would seem set for Tuesday's opening of Parliament, at which the Government will, as tradition dictates, outline its economic agenda for the year.

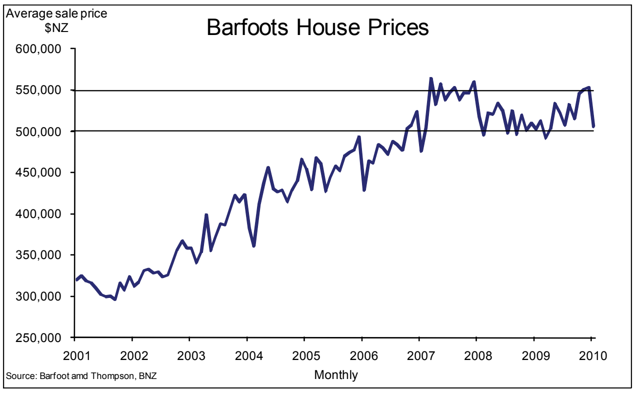
This occasion, of course, is always important for anyone with a serious interest in the economy's future – but particularly now, when many voters are wanting to know the true stripes of this new Government, and what it plans to shake up in order to sustain economic growth over the medium term.

The Government's announcements in Parliament – from 2pm, local time – will be of particular interest to anyone with a stake in the housing market. And we're not just talking about landlords. Proposed changes to the tax treatment of housing could have important ramifications for first-home buyers, renters and existing owner-occupiers alike.

In the end, Tuesday's proclamations might fall short on specifics, to the point of disappointing the many who will no doubt be tuning in for a clear steer. Still, there is a growing recognition there are some material policy changes in the wind, with crystallisation set for May's Budget – whether one agrees with the various proposed tax changes or not.

And we say this with the housing market having shifted into a cautious mode already. It's hard to know how much of this reflects uncertainty around tax treatment. However, we did find it interesting that today's QVNZ market report suggested weakness in investor interest is beginning to emerge, relative to first-home buyers.

What's most obvious, however, is that turnover, overall, is hitting skids again. The latest example was last week's Barfoot and Thompson (B&T) report for the Auckland market, where sales dropped nearly 20% in January, on our seasonally adjusted estimate.



And much of the fall in the B&T average sale price, to $505,301 reflected moving to a normal composition of sales. It was December's price, of $552,933, that seemed skewed, as sales of higher-end properties in that month inflated the average. Overall, we were left with the impression like-for-like home prices were only slightly up on a year or two ago.

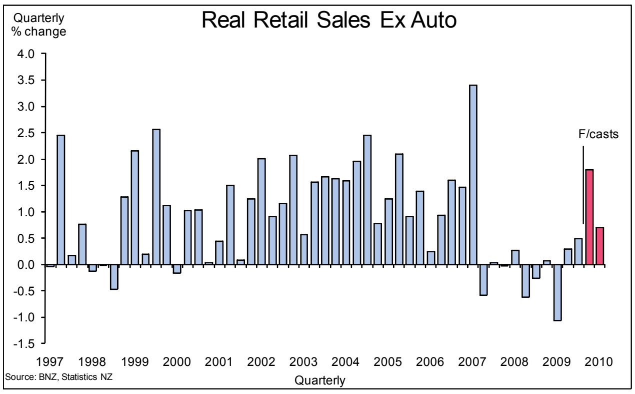
We can say the same about the latest QVNZ house price index, especially considering it's a three-month average reading, and so will be slow to reflect the moderation we've been seeing, month to month, in a broad range of housing indicators. No wonder Alan Bollard, in his TV interview over the weekend, described the local housing market as "spongy".

And further holes are likely to be evident in Friday's REINZ housing report. To be as soggy as we reckon, we're looking for January's home sales to be in the order of 4,000. While this would be up nearly 10% on a year ago, it would nonetheless imply the fourth clear fall in as many months, seasonally adjusted.

There is even a good chance of the REINZ median sale price slipping from December's $360,000, given the sort of compositional correction noted in the B&T results.

Friday's other important data release, of course, is retail sales. We expect these to be not as soft as much of the recent domestic data have been. In particular, we anticipate Q4 retail volumes expanded 1.4%, in line with market expectations. Ex-auto volumes could well increase by even more. If so, it will fit with the robust consumer confidence we've seen over recent months.

However, we are not convinced it all signals the start of consumer spending resurgence. Some of the improved



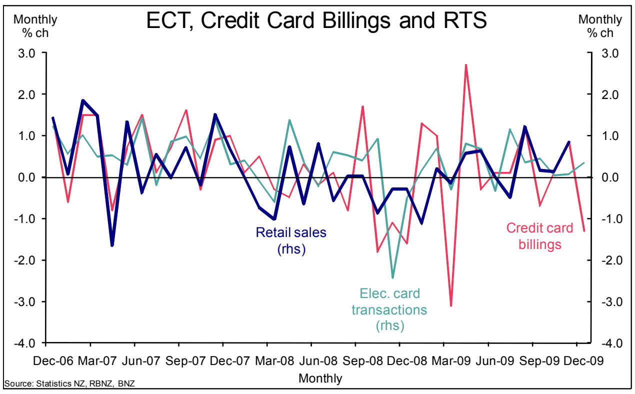
volume, for example, will likely reflect discounting, manifest in a flat to lower retail price index for the December quarter.

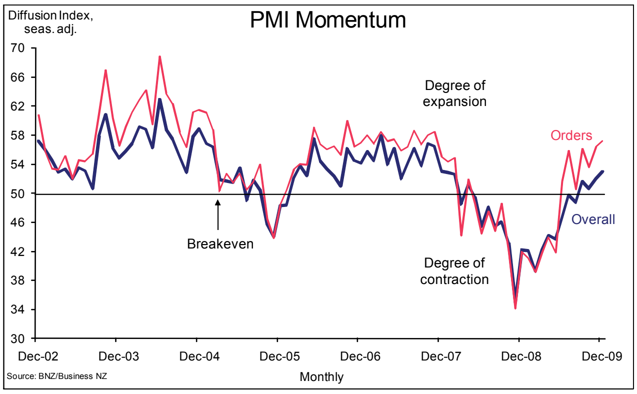
What interests us the most, however, is the retail result for the month of December. We are looking for this to expand 0.2%, overall, and 0.1% in ex-auto terms (a bit lower than the market medians, respectively).

One of the reasons we've been conservative on these numbers is that credit card billings and electronic card transactions have already printed on the soft side for December. In this vein, Wednesday's electronic card transactions, for January, will be a more immediate test of the spending pulse, ahead of Friday's retail figures.

As for Thursday's Performance of Manufacturing Index, this will be watched for a consolidation of its recent good gains (to a seasonally adjusted 52.9, in December), while we expect January's food prices to bounce back a bit from recent successive declines.

And speaking of reversals, we also note the NZ Government noises about withdrawing its wholesale





funding guarantee scheme. This is no real news – in that the scheme was "tapped" just the once, quite a while ago. And the withdrawal is essentially good news, in that it signifies the strength of the wholesale markets. For similar reasons, the Australian Government has just announced its scheme will expire at the end of March.

New Zealand's wholesale guarantee scheme, of course, is different to the retail deposit guarantee scheme. The latter is set to run until the end of 2011 – albeit with prescriptions that have been tightened since first announced.

In respect of regular monetary policy, however, the RBNZ Governor, Alan Bollard, sounded cautious in a TV interview over the weekend. Speaking to TV One's Q&A programme, suffice it to say he frequently used the word fragile, or some conjugation of it, to describe the domestic and international economy. And well he might.

Yes, he did downplay the surprisingly high jobless number from last week. However, the bulk of what he said would hardly have been good news for a market still eager to price a tightening cycle sooner, and more definitely, than the RBNZ itself is forecasting and intoning. When grilled on the prospects of a June lift to the OCR, the most Bollard could muster was a maybe.

And it wasn't just the wholesale money market traders the Governor was having a bit of a dig at, but also currency traders, in a gentler way. His remarks that the NZ dollar was probably overvalued, in relation to still tender fundamentals, was another something hinting at his ongoing caution about the way ahead. It might not quite wash with many in the markets. But Bollard's tack looks like common sense to us.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates rallied and steepened significantly on the week with the major drivers being an unexpected pause by the RBA and unemployment coming in unexpectedly high at 7.3%. This combination saw the market move the projected hiking track back significantly, with the April meeting now priced as just a 40% chance of a hike and a further 25bp priced for the June meeting. Around 140bp of total hiking is priced into the OCR by the end of 2010. While there is potential for the market to price the start of the hiking cycle further out still, it is likely that this rally should run out of steam fairly soon.

The front end of the bond market followed the general theme of the week and 2011 maturity bonds saw a 15pt rally on the week and were well supported in the tender. There has been a notable lack of issuance in longer bonds recently and with the recent outperformance of the short bonds we favour a flattener for this week.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
29-Jan-10	2.76%	3.99%	5.62%	4.38%	5.88%	150
5-Feb-10	2.76%	3.84%	5.53%	4.24%	5.88%	164
Change (bps)	**0**	**-15**	**-9**	**-14**	**0**	**14**

The swaps market also saw good performance from the shorter dates while steepening considerably, the 10-yr swap finishing the week unchanged. There seems to be good interest for borrowers to hedge 10-yr swap risk below 6% and this is holding up the back end of the curve. Risk reward now seems good to pay 2-yr swap around these levels, with the hiking cycle implied by the swap rate not particularly aggressive and the lack of term premium that is usually built into the rate.

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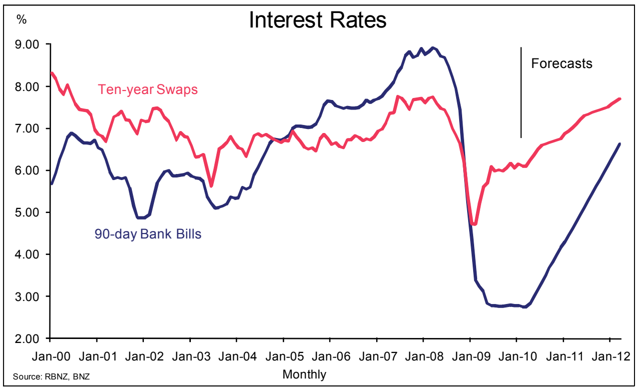

Interest Rate Technicals

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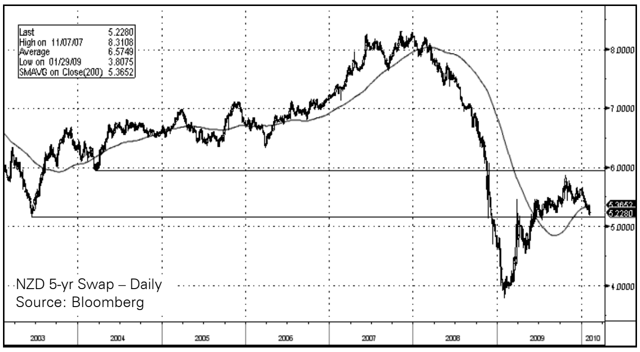
NZD 5yr Swap Rate

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

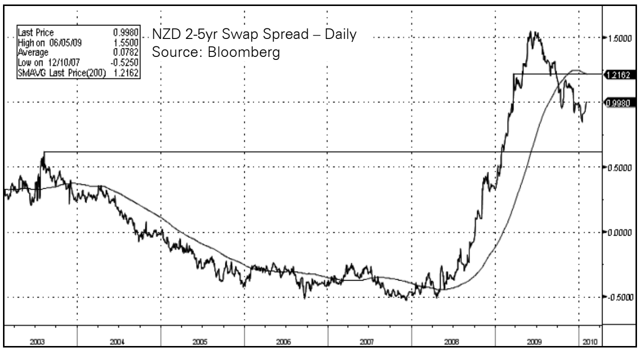
We continue to track towards LT support at 5.09%. Overall, however, the market is range trading and does not look like breaking out in the near term.



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

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

Last week we steepened as the short end rallied hard. However, 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

The NZD was the worst performing currency last week. It tumbled about 2.7% against the USD to a 5-month low of nearly 0.6800.

Global risk aversion was the dominant theme in currency markets last week. Renewed concerns about the health of European sovereigns pummelled equity markets and sent global risk appetite tumbling. Following the EU's endorsement of Greece's deficit cutting plans, market focus quickly shifted to other troubled sovereign states – Spain and Portugal. A Spanish government back-down on pension reform added to deficit concerns, while Portuguese sovereign CDS spreads widened to almost 230bps amid mounting political tensions over cutbacks in regional spending. Our risk appetite index (which has a scale of 0-100%) slumped to 44% from 56% in the middle of the week. The MSCI World Equity Index fell 2.1%, the fourth consecutive weekly decline.

Global data did nothing to allay investor concerns about the global recovery. Most notably, January's US non-farm payrolls report showed that 20,000 jobs were shed during the month. Not only was this worse than the expected 15,000 gain, but heavy downward revisions to previous months meant that job losses in 2009 were far worse than previously reported.

Heavy losses across global equities and rising risk aversion took a toll on growth sensitive currencies like the NZD as investors rushed back into the relative safety of the USD and JPY. Short-term speculative players and model-driven accounts were noted as active sellers of JPY crosses last week. NZD/JPY skidded from around 65.00 to below 61.00 and NZD/USD was dragged down to nearly 0.6800.

The NZD was also weighed down by disappointing local data. The fourth quarter HLFS revealed a spike in NZ's unemployment rate to 7.3% in Q4, from 6.5% a quarter earlier. It was the highest reading since June 1999. The extent of the move caught everyone by surprise, most notably the RBNZ who were looking for an unemployment rate of just 6.6%. As such, markets quickly backed off the April hike they had previously favoured, and NZ-US 3-year swap spreads narrowed to 305bps from 315bps at the start of the week.

G7 finance ministers met over the weekend. European policy makers tried to reassure their peers that the fiscal troubles in Greece were under control. We suspect the fiscal woes of Greece, Portugal and Spain will remain the spotlight again this week, while investors wait for a concrete plan from the EU to tackle the crisis. Despite assurances from EU officials at the weekend's G7, investors remain sceptical as to whether Europe can solve the crisis.

Locally, there's a bit to keep an eye on this week – including Q4 retail sales, January's REINZ housing market report and the BNZ PMI. However, global sentiment and risk aversion will likely be the key influence on NZD again this week. In the absence of another meltdown across global equities, we expect NZD/USD to find some support ahead of 0.6800 and stabilise a little this week.

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Foreign Exchange Technicals

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NZD/USD

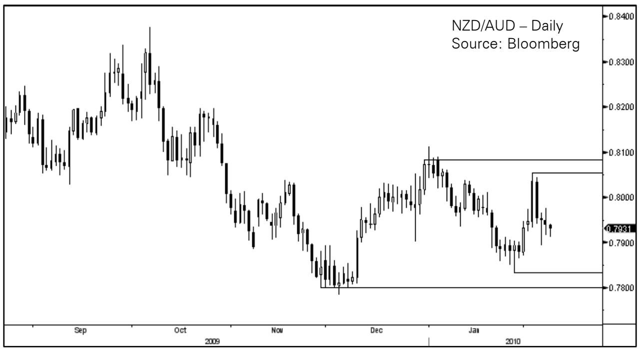
Outlook:	Sell a rally
ST Resistance:	0.7000 (ahead of 0.7170)
ST Support:	0.6790 (ahead of 0.6720)

The break below 0.6970 confirmed the downtrend. However, the failure to break 0.6800 suggests a rebound towards 0.7000 is on the cards.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8050 (ahead of 0.8085)
ST Support:	0.7830 (ahead of 0.7790)

The failure to sustain dips below 0.7850 suggests the downtrend has stalled for now. Equally, the rejection of 0.8050 last week suggests we are in for more range-trading near-term.



Key Upcoming Events

	Forecast	Median	Last
Monday 8 February			
NZ, QVNZ House Prices, January			+2.8%
Jpn, Eco Watchers Survey (outlook), January			36.3
Tuesday 9 February			
NZ, Govt. Comments on Tax Policy (from 2pm NZT)			
UK, BRC Retail Sales Monitor, January y/y			+4.2%
UK, RICS Housing Survey, January		+27%	+30%
UK, Trade Balance, December		-£2.8b	-£2.9b
US, Wholesale Inventories, December		+0.5%	+1.5%
Germ, Trade Balance, December s.a.		+€15.0b	+€17.4b
Wednesday 10 February			
NZ, Electronic Card Transactions, January			+0.3%
Aus, Housing Finance, December	-7.0%	-5.0%	-5.6%
Aus, Consumer Sentiment - Wpac, February			120.1
Jpn, Machinery Orders, December		+8.0%	-11.3%
UK, BOE Inflation Report			
UK, Industrial Production, December		+0.2%	+0.4%
US, International Trade, December		-$35.5b	-$36.4b
US, Fed's Plosser Speaks, Financial Crisis			

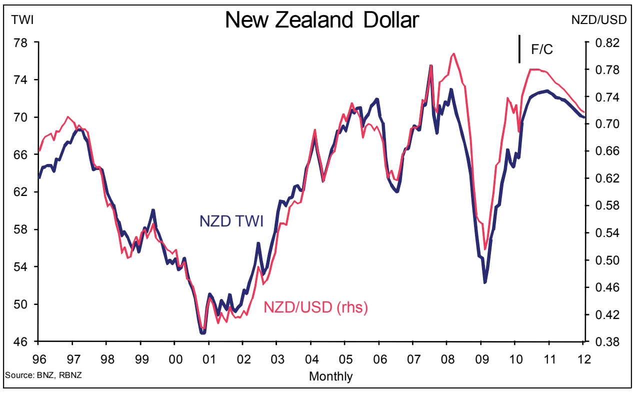
	Forecast	Median	Last
Wednesday 10 February *continued...*			
US, Bernanke Testifies, Liquidity Programmes			
China, Trade Balance ($US), January			+$18.4b
Thursday 11 February			
NZ, BNZ PMI (Manufacturing), January			52.9
NZ, Food Price Index, January	+0.5%		-0.3%
Aus, Unemployment Rate, January	5.6%	5.6%	5.5%
Aus, Employment, January	+15k	+15k	+35k
Euro, ECB Monthly Bulletin			
US, Business Inventories, December		+0.3%	+0.4%
US, Retail Sales, January		+0.3%	-0.3%
US, Jobless Claims, week ended 06/02		465k	480k
Friday 12 February			
NZ, Retail Trade, December	+0.2%	+0.5%	+0.8%
NZ, Retail Trade, Q4 vol s.a.	+1.4%	+1.4%	+0.1%
NZ, REINZ Housing Data, January			
Euro, Industrial Production, December		+0.1%	+1.0%
Euro, GDP, Q4 1st est		+0.3%	+0.4%
US, Mich Cons Confidence, February 1st est		75.0	74.4

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	2.72	2.73	3.96
2 mth	2.74	2.75	2.75	3.72
3 mth	2.74	2.75	2.76	3.54
6 mth	2.94	3.01	3.03	3.20
GOVERNMENT STOCK				
11/11	3.99	3.99	4.21	3.45
04/13	4.70	4.70	4.94	3.86
04/15	5.18	5.18	5.43	4.24
12/17	5.62	5.62	5.77	4.54
05/21	5.93	5.93	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.61	3.76	3.88	-
BNZ 05/15	6.44	6.49	6.68	-
GEN 03/14	6.56	7.25	6.69	-
GEN 03/16	7.17	7.65	7.14	-
TRP 12/10	4.07	4.20	4.36	4.10
TRP 06/20	7.15	6.95	7.39	5.87
SWAP RATES				
2 years	4.38	4.38	4.56	3.45
3 years	4.84	4.84	5.07	3.75
5 years	5.30	5.30	5.52	4.12
10 years	5.88	5.88	6.07	4.76

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6881	0.7002	0.7387	0.5303
NZD/AUD	0.7930	0.7958	0.7957	0.7855
NZD/JPY	61.51	63.00	68.24	48.68
NZD/EUR	0.5037	0.5053	0.5115	0.4092
NZD/GBP	0.4413	0.4390	0.4596	0.3585
NZD/CAD	0.7350	0.7502	0.7602	0.6479
TWI	64.02	64.69	66.90	53.15

NZD Outlook



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