15 February 2010

What Next?

- Consensus now just fine-tuning recovery stories
- As financial markets await clear direction
- Will recoveries surprise to the upside, or disappoint?
- This week's 2nd tier data to affirm gradual NZ recovery
- Next week's business survey the next big test

Global growth expectations continue to edge up. But they now seem close to being an exercise in fine-tuning, of a "reasonable" economic recovery. The great majority of nation economies are forecast to advance at a solid, if unspectacular, fashion from here on – although some are clearly lagging in the recovery stakes at the moment (with Euro-zone's Q4 GDP increment of just 0.1% the very latest example).

Formally, the consensus sees its "global" GDP measure expanding 3.1% this calendar year. This is a bit above the average outcome since the early 1990s but probably bang on average if one considers the greater weight of naturally faster-growing economies in world GDP these days. A steady 3.3% is projected for 2011.

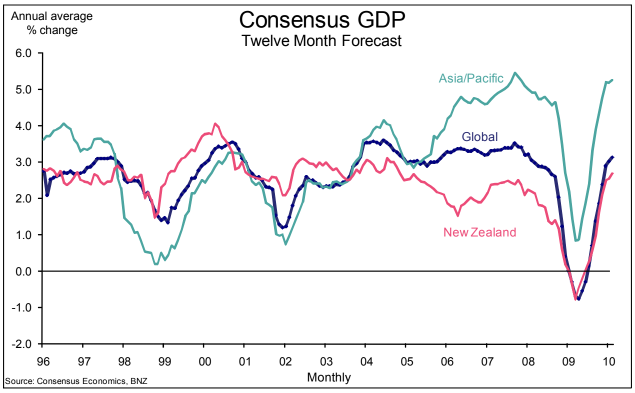
So, not a booming recovery by any stretch, but no room for any hiccups along the way either.

From here, then, it's a matter of wondering whether things do surprise to the strong side, as can so often happen following recessions. Or whether there will be a loss of momentum for any number of reasons, which would be a real blow.

The markets are intently weighing up these risks, searching for clues, as they continue to chop around.

And what's true for the world is true for New Zealand at present. The consensus envisages local GDP growth of 2.6% this year and 3.1% next. These probably average out at about New Zealand's potential growth rate. That's good, but hardly the four to five to six percent annualised rates of expansion we experienced following previous recessions and that were important for soaking up the slack.

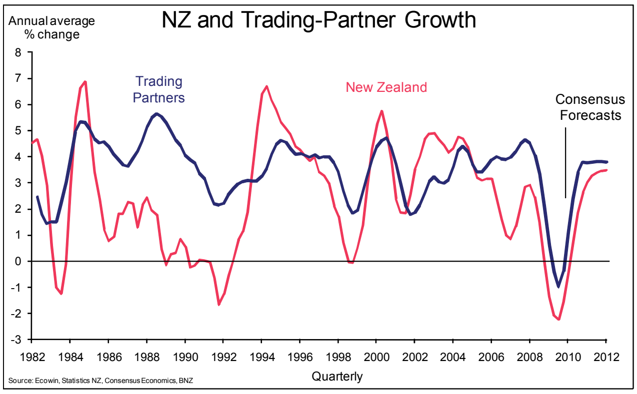
As for the markets' view on NZ interest rates, following a bit more of a rally over the last week or two they have essentially further delayed the start of the tightening cycle to June, much as the RBNZ has recently indicated. As such, market pricing is also now reasonably well aligned to our existing view.



For the near term, we're still conscious of the risks of disappointment, with a fair bit now depending on the local housing market, and its impact on spending and confidence. We say this not being convinced the recent softening is simply a reservation around the housing taxation proposals. We thought the market would struggle to push on anyway.

Sure, there's a chance of some bounce-back with the Government last week ruling out a land tax, a comprehensive capital gains tax, and a risk-free-rate-of-return charge on landlords. However, the strong suggestions that depreciation allowances for property investors will be culled would seem to be enough of a big deal in itself. We'll thus be watching the upcoming housing data, half-expecting further weakness.

But beyond the near term other taxation proposals have the potential to give demand a boost, relative to what was previously expected. On the assumption GST will be hiked to 15% (from its current 12.5%) as soon as 1 October, accompanied by personal tax cuts of more than



compensatory degree, the potential for rip-roaring demand in Q3 looms large, with only part of the momentum lost in Q4 owing to the post GST-hike hangover.

Yes, the Government should be “fiscally neutral” with its May Budget, with deficits and debt under great scrutiny nowadays. But it will be sorely tempted to err on the side of net stimulus, in effect.

This is part of what’s keeping us at June for a first OCR from the Reserve Bank, when the broader risks were probably tilting toward further delay.

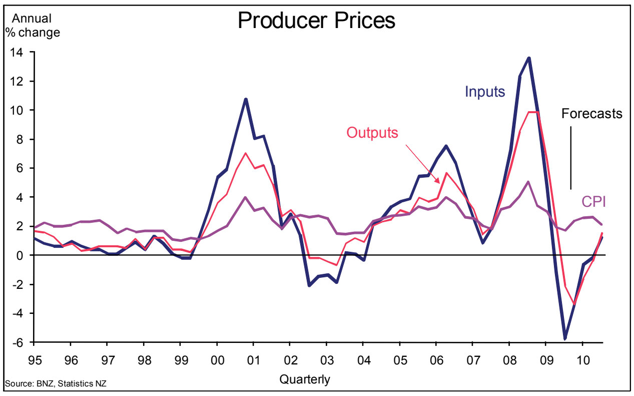
Put another way, if the RBNZ wanted a window to simply tweak its OCR up a bit, then there might be some excuse for it from around mid-year, if the indicators prove as strong as they could be based on policy changes.

As for this week’s local data, however, none of it looks likely to give the markets clear direction (that will probably have to wait for next week’s NBNZ business survey).

While this morning’s Performance of Services Index continued to drift off its November high, this seemed largely a seasonal phenomenon (the PSI is not yet long enough to allow a reliable seasonal adjustment). Underneath the headline results, we judged a maintained forward momentum in the services sector, of reasonable extent.

Tomorrow’s Q4 producer prices will likely affirm the mild inflation undertones already seen in the likes of the CPI, wages and even last week’s retail price deflator. While the PPI results are always extremely difficult to pick, and invariably ignored by the markets in any case, there are usually interesting stories in the economy-wide detail. That’s what we’ll be digging for.

As for the overall PPI prints, we’re expecting pretty flat results for each of output and input prices in Q4, meaning



annual declines in the order of 3.5%. These are in line with the market medians.

For Wednesday’s NBNZ Regional Trends survey, we anticipate this to be broadly consistent with the 0.4% expansion we still estimate for Q4 GDP.

Thursday’s ANZ-RM consumer poll will be of more interest to us, relatively speaking. We wouldn’t be surprised to see it knocked a bit from the strong 131.4 it hit in January. That looked a bit overdone, given the mild trend in actual consumer spending and the faltering housing market.

December’s Crown accounts are due for publication Friday morning, for which square-up from the trading-day boosted November results will be of some interest.

But it’s Friday afternoon’s credit card billings that will be of more significance. For January, these will be a useful test on the pulse of consumer spending – especially following last week’s underwhelming retail statistics for Q4, and particularly the month of December. We still believe some underlying growth is budding. Still, we’ll need to see a strong bounce in January’s credit card billings, from their big dip in December, in order to affirm a positive trend.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

Domestic interest rates saw some volatility on the week but relatively little direction, with a further rally in the short dates the most significant move of the week. The market has continued to push the expected hiking cycle back, with the April meeting now priced at around a 20% chance of a hike, with 25bp priced in June. There is still around 140bps of hiking priced into the curve through to the end of the 2010. With relatively little data and a significant rally behind us, it is likely that we'll consolidate around this pricing over the next week.

The bond market washed around on the week, taking its lead from offshore and the swaps market. The tender was unusually small with just $100 million on offer, but was well supported. The weak economic data should keep a bid tone to the short end while the market will continue to watch offshore for direction.

The swaps market followed the general theme and finished the week largely as it had begun. Technically the 2-yr swap is near resistance at 4.20% – a level that was significant on the way up. The back of the curve remains fairly well anchored around the same point, with corporate paying interest still significant a little below here. At these levels it still seems likely that the next significant move will be to higher yields and is likely a good place to look to enter into paid positions, although timing the market is important with carry still very expensive.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
5-Feb-10	2.76%	3.84%	5.53%	4.24%	5.88%	164
12-Feb-10	2.74%	3.86%	5.55%	4.25%	5.89%	164
Change (bps)	**-2**	**2**	**2**	**1**	**1**	**0**

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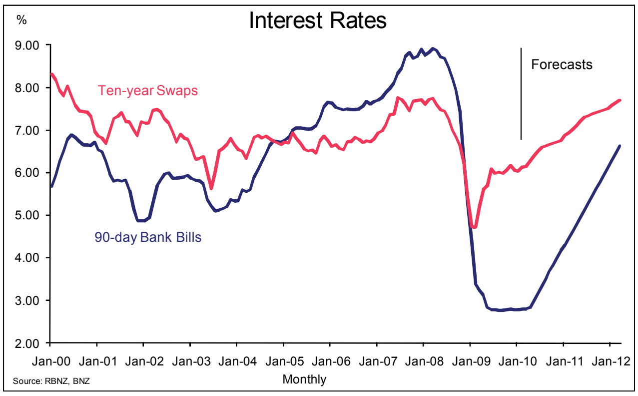

Interest Rate Technicals

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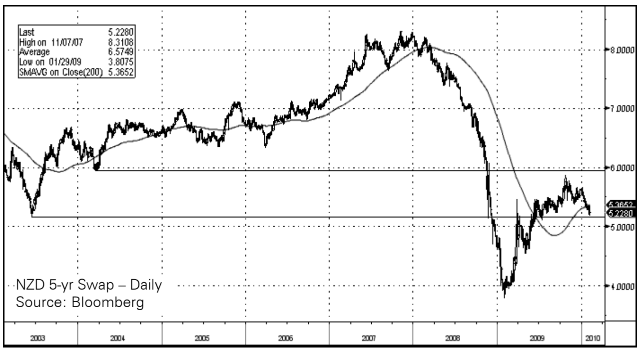
NZD 5yr Swap Rate

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

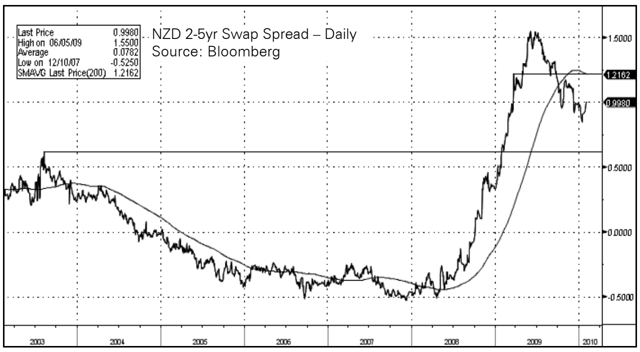
We continue to track towards LT support at 5.09%. Overall, however, the market is range trading and does not look like breaking out in the near term.



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 stabilised last week. After testing 5-month lows around 0.6800 early in the week, NZD/USD finished the week closer to 0.7000.

Having started the week on the back foot, investors' risk appetite recovered towards the end of last week. Hopes the EU would ride to the rescue of Greece and prevent a potentially calamitous sovereign default saw Greek bond spreads ease off their highs and equity markets claw back some of their losses. The DAX, FTSE and S&P500 all rose over the week, breaking a 4-week losing streak. Our risk appetite index (which has a scale of 0-100%) recovered nearly 10% to 52.8%, from 43.3% at the start of the week.

Improving risk appetite and gains in equity markets helped stem the losses in NZD/USD, and the currency finished the week up a bit over 1%. Against the friendless EUR, gains were more like 1.5%. However, it wasn't all one-way traffic for the NZD. China's surprise decision to raise reserve requirements by another 50bps provided another set-back for risk appetite and the NZD. The local backdrop also failed to provide any solid support for the currency last week. Both December retail sales and January REINZ housing market data undershot expectations, calling into question the strength of NZ's economic recovery and capping NZD/USD gains at around the 0.7000 region.

For this week, it's really only bits and bobs on the local data schedule. As such, the NZD will likely continue to take its cues from offshore. In particular, markets' focus early in the week will be the EU Finance Ministers meeting where investors are hopeful officials will fill in the blanks in terms of exactly what form of support will be provided to Greece.

We remain of the view the recent NZD correction is more of a setback than a new trend. It seems likely that some form of support will eventually be extended to Greece and, at that point, fundamentals should begin to reassert themselves. The lower bound of our short-term valuation model (which is based on risk appetite, NZ-US interest rate differentials and commodity prices) is currently sitting at 0.7150. This suggests that, failing another flare up in sovereign debt concerns, dips in NZD/USD towards 0.6800 are unlikely to be sustained this week.

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Foreign Exchange Technicals

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NZD/USD

Outlook:	Buy a dip
ST Resistance:	0.7120 (ahead of 0.7170)
ST Support:	0.6820 (ahead of 0.6780)

The failure to sustain dips towards 0.6800 suggests the downward momentum has stalled. A daily close above 0.7000 would be consistent with a rebound back towards 0.7150.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8000 (ahead of 0.8055)
ST Support:	0.7830 (ahead of 0.7790)

The market has been trading choppily within familiar ranges. We'd view a failure to break above 0.7900 as a sell signal.

Key Upcoming Events

	Forecast	Median	Last
Monday 15 February			
NZ, BNZ PSI (Services), January			54.4
Jpn, GDP, Q4 1st est		+0.9%	+0.3%
Tuesday 16 February			
NZ, PPI Outputs, Q4 y/y	-3.4%	-3.5%	-2.1%
Aus, NAB Business Survey, January			
Aus, RBA's Debelle Speaks			
Aus, RBA Minutes, 2 Feb Meeting			
UK, CPI, January y/y		+3.5%	+2.9%
US, Empire Manufacturing, February		+18.00	+15.92
US, NAHB Housing Index, January		16	15
Germ, ZEW Sentiment, February		+41.0	+47.2
Wednesday 17 February			
Aus, Westpac Leading Index, December			+1.0%
UK, BOE Minutes, 3/4 Feb Meeting			
UK, Unemployment rate (ILO), December		7.8%	7.8%
Euro, Trade Balance, December (s.a.)		+€3.9b	+€3.9b
US, Housing Starts, January		580k	557k
US, Industrial Production, January		+0.8%	+0.6%
US, FOMC Minutes, 26/27 Jan Meeting			

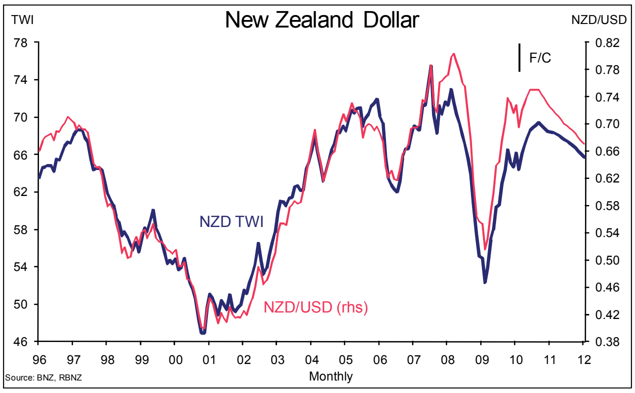
	Forecast	Median	Last
Thursday 18 February			
NZ, ANZ-RM Consumer Confidence, February			131.4
Aus, NAB Business Survey, Q4			
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%
UK, CBI Industrial Trends, February			-39
US, Philly Fed Index, January		+17.0	+15.2
US, Leading Indicator, January		+0.5%	+1.1%
US, Jobless Claims, week ended 13/02		430k	440k
US, PPI ex-food/energy, January y/y		+0.8%	+0.9%
Friday 19 February			
NZ, Credit Card Billings, January			-1.3%
NZ, Crown Financial Statements, December			
Aus, Stevens Testifies, House of Reps.			
Jpn, BOJ Economic Report			
Jpn, All Industry Index, December		+0.1%	+0.1%
UK, Retail Sales vol., January		-0.5%	+0.3%
Euro, PMI Manufacturing, February 1st est		52.7	52.4
Euro, PMI Services, February 1st est		52.5	52.5
US, CPI ex food/energy, January		+1.8%	+1.8%
Germ, PPI, January y/y		-4.0%	-5.2%

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	2.75	3.90
2 mth	2.74	2.74	2.76	3.59
3 mth	2.74	2.74	2.77	3.39
6 mth	2.94	2.94	3.05	3.20
GOVERNMENT STOCK				
11/11	3.85	3.99	4.20	3.48
04/13	4.59	4.70	4.87	3.89
04/15	5.08	5.18	5.36	4.26
12/17	5.55	5.62	5.70	4.57
05/21	5.85	5.93	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.59	3.61	3.86	-
BNZ 05/15	6.50	6.44	6.59	-
GEN 03/14	6.56	6.56	6.60	-
GEN 03/16	7.18	7.17	7.05	-
TRP 12/10	3.94	4.07	4.35	3.93
TRP 06/20	7.16	7.15	7.30	5.81
SWAP RATES				
2 years	4.21	4.38	4.57	3.33
3 years	4.70	4.84	5.01	3.65
5 years	5.20	5.30	5.43	4.02
10 years	5.85	5.88	5.98	4.70

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6953	0.6881	0.7345	0.5215
NZD/AUD	0.7828	0.7930	0.7977	0.7979
NZD/JPY	62.60	61.51	66.65	47.74
NZD/EUR	0.5108	0.5037	0.5118	0.4070
NZD/GBP	0.4436	0.4413	0.4518	0.3669
NZD/CAD	0.7308	0.7350	0.7568	0.6438
TWI	64.52	64.02	66.54	52.91

NZD Outlook



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