8 March 2010

OCR Upside Coming Into Sharper Focus

- RBNZ to stay "on message" at Thursday's MPS
- June OCR hike still most likely
- Today's data strengthen our Q4 GDP pick to 0.8%
- January's retail sales likely recovered very well
- Most other reports to affirm New Year momentum too

We expect the RBNZ will remain "on message" at its Monetary Policy Statement (MPS) this Thursday. It has no obvious justification to shift tack at this stage.

The recent economic evidence has not been screaming for the Bank to start lifting the Official Cash Rate "around the middle of the year", as it previously indicated. Indeed, some of the data have been a tad disappointing. Meanwhile, international concerns linger large, with sovereign debt issues the latest incarnation.

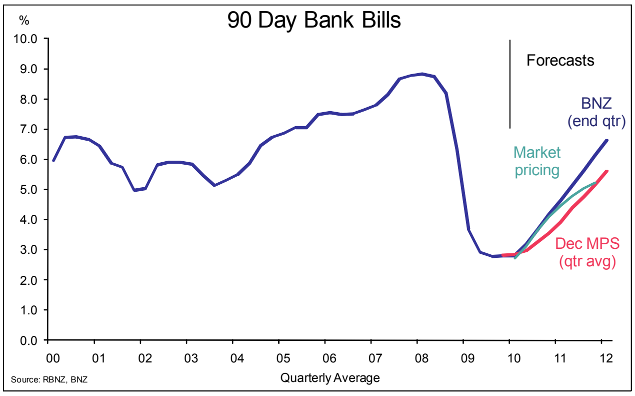
However, there also seems enough to indicate the NZ economy will pick up as strongly as the Reserve Bank anticipates. Business and consumer expectations are strong to the point of foretelling a veritable surge in GDP growth. The May Budget, on balance, promises to reinforce momentum from mid-year. Even some of the data from the global economy's weakest links are looking stronger, while our largest trading partner, Australia, simply swims forth.

And while there are obvious risks of starting to remove stimulus too soon, there are also hidden dangers in diluting the message that short-term interest rates will need to rise before too much longer. Softening this warning might slacken the intent of businesses and consumers to sort out their debt loadings, just when such a desirable de-leveraging process would appear to be underway.

All things considered, then, we still prefer June as the start-point to OCR hikes – a view we've had on the board for quite some time now.

Granted, for the very near term, the risks are for a drift toward July as a starting point, at least in the market's mind. However, we're also conscious of news that might stop this process firmly in its tracks and even force the RBNZ to do more than the 25bps per meeting we expect, at least initially.

This, of course, simply underscores the bigger message we continue to stress; in the end, the shape of the RBNZ tightening cycle is highly dependent on the news, and the outlook.



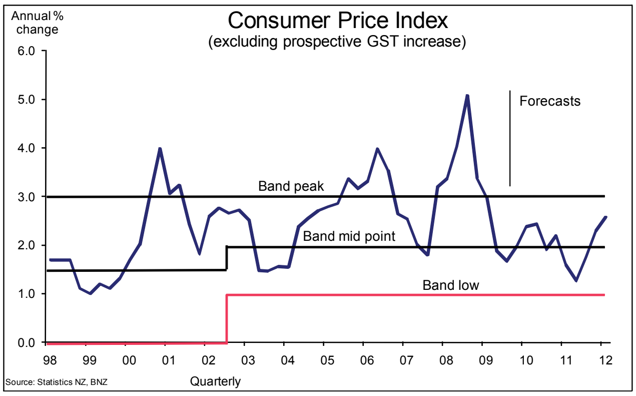
As for the Reserve Bank's core forecasts, we suspect Thursday's edition will not be dissimilar to what it had last time, or our own projections. The only true difference will be a slightly softer starting point for the economy in terms of the labour market, core inflation and the immediate housing prognosis. But we wouldn't make too much of this. The Bank's bigger job is to gauge the outlook for overall GDP growth and inflation. And these do not offer oodles of slack.

In this vein, perhaps the most interesting thing about this week's MPS is whether it makes any mention of the Government's Budget, due 20 May. Formally, the Bank is hamstrung on such things, as it has to defer to announced government policy, for obvious reasons.

But the Government itself has been sounding the high likelihood of the Budget doing such things as abolishing depreciation allowances on property investments, increasing the Goods and Services Tax to 15% as early as 1 October, while reducing the top personal tax rate to 33%, from 38%.

The net result will probably be a stimulative Budget, especially for its potential to boost spending for the very near term. This would include the potential for new home-building activity and sales to rush to beat any rise in GST, for which it is liable.

And the presumed rise in GST will overlap with a number of other one-offs directly impacting on the CPI. Prime examples are the 1 July introduction of the Emissions Trading Scheme, which will bump up fuel and electricity prices, and the higher ACC charges implemented to better fund the Government's insurance scheme. All of this has the potential to push annual CPI inflation above 4.0% by the end of this year.



We know the Reserve Bank will look through these spikes as best it can. And it can probably do so with some comfort in that core price pressure is likely to be relatively muted this year. Still, CPI inflation running above 4.0% could prove nettlesome for the RBNZ if it coincides with surging GDP growth.

Of course, none of the indicated Budget changes – CPI-wise or GDP-wise – will be in the Reserve Bank's MPS projections this Thursday. But they should certainly be in its thoughts and risk profiles.

Other than that, we'll expect the key policy signal from this week's MPS to come courtesy of its forecasts of 90-day bank bill yields. We would expect these to be essentially unaltered from that portrayed in the December MPS. This would imply a first OCR hike "around the middle of the year", with decimal rounding disallowing any more precision than that.

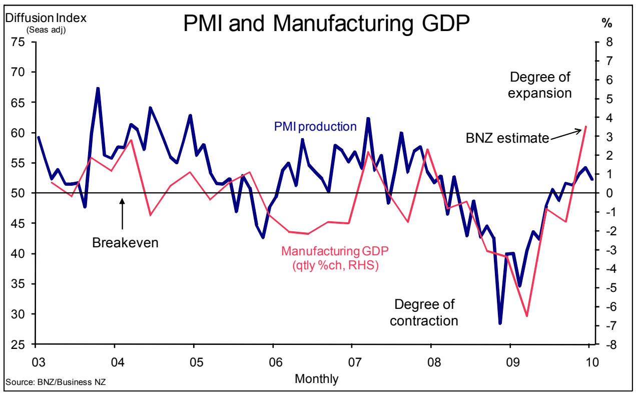
All the while, we'll keep monitoring the news in order to gauge the timing and degree of the economic rebound and RBNZ response we currently anticipate.

In this context, there's certainly a lot of data this week to check off.

This morning's Q4 GDP indicators were an immediate example of the sort of turnaround we believe is brewing, and will keep the RBNZ on its game. Indeed, the manufacturing and construction results were each clearly better than we expected.

We had been looking for the Q4 manufacturing survey to imply a production bounce of 1.5%. Instead, it looks to be more like 3.5%. Sure, it's mainly coming from petroleum (no doubt related to the new Maari oil field), wood and dairy – the very groups also looking by far the best in the export figures. However, it's an overall positive for GDP growth.

And there were even signs that inventories for the manufacturing sector as a whole were still being run to the low side, which helps support production going forward.

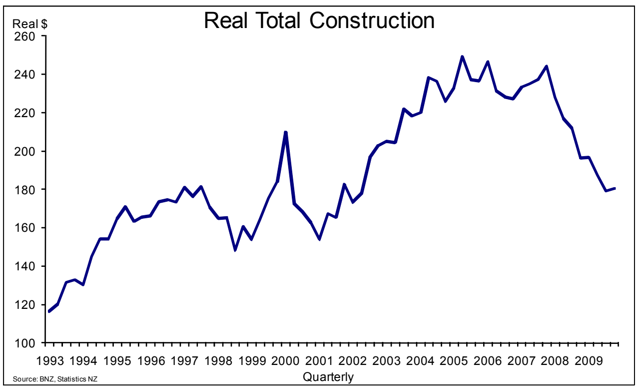


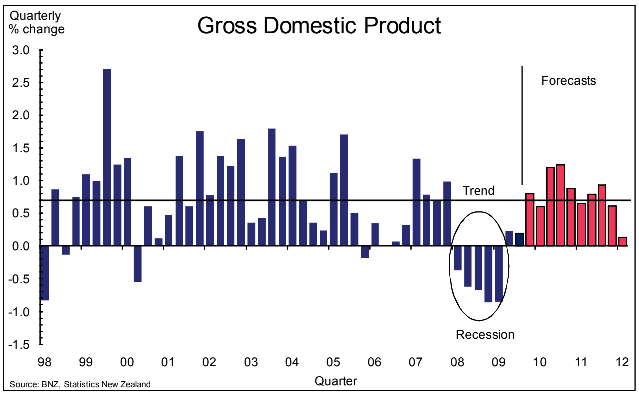
In this sense, the Q4 manufacturing results aligned very well with the recent trends in the Performance of Manufacturing Index. The PMI has been describing a rebound in production, on the firmer foundation of tighter stock control and improving demand by way of rising new orders. It will thus be interesting to see if this good momentum continued in February's PMI survey, due Thursday (10:30am).

As for the December quarter construction results, yes, the 0.7% volume gain was hardly much. However, we expected a further, albeit mild, slip. The 6.1% drop in non-residential construction (-13.0 y/y) was about what we anticipated. What surprised us was the timing of the 7.4% increase in real residential work. We thought the gains heralded by the pick-up in building consents would begin to show more in the first half of 2010.

Timing or no, the actual Q4 construction results complement the upside GDP forces outlined in the manufacturing survey. Indeed, they bumped up our production GDP growth estimate to 0.8%, from 0.4%. This better matched it, interestingly enough, to our expenditure GDP computation, which had been tugging more on the leash to begin with. It's also worth recalling that 0.8% is more than the 0.6% growth the RBNZ previously expected for Q4 GDP.

For more on Q4 economic activity, Wednesday's Overseas Trade Indexes (OTI) will oblige. We're assuming they register a 2-3% drop in merchandise export volumes,





on the basis export prices jump 7.7% as the OTI dairy price measures catch up to the increases we know have occurred in spot markets.

For goods imports, the waters are muddier, but we're looking for a marginal drop in prices and a modest increase in core volume.

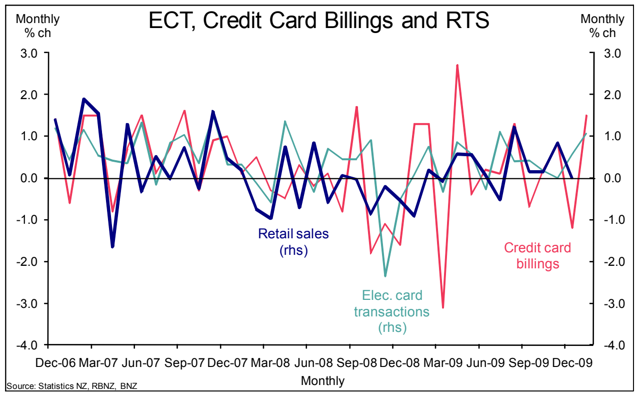
The market is different to us principally in picking less of a bounce in export prices (so inferring a relatively solid volume result), which manifests in a lesser terms of trade rebound of about 2.5%. We're picking +8.3%.

As well as the various surveys of Q4 economic activity this week, there are a number of indicators of New Year activity. We believe most of them will affirm continued momentum.

Overnight, we get the latest quarterly Manpower survey of staffing intentions. The previous survey had already repaired to +14 as a net balance. And we know employment intentions have only improved over recent months, suggesting net job increases will emerge by mid-year. This will gradually make inroads into unemployment.

Later tomorrow morning, Statistics NZ publishes its electronic card transactions (ECT) for the month of February. We expect these retained a moderately positive trend with gains in the range of 0.5-1.0%.

In many ways the ECT data will trump Friday's retail trade results for January. Still, there will be a lot of attention on the retail numbers, following the way they surprised very much to the downside for December. We were not



convinced they signalled a complete stalling. And so we look for January's retail sales to recovery by about 0.8%, with an even better bounce-back in ex-auto terms, of 1.3%. The market is not quite so confident, with median expectations of 0.5% and 0.9% respectively.

We've already mentioned Thursday's PMI, but also note the day's Food Price Index for February. It surged 2.1% in January, much of which looked to be fundamental rather than peculiar to a specific category. So we're picking a sticky 0.2% result for February, which will keep a strong contribution to the Q1 CPI in view.

In this sense, perhaps the only soft data item of the week will be Friday's report from the Real Estate Institute. Covering the month of February, it seems set to confirm soft sales. And with its median sale price probably flattered by a skew toward higher-end properties, it will be even more important to reference the Stratified House Price Index, which helps to control for such things.

There seems little doubt the housing market is struggling for the moment, in the least because of the Government's proposal to remove tax allowances for investors. But then the great majority of the rest of the economy looks to be turning up, and perhaps strongly so in some areas. This is what's important for the RBNZ. And if the GDP pick-up is as clear as we think it will be then the Bank remains well on course to start increasing the OCR around the middle of this year. We still like June.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates saw a quiet week as minimal data and relatively low deal flow kept activity and movement to a minimum, although we did rally a small amount across the curve. The front of the curve is largely unchanged, with the first hike to the OCR priced in June and 25bp per meeting from there. Gradually the market sentiment has moved away from pricing the possibility of 50bp hikes to now pricing a small chance of a pause during the hiking cycle. This is similar to the path the RBA is seen to be taking. Further clarity to the coming hiking cycle will no doubt be provided by the MPS on Thursday.

The bond market was also quiet on the week, with a slow rally grinding out. The tender was well supported though smaller than in the previous week. All eyes in the coming week will be on the MPS, although offshore moves will continue to be a major factor. Offshore bond markets took a hit at the end of last week due to slightly stronger than expected US payrolls data. How these bond markets settle this week will be watched closely by the NZD market.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
26-Feb-10	2.71%	3.69%	5.48%	4.14%	5.82%	168
5-Mar-10	2.69%	3.67%	5.44%	4.09%	5.76%	167
Change (bps)	**-2**	**-2**	**-4**	**-5**	**-6**	**-1**

The swaps market continued to grind lower in the past week with the feeling in the market being that it was short on the back of recent issuance. The low levels do seem to indicate the market is due for a move to the upside, but with current positioning it may take a significant hawkish surprise from the RBNZ for this to happen on Thursday. That said the levels here are particularly low and do strike us as a good level to hedge floating rate borrowings.

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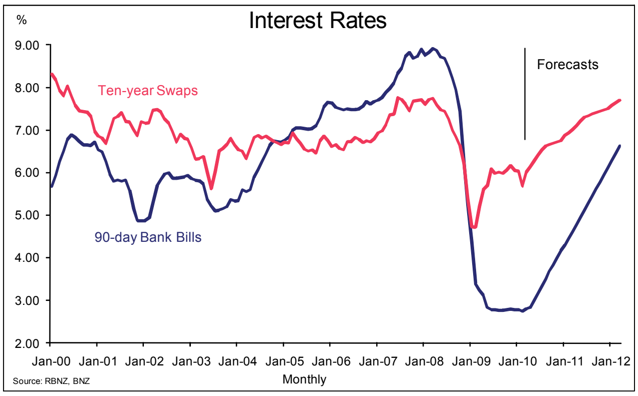

Interest Rate Technicals

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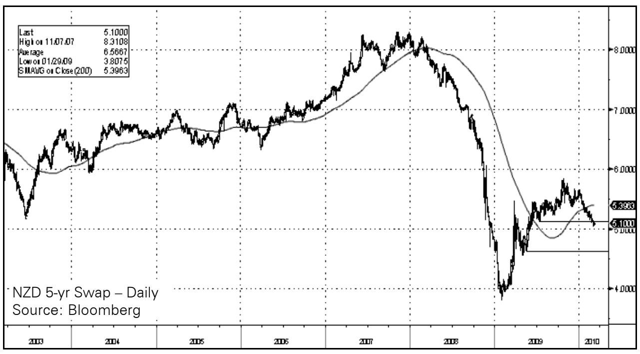
NZD 5yr Swap Rate

Outlook: Lower
LT Resistance: 5.90%
LT Support: 4.60%

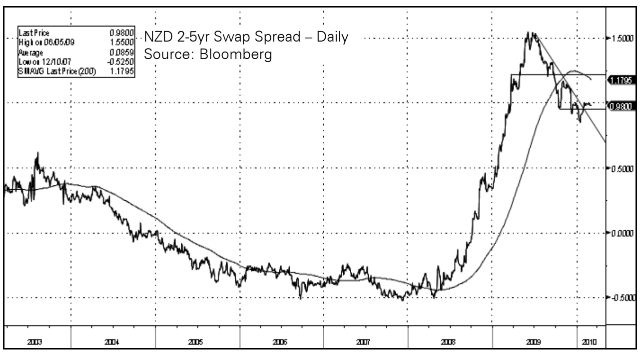
Break of support at 5.20% has opened up the downside. 5.09% first target en route to 4.90%. Longer term, 4.60% is major support.



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

Outlook: Rangebound
MT Resistance: +122
MT Support: +92

Trendline from mid 09 has been broken suggesting a near-term steepening. However expect resistance at +122 to hold.



Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD/USD spent most of last week inside a 0.6850-0.7000 range. Having spent the early part of the week drifting lower, NZD/USD found its feet on Friday to end the week more or less where it started.

The NZD was buffeted by countervailing forces last week. While an easing in concerns about Greece's fiscal crisis supported demand for 'risk sensitive' currencies like the NZD, a slide in NZD/AUD capped the topside. Tuesday's 25bps RBA rate hike, and Wednesday's robust Australian GDP figures underscored the fact Australia is clearly in better shape than NZ at present. NZ-AU 3-year swap spreads fell below -70bps and NZD/AUD tumbled to near 10-year lows below 0.7650.

However, sentiment towards the NZD recovered towards the end of the week. February's better-than-expected US non-farm payrolls report (-36,000 vs. -68,000 expected) and Greece's successful 10-year bond placement spurred optimism about the global outlook, underpinning investors' risk appetite. The MSCI World Equity Index rose 1.3% on Friday, to end the week 3.3% stronger. Our index of risk appetite (which has a scale of 0-100%) reached year to date highs around 70%, having started last week closer to 60%.

Against this backdrop, investors ditched 'safe-haven' currencies like the JPY and USD in favour of global growth-sensitive currencies like the NZD. NZD/JPY jumped from 61.50 to 63.00, helping drag NZD/USD back towards 0.7000.

Looking ahead, this week's packed local event calendar should see the NZD's focus shift from offshore towards local developments.

The highlight will no doubt be the RBNZ's Monetary Policy Statement on Thursday. We expect the RBNZ will stay "on message" and affirm its mid-year focal point for starting to increase its OCR. While recent local data, and international events, argue for more of a delay, forward-looking indicators, and the May Budget, suggest there will be enough momentum to keep the Bank on its previously stated course. We retain our long-held view of a first hike, in June, of 25bps. However, the risks appear tilted towards a delay until July, or even September.

Market pricing is currently bang in-line with our view of a June start to RBNZ tightening. As such, any dovish undertones from the RBNZ intimating a later start would provide headwinds for the NZD in the form of reduced interest rate support (NZ-US 3-year swap spreads are sitting at 6-month lows around 285bps). Absent any major surprise from the RBNZ, we'd expect improving confidence about the global backdrop to keep NZD/USD supported on dips towards 0.6850 this week.

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Foreign Exchange Technicals

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NZD/USD

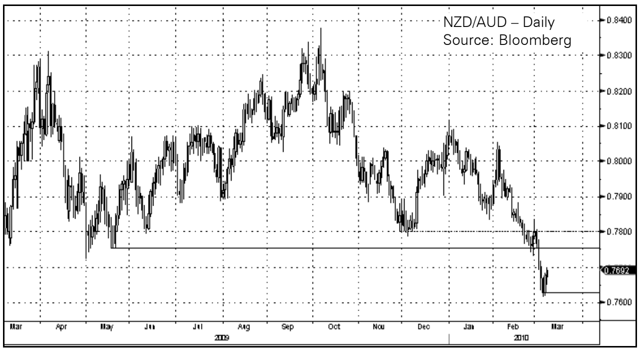
Outlook:	Consolidation
ST Resistance:	0.7070 (ahead of 0.7120)
ST Support:	0.6830 (ahead of 0.6780)

The market has been trading choppily within familiar ranges. A daily close above 0.7070 would be consistent with a rebound back towards 0.7200.

NZD/AUD

Outlook:	Buy a dip
ST Resistance:	0.7750 (ahead of 0.7800)
ST Support:	0.7630

The break below the 2008 low of 0.7720 suggests a negative bias, but the bounce off 0.7630, combined with the daily RSI in 'oversold' territory, suggests downward momentum is abating.



Key Upcoming Events

	Forecast	Median	Last
Monday 8 March			
NZ, Bldg Work Put in Place, Q4 vol s.a.	-1.5%		-4.9%
NZ, Manufacturing Sales, Q4 vol s.a.			-1.4%
Aus, Holiday			
Jpn, Eco Watchers Survey (outlook), February			41.9
Germ, Industrial Production, January		+1.0%	-2.6%
Tuesday 9 March			
NZ, Electronic Card Transactions, February			+1.0%
NZ, Manpower Survey, Q2			+14
Aus, NAB Business Survey, February			
UK, BRC Retail Sales Monitor, February y/y			+1.2%
UK, RICS Housing Survey, February		+30%	+32%
UK, Trade Balance, January		-£3.0b	-£3.3b
Wednesday 10 March			
NZ, Terms of Trade, Q4	+8.3%	+2.5%	-1.3%
Aus, Housing Finance, February	+3.0%	+2.0%	-5.5%
Aus, Consumer Sentiment - Wpac, March			117.0
Jpn, Machinery Orders, January		-3.5%	+20.1%
UK, Industrial Production, January		+0.3%	+0.5%
Germ, Trade Balance, January s.a.		+€14.5b	+€13.5b
China, Trade Balance ($US), February		+$7.15b	+$14.2b

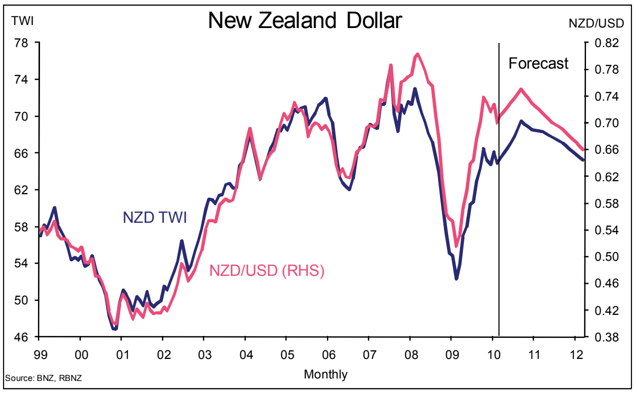
	Forecast	Median	Last
Thursday 11 March			
NZ, BNZ PMI (Manufacturing), February			52.0
NZ, Food Price Index, February	+0.2%		+2.1%
NZ, Monetary Policy Statement	2.50%	2.50%	2.50%
Aus, Employment, February	flat	+15k	+53k
Jpn, GDP, Q4 2nd est		+1.0%	+1.1%P
Euro, ECB Monthly Bulletin			
US, International Trade, January		-$41.0b	-$40.2b
China, Retail Sales, February y/y		+18.1%	+17.5%
China, Industrial Production, February y/y		+19.0%	+18.5%
China, CPI, February y/y		+2.5%	+1.5%
China, Fixed Investment (Urban), Feb ytd y/y		+25.6%	+30.5%
China, PPI, February y/y		+5.1%	+4.3%
Friday 12 March			
NZ, REINZ Housing Data, February			
NZ, Retail Trade, January	+0.8%	+0.5%	flat
US, Retail Sales, February		-0.2%	+0.5%
US, Business Inventories, January		+0.2%	-0.2%
US, Mich Cons Confidence, March 1st est		73.8	73.6
Euro, Industrial Production, January		+0.7%	-1.6%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	3.50
1 mth	2.67	2.67	2.72	3.40
2 mth	2.69	2.70	2.74	3.31
3 mth	2.67	2.70	2.74	3.16
6 mth	2.86	2.86	2.94	3.05
GOVERNMENT STOCK				
11/11	3.69	3.69	3.99	3.35
04/13	4.45	4.50	4.70	3.79
04/15	4.99	5.02	5.18	4.13
12/17	5.46	5.48	5.62	4.50
05/21	5.76	5.76	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.46	3.47	3.61	-
BNZ 05/15	6.32	6.40	6.44	-
GEN 03/14	6.39	6.46	6.56	-
GEN 03/16	7.03	7.10	7.17	-
TRP 12/10	3.81	3.83	4.07	4.12
TRP 06/20	7.05	7.11	7.15	6.35
SWAP RATES				
2 years	4.11	4.14	4.38	3.24
3 years	4.57	4.63	4.84	3.65
5 years	5.09	5.14	5.30	4.13
10 years	5.78	5.82	5.88	4.91

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6947	0.6996	0.6881	0.5030
NZD/AUD	0.7657	0.7780	0.7930	0.7845
NZD/JPY	62.81	62.09	61.51	49.45
NZD/EUR	0.5096	0.5118	0.5037	0.3975
NZD/GBP	0.4591	0.4600	0.4413	0.3569
NZD/CAD	0.7147	0.7363	0.7350	0.6476
TWI	64.31	64.66	64.02	51.96

NZD Outlook



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