22 March 2010

Growing Stronger

- Recovery continues
- Consumer demand and house construction to rise
- Boosting domestic manufacturing and imports
- Productivity improving after recession demolition
- Current account deficit to narrow further

There is quality not quantity on the local data calendar this week. Despite a mere three data releases scheduled for the week, with top-tier indicators like GDP and the balance of payments among them there will be plenty to chew on.

Thursday's report on Q4 GDP will receive most attention. Even though it refers to economic activity from late last year, it is important.

First, from a business point of view, it will quantify the speed that the economy is pulling out of recession – thus setting the base and momentum for business conditions through 2010.

Second, from a consumer perspective, the extent of economic acceleration in Q4 will play an important role for determining if, and eventually when, and how fast, the unemployment rate starts trending down.

Third, from a market perspective, it is the first litmus test of how the economy is tracking relative to the latest RBNZ forecasts and thus a factor in determining when interest rates are likely to start rising. That said, we think it would take a relatively large surprise to materially alter the status quo on all three fronts.

Growth in the quarter should be solid, even a nudge above trend. We think the economy grew 0.8% in Q4, a good deal faster than the 0.2% recorded in both the second and third quarters of last year. The lift in business and consumer confidence late last year certainly point to acceleration in economic activity after the initial baby steps made out of recession in the middle of 2009.

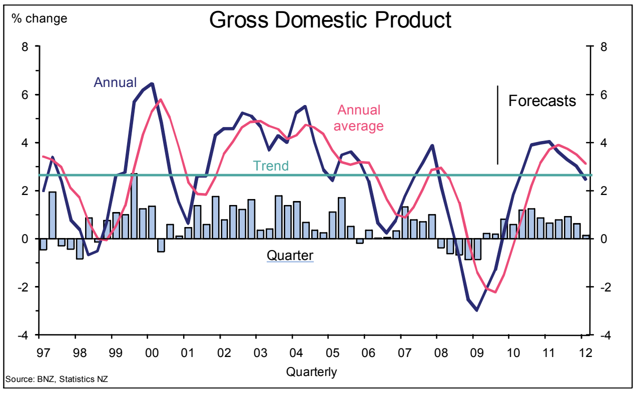
The median market expectation also sits at 0.8%, within a relatively tight range, while RBNZ had 0.6% in its March Monetary Policy Statement.

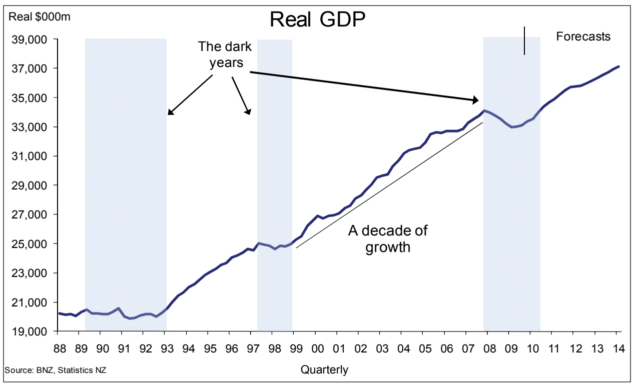
Another sign that the recovery is gaining traction will be annual growth turning positive for the first time since Q2 2008. We think annual growth will come in around 0.4%. Even so, the economy is still making up for lost ground. We do not see the level of GDP getting back to its previous peak, achieved in late 2007, until later this year (most probably in Q3). The economy is recovering, yes, but it has not yet recovered.

We expect the details to show consumers posted their third consecutive quarterly increase in spending. Discounting by some firms looking to cut inventory no doubt encouraged some buying. But we also think there is an underlying trend improvement in demand emerging, primarily driven by the lagged impact of monetary and fiscal policy, a buoyant currency, and strong net inward migration.

We think firms cut inventory further, on net, but we suspect the rundown over Q4 was much smaller than in Q3, leading to a strong positive contribution to overall growth from stocks, at least in an accounting sense.

A standout on the demand side will be a turn around in house construction that had previously been put through the ringer. The real value of house building fell by more than a third from peak to trough between mid-2007 and mid-2009. So, while a forecast 5% lift in residential investment in Q4 will be a strong positive contributor to overall growth in the quarter, the level of residential construction activity is still low compared to historical standards.





Look for these stronger elements of demand to filter through the supply chain. Retail and wholesale trade are the most obvious beneficiaries; we expect around 1% growth here. But the big kicker is expected to come through the manufacturing sector. Stronger final demand, including a recovery in domestic demand for durable goods, is encouraging more production. The international rebound and strong Australian growth (and a favourable cross exchange rate) is helping too. Production is ramping up now that stocks to sales ratios have returned to more normal levels. In a sector that was hit harder than most during the recession, we are looking for a chunky 3.5% gain in manufacturing that should prove to be the largest sectoral contribution to Q4 growth.

Stronger demand will also see imports rise, despite still lacklustre business investment. We anticipate a 1.6% rise in import volumes. The associated distribution of goods will flow through to some growth in transport activity.

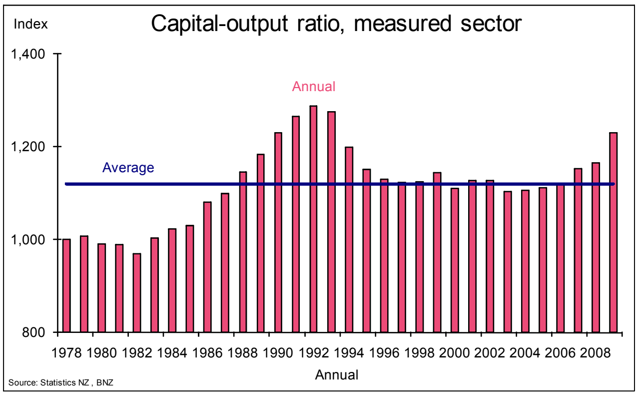
The primary sector is expected to show solid growth thanks to reasonable weather conditions for agriculture and further growth in forestry on the back of strong log demand from China. However, we suspect this will not be enough to lift overall export volumes, which continue to battle the strength of the NZD.

Mining value-added in the quarter is difficult to pick given many moving parts. The Maari oil field reached full flow in Q3/Q4 and production from Tui is now on an easing path after the initial surge back in 2007. Meanwhile, strikes at coal mines severely limited coal production in Q4. A big positive will come from gas, the result of the Kupe field coming online. Then there is the uncertainty around exploration activity, with the possibility of a downward correction following a big jump in Q3. All up, we've plugged in a moderate positive for the sector, thanks to Kupe gas, but the margin for error feels wide and mostly skewed downward.

From a wider-angle lens, stronger demand will be met by increasing utilisation of existing labour and capital equipment, as is usually the case in the initial stages of recovery. In other words, the forecast rise in GDP will coincide with a rise in productivity – something that took a battering during the recession.

We know this from the annual productivity figures released last week. These data revealed labour productivity fell 1.5% while capital productivity plunged 5.3% in the year to March 2009. Put together, multifactor productivity in the measured sector slumped 3.1%, the biggest fall in the series that dates back to 1978.

In the short term, changes in productivity tend to have more to do with the degree of resource utilisation than marked changes in technology or efficiency that we look for over the longer term.



A sharp rise in the capital-output ratio is another way of looking at the same thing. Side-stepping the jargon, this means idle machines and/or higher vacancy rates in non-residential buildings. And just as higher unemployment in the labour market leads to less wage pressure, underemployed capital brings less inflationary pressure in things such as commercial rents. Given this backdrop, little wonder business investment has been weak and probably fell further in Q4.

This context is important for the expected pick up in Q4 GDP. Given the degree of slack in the economy that the capital-output ratio implies, or the more timely 7.3% unemployment rate suggests, a fair degree of above trend growth can be accommodated before it drives core inflation higher.

This means the RBNZ has been under no urgency to start raising interest rates – a clear message from the March Monetary Policy Statement. Of course, the RBNZ cannot wait forever if growth continues to improve. Given the lags involved, it will want to begin removing monetary stimulus well before resources become fully employed. As we have thought for many months, we think the first interest rate hike will be in June, with July the next most favoured option.

This fits nicely with the RBNZ's stated intention of removing monetary stimulus from around the middle of the year. We suggest that it would take a major surprise to the RBNZ's Q4 GDP forecast of 0.6% to throw it off this course.

We should note that there are still question marks over the sustainability of the pick up in demand as policy stimulus is removed. On this, data last week was mixed. A smaller net inflow of migrants in February, shown in last Friday's data, is the first signs of an easing we have been expecting. And, although the dip in credit card billings in February was off a jump in January it suggests growth in consumer spending has not kicked on in Q1. On the plus side, the two consumer confidence surveys released last week showed healthy levels of optimism. All up, enough to suggest a moderately positive demand trend going forward.

The other major release for this week will be Q4 Balance of Payments data on Wednesday. On an annual basis, New Zealand's current account is shrivelling as a consequence of the recession. Imports have slumped on an annual basis. Interest payments on foreign debt have moderated in line with interest rates. And local profitability has been hit, which stems 'outflows' to foreign direct investors. The latter has been further crimped by the tax judgements against domestic banks (worth around 1.0% of GDP). Combined, these factors have trimmed the calendar year deficit back to about $3.8b (2.1% of GDP), we reckon.

An even smaller deficit can be expected for the year to March 2010. Something that Friday's monthly overseas trade data should give a hint too. We're looking for a trade surplus of around $700m for the month, larger than the median market expected surplus of around $430m. In any event, we will be picking through the details for any steer on how the broader economy is shaping up in Q1, fully armed with the knowledge from Wednesday's release of the goings-on in Q4.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates saw another generally quiet week with a relatively small steepening of the curve the only significant move. The 3-mth bank bill rate has rallied a little further, as the margin to 3-mth OIS has contracted a little further again. With this margin now at just 12 basis points and the 3 month time frame now overlapping with the projected hiking cycle from the RBNZ, it seems unlikely this rally can continue too much further. The first hike is now priced at around 70% to occur at the June meeting, with 25bp per meeting priced through to the end of the year. Thursday's GDP number will be the most important data of the week, with the market picking a gain of 0.8%, compared to the RBNZ's forecast of 0.6% in the latest MPS.

The bond market saw a quiet week with a small tender of just $100m, which was met with somewhat muted interest. Offshore bond markets have generally been weak, which hasn't fed through to the NZ market all that strongly. However, with the NZ market still feeling long and issuance continuing to weigh on the market we feel that bonds will trade heavily for the coming week.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
12-Mar-10	2.70%	3.75%	5.57%	4.20%	5.83%	163
19-Mar-10	2.64%	3.72%	5.60%	4.17%	5.85%	168
Change (bps)	**-6**	**-3**	**3**	**-3**	**2**	**5**

The swaps market was fairly quiet on the week with a small steepening bias the only real trend. Short end rates are now looking quite attractive to pay as we continue to move closer to the coming hiking cycle but rates are holding at low levels. The natural payside interest in the market remains muted but the total amount of money sitting on floating and available for fixing on short notice means this could turn around quite quickly. As a result we feel risk reward favours a short position from here.

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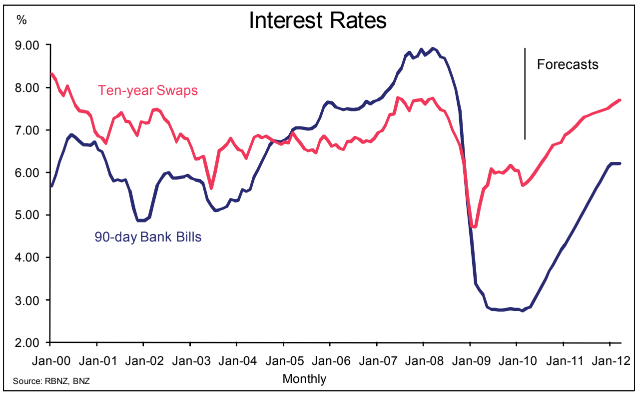

Interest Rate Technicals

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NZD 5yr Swap Rate

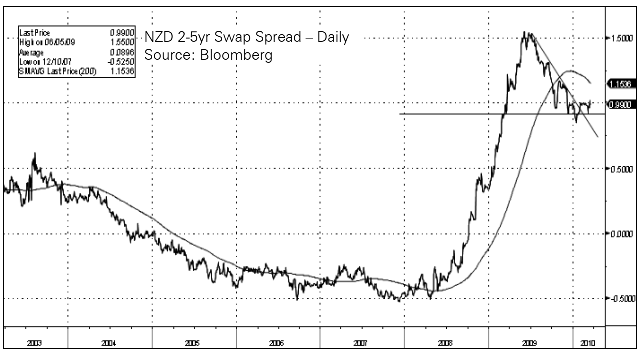
Outlook: Higher
ST Resistance: 5.50%
ST Support: 5.03%

The market has tested the downside and failed. We are likely in a fairly tight range but we look for support at 5.03% to hold and a gradual move higher towards 5.50% resistance.

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 was the strongest performing currency last week. NZD/USD climbed from below 0.7000 to above 0.7150 and NZD/EUR hit a 2-year high above 0.5250.

Solid demand from both macro and leveraged accounts, combined with further recovery in NZD/AUD, helped support NZD/USD last week. It seems markets have come around to our view that a NZD/AUD below 0.7700 is unjustified on the basis on NZ's economic fundamentals. We are picking annual average GDP growth for NZ of 3.1% for calendar 2010 and 3.5% for 2011. While hardly awe inspiring, such an outcome would see Australia's growth advantage largely eroded by year-end. If AU-NZ growth differentials narrow as we expect, NZD/AUD should continue to trend higher in coming months, albeit slowly.

In contrast, EUR recorded its biggest weekly drop since January, falling from above 1.3800 to nearly 1.3500. The confusion as to whether or not the EU will support Greece continues – Germany's Merkel told parliament last week that the IMF may be the only solution to Greece's woes. However, ECB President Trichet and French PM Sarkozy have expressed concern that an IMF bailout would suggest the EU can't solve its own crises. Either way, the failure of Greece to secure financial assistance from the European Union continues to rattle EUR sentiment.

Despite performing strongly for much of last week, the NZD hit a stumbling block on Friday. In a surprise move, the Bank of India (BoI) raised its repo rate to 5.00% from 4.75% and said controlling inflation was "imperative". The tightening from the BoI raised fears that central banks from other emerging economies may soon follow suit and sparked fears about how the global economy would cope. The BoI decision took a toll on commodity prices, equities and risk appetite. Worries about the global outlook saw investors ditch growth sensitive currencies like the NZD in favour of the relative safety of the USD. NZD/USD breached 0.7100 and skidded below 0.7070. However, rumoured sovereign demand for risk currencies as well as fix related buyers helped lift NZD off its lows as the week drew to a close.

The global outlook isn't looking too promising this week. The hangover from Friday's BoI decision may well temper risk appetite and demand for growth sensitive currencies like NZD early this week. However, the main event will likely be the EU Summit (March 26 & 27), where investors will be looking for a steer on what, if any, agreement the EU come to in terms of a bailout package for Greece.

Meantime, there's a raft of NZ data to keep an eye on. Wednesday's data should confirm the current account deficit is rapidly shrinking, it's expected to improve from Q3's -3.1% of GDP to -2.1% in Q4. And we're looking for a relatively solid 0.8%q/q expansion in Thursday's Q4 GDP release.

The global backdrop of tempered risk appetite, and a weaker EUR, may weigh on NZD/USD early in the week. However, with the NZ data expected to confirm a relatively solid NZ economic picture, we suspect any dips below 0.7000 will be relatively short-lived this week.

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Foreign Exchange Technicals

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NZD/USD

Outlook: Consolidation
ST Resistance: 0.7190 (ahead of 0.7240)
ST Support: 0.6990 (ahead of 0.6955)

The daily close above 0.7070 paved the way for a move higher, but the uptrend stalled ahead of 0.7200. In the absence of a daily close below 0.6990, we look for consolidation within familiar ranges.

NZD/USD – Daily
Source: Bloomberg

NZD/AUD

Outlook: Consolidation
ST Resistance: 0.7795 (ahead of 0.7836)
ST Support: 0.7669 (ahead of 0.7620)

The daily close above 0.7730 suggests the downtrend in the NZD/AUD has stalled. The currency is in range trading mode, with a daily close above 0.7836 needed to suggest the uptrend is gaining traction.

NZD/AUD – Daily
Source: Bloomberg

Key Upcoming Events

	Forecast	Median	Last
Monday 22 March			
UK, King Speaks, Risk and Uncertainty			
US, Fed's Lockhart Speaks, Economic Outlook			
Tuesday 23 March			
Jpn, BOJ Minutes, 17/18 Feb Meeting			
UK, BBA Home Loans, February		36.5k	35.1k
UK, CPI, February y/y		+3.1%	+3.5%
US, Existing Home Sales, February		4.98m	5.05m
US, Fed's Yellen Speaks, Economic Outlook			
Wednesday 24 March			
NZ, Balance of Payments, Q4	-2.1%	-2.0%	-3.1%
Jpn, Merchandise Trade Balance, February		+¥561b	+¥63b
UK, Budget			
UK, CBI Dist Trade Survey, March			+23
Euro, PMI Manufacturing, March 1st est		54.0	54.2
Euro, PMI Services, March 1st est		52.0	51.8
Euro, Industrial Orders, January		+1.8%	+0.7%
US, New Home Sales, February		315k	309k
US, Fed's Kohn Speaks, Monetary Policy			
US, Durables Orders, February		+0.5%	+2.6%

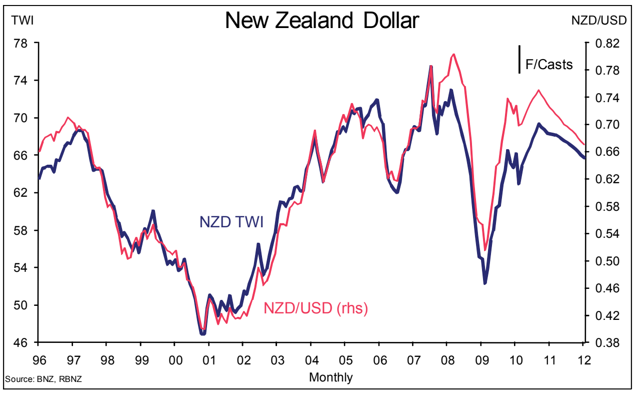
	Forecast	Median	Last
Wednesday 24 March *continued...*			
Germ, IFO Index, March		95.8	95.2
Thursday 25 March			
NZ, GDP, Q4	+0.8%	+0.8%	+0.2%
US, Jobless Claims, week ended 20/03		450k	457k
US, Bernanke Testifies, Exit Strategy			
Aus, Financial Stability Review			
Aus, RBA's Lowe Speaks			
UK, Retail Sales vol., February		+0.8%	-1.8%
Euro, Trichet Speaks, Brussels Conference			
Euro, M3, February y/y		-0.1%	+0.1%
Friday 26 March			
NZ, Merchandise Trade, February	+$714m	+$480m	+$269m
US, Mich Cons Confidence, March 2nd est		73.0	72.5
US, GDP, Q4 saar 3rd est		+5.9%	+5.9%P
Aus, Stevens Speaks			
UK, Business Investment, Q4 2nd est		-5.8%	-5.8%P
Jpn, CPI, Febuary y/y		-1.1%	-1.3%
Sunday 28 March			
Euro, Daylight Saving Begins			

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	3.00
1 mth	2.58	2.65	2.67	3.36
2 mth	2.63	2.67	2.73	3.36
3 mth	2.62	2.71	2.71	3.23
6 mth	2.84	2.86	2.90	3.13
GOVERNMENT STOCK				
11/11	3.72	3.74	3.82	3.42
04/13	4.53	4.53	4.63	3.94
04/15	5.11	5.09	5.13	4.32
12/17	5.60	5.57	5.59	4.74
05/21	5.89	5.86	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.41	3.44	3.54	0.00
BNZ 05/15	6.38	6.39	6.49	4.22
GEN 03/14	6.45	6.48	6.55	6.56
GEN 03/16	7.07	7.12	7.17	6.59
TRP 12/10	3.79	3.82	3.90	4.34
TRP 06/20	7.12	7.12	7.16	6.60
SWAP RATES				
2 years	4.18	4.21	4.23	3.47
3 years	4.64	4.66	4.72	3.90
5 years	5.17	5.17	5.22	4.42
10 years	5.86	5.84	5.87	5.15

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7066	0.7038	0.6999	0.5598
NZD/AUD	0.7717	0.7662	0.7772	0.8114
NZD/JPY	63.95	63.92	64.03	53.54
NZD/EUR	0.5219	0.5108	0.5136	0.4108
NZD/GBP	0.4701	0.4639	0.4523	0.3879
NZD/CAD	0.7176	0.7160	0.7268	0.6938
TWI	65.45	64.81	64.93	55.52

NZD Outlook



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