6 April 2010

QSBO Warns of Measured Recovery

- Q1 QSBO not quite as solid as expected
- Expectations consistent with firming recovery
- Investment looking good, pricing intentions off lows
- But broader activity measures dragging the chain
- Increasing odds of RBNZ delaying first hike until July

While this morning's Quarterly Survey of Business Opinion (QSBO) was consistent with ongoing economic recovery, in some key respects it was a bit disappointing.

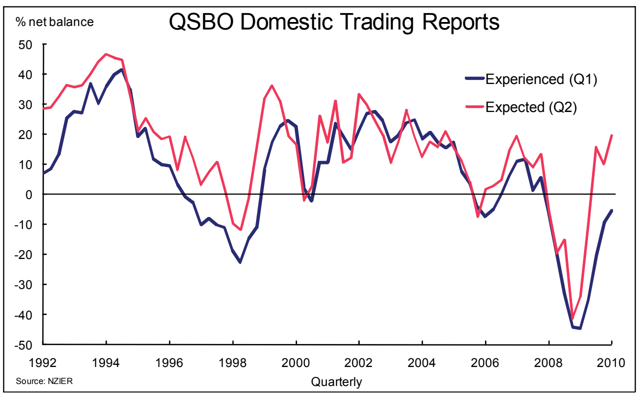
It wasn't that general confidence faltered, or expectations of own activity came off the boil. Indeed they both strengthened from December, in seasonally adjusted terms, thus aligning with our forecasts of strengthening GDP growth this year.

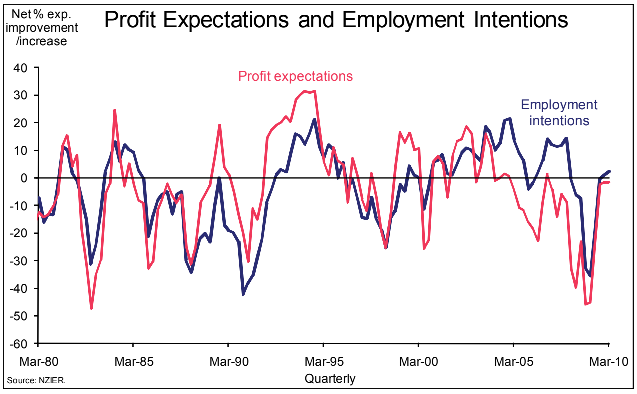
It was more the undertones from the QSBO, and its intimations of recent activity, that had us wondering about the strength of the recovery for the moment, and the risks of high hopes continuing to be questioned by reality.

We say this with reports of recent activity having undershot, yet again, what firms expected to occur in the said period. Looking back at previous surveys, respondents had expected net positive trading results for 2009 Q4 (+16) and 2010 Q1 (+10) but have reported results of -10 and -5 respectively.

These "misses" are relatively high in an historical context, reinforcing the sense of early stumbling at the high hurdles.

Granted, the latest reportage, of a net -5, is not exactly negative for GDP. Given the natural downward bias of this series, it's consistent with some growth in the March quarter, but not much. Its long-term average – a proxy for normal growth – is +12.



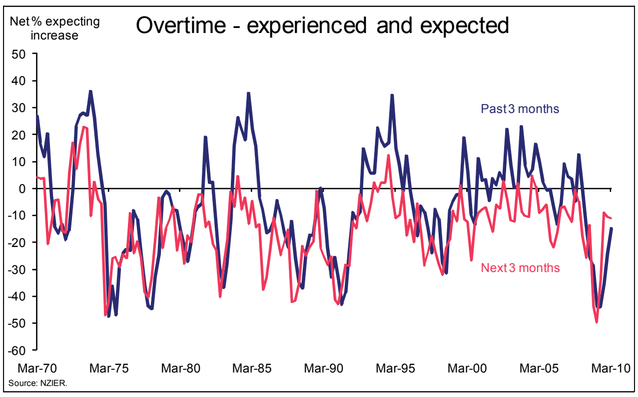


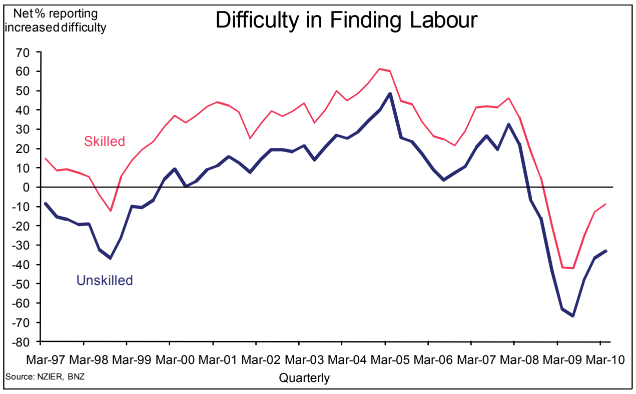
Knowing this, let's just say we're more comfortable with the 0.4% we're picking for Q1 GDP than the 0.9% expansion the RBNZ estimated in its March Monetary Policy Statement.

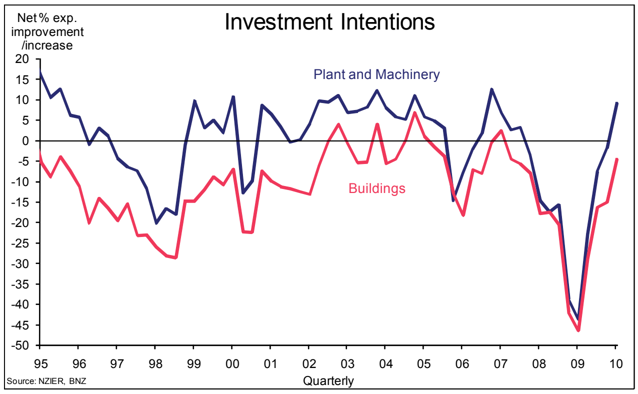
This was reinforced by the tepid QSBO undertones in respect to March quarter activity. For example, the QSBO jobs indicator was hardly improved from Q4, and was still negative, on balance. The trend recuperation in profitability didn't really push on in Q1 either. Overtime continued to recover, but was not perky. Nor were there signs that inventories were ramping back up in the March quarter.

These signs of meandering in the QSBO were especially instructive, in that they portray a softer immediate edge to the National Bank's survey better tone from looking six to twelve months ahead. So, as recoveries go, while the NBNZ survey is proving the thinking man's crumpet, the QSBO has elements of the working man's pancake – nutritional enough, but rather flat.

Nor could we infer from the QSBO a strong turning point in the economy, yet, by looking at the capacity measures.







Given the recent volatility in the high-profile measure, CUBO, we prefer to note that the more general metrics on idle capacity were hardly tightening up any.

For the labour market, all we got were firmer signs of stability emerging from the mire, with reported difficulty in finding skilled staff moving to +9, from +13, while for unskilled skilled staff it went to +33, from +37. If anything, these results suggest the jobs market was still slackening a tad through the March quarter.

As for CUBO, suffice to say that while it fell to 90.5%, from 91.1% in Q4, it remained strangely above its long-term norm of closer about 89.0%.

From a broad perspective on spare capacity we can down-rate CUBO. As noted, it just doesn't gel with the labour market slack nor with the capacity-as-a-main constraint variable (which was basically unchanged for Q1, at a low 5%). CUBO also appears out of whack with such things as vacancy rates in commercial property sector being high (and still rising?).

Having said this, there may be some reasons for CUBO, specifically, to be comparatively high, which bear thinking about. Limited slack in plant, machinery and equipment amongst manufacturers and builders – which is what CUBO proxies, in effect – is conceivable where investment in this area was cut back the most aggressively. And PME investment has certainly been extremely weak in the GDP accounts (much more so than has head-count, in the least).

And so it was interesting to see investment intentions continuing to recover quite well in today's QSBO – a good sign for GDP, especially so early in the recovery. A net 9% of respondents expected to lift investment in plant and machinery over the coming twelve months. While this doesn't sound very much, bear in mind the long-term average is slightly negative.

Similarly, investment intentions in respect to buildings were also above average. This was, incidentally, supported by architects' improved outlook in the QSBO for the commercial sector (albeit with the pipeline for this sort of work drying up a bit for the meantime, judging by recent building consents).

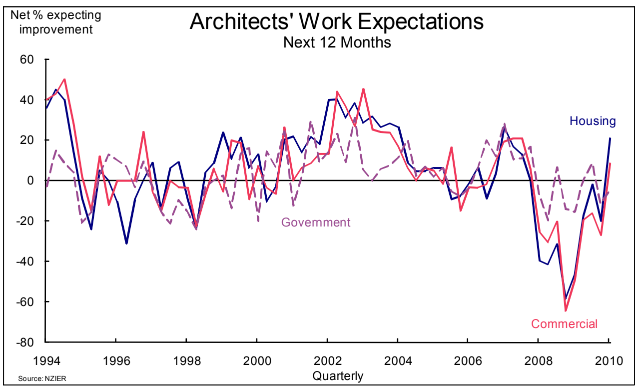
When it comes to residential construction, however, there were definite signs in the QSBO that the recent improvements will continue. Amongst architects, the housing outlook improved the most from December, to be to more obviously optimistic. This fits with our view that new home construction be a key thread in the GDP pick-up we expect this year (even though the existing home market might well remain subdued).

On inflation, directly, the QSBO was neither hot nor cold. While pricing intentions, at +27, were not dead in the water, nor were they particular cause for concern. Just something to keep an eye on – although the reality is that the headline CPI outlook is likely to be pushed up by increased GST as early as 1 October (and other, more immediate, policy measures for that matter).

The potential upward distortions to the near-term CPI will make it all the more important to stay attuned to the more general, demand-driven, inflation pulses. In this respect, upcoming wage and salary results will be instructive (just as they were during the previous inflation cycle).

For the meantime, however, we're seeing nothing that says we're under-appreciating risks to underlying inflation, or the likely strength of the GDP recovery.

From what looks to be moderate Q1 growth, we simply trust that the net +20 of QSBO respondents picking



increased trading over the next three months is close to the truth, this time. Otherwise our expectation of 1.2% growth in Q2 GDP will be looking a bit of a stretch. And that expectations shift up a gear for Q3, given the 1.5% we see for that quarter's GDP.

In a similar vein, it's worth recalling the March MPS forecast a 1.1% expansion for each of Q2 and Q3 GDP this year.

While the QSBO largely bolsters such expectations, the room for disappointment cannot be overlooked – especially when considering what the QSBO doesn't capture very well, if much at all.

One is the government sector. While it will undoubtedly offer some net relief to households in the May Budget, it's more direct expenditure in the economy has come, and will stay, under a broad sinking lid, especially as the Government adheres to its promises of pruning excesses in the bureaucracy.

The other sector not well reflected in the QSBO is the farming sector. Sure, it will be thankful for the bettered dairy payout projected for this season. However, New Zealand's land-based sector, more widely, is materially stressed by weakened balance sheets (in keeping with a very depressed rural property market), a strong NZ dollar, and dry/drought conditions in the upper half of the North Island.

These are hardly ingredients for a recovery as strong as New Zealand has typically seen post previous recessions.

Indeed, it's a recovery that's dragging the chain a bit, according to the latest QSBO, even though expectations remain optimistic.

While it can't be held up as something to put the RBNZ off the June/July start-point it has indicated, the QSBO certainly makes the case for delay, and more information. We'll stick with June for the meantime, but bear in mind in wouldn't take much to shift us to July. In the meantime, much will still hinge on the economic information. Will it be strong enough to force the Bank's hand as early as June?

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates saw a relatively quiet week with comparatively tight ranges and minimal data flow. The 90-day bank bill sold off somewhat as we moved to a new bucket and with an increase in the bank bill margin. The market pricing for the hiking cycle remains largely unchanged, with approximately 15 basis points priced for the June meeting and then roughly 25bp per meeting through to the end of 2010.

The bond market rallied back somewhat on the week as the market recovered from the previous week's move. The strong US non-farm payrolls number on Friday (after the NZ market had closed for the short week) saw a sharp sell-off in US treasuries, which will feed through into the NZ market. With the RBA's decision this afternoon to come, it is likely these offshore moves will dominate the NZ bond market 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)
26-Mar-10	2.66%	3.82%	5.71%	4.28%	5.91%	163
1-Apr-10	2.70%	3.75%	5.68%	4.25%	5.91%	166
Change (bps)	**4**	**-7**	**-3**	**-3**	**0**	**3**

The swaps market was also quiet on the week with some position squaring into the payrolls number leading to a small rally. Fundamental levels still look too low here, but payside interest remains subdued which has meant the sell-offs we have seen have failed to follow through so far. However, the sell-off post payrolls was significant in the US and how we follow through in NZ will be interesting to see. The RBA decision this afternoon will also provide impetus to the NZ market.

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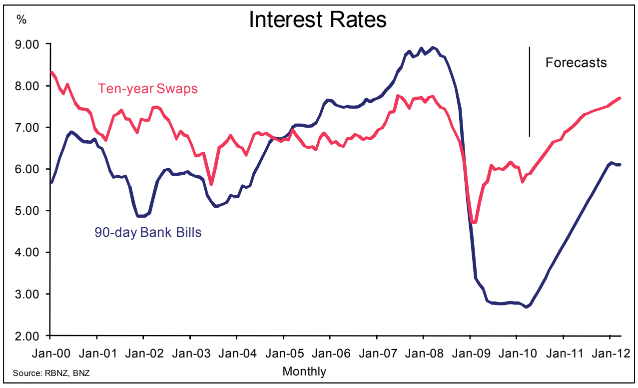

Interest Rate Technicals

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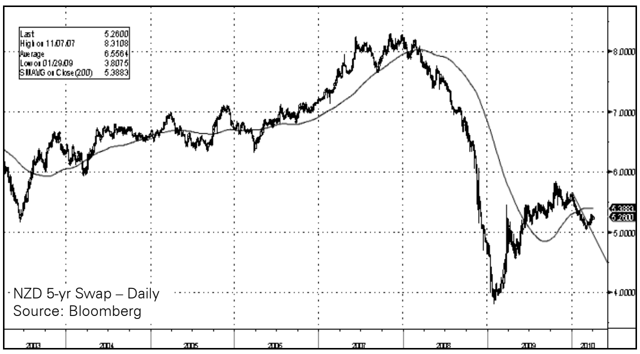
NZD 5yr Swap Rate

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

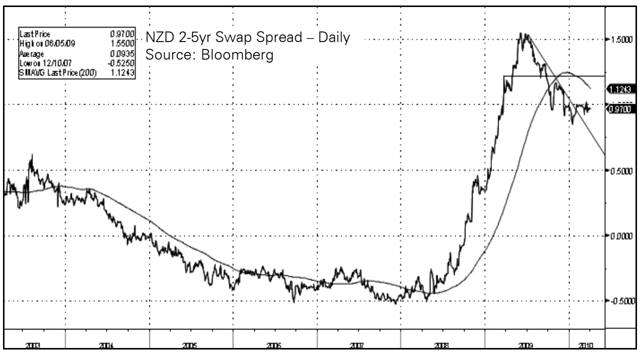
The market has tested the downside and failed. We are likely in a fairly tight range but we look for support at 5.03% to hold and a gradual move higher towards 5.50% resistance.



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

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

The 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 chopping around a 0.7030-0.7130 range. Having started the week on a relatively firm footing, the NZD/USD generally drifted lower over the Easter break.

For the most part, it was a stronger USD that set the NZD/USD on a course southwards. While the US non-farm payrolls report looked a little weaker than market expectations on the surface (162,000 vs. 184,000 expected), the details of the report were anything but. In fact, nearly all last weeks US data came out on the stronger side of the ledger, underscoring analyst views of a rapidly improving US economy. Reflecting this sentiment, US bond yields have marched higher (10-year US Treasury yields touched 4% on Monday – the highest since October 2008), underpinning last week's broad-based gains in the USD.

Not only did the NZD have the stronger USD to deal with, but the IMF said on Thursday "the currency is presently overvalued by 10-25 percent". The NZD/USD immediately slipped around ½ cent in response, and continued to trade heavily over the rest of the week, despite what was a generally positive week for equity markets and commodity prices (the S&P500 rose 1.2% over the week, while the CRB commodity price index was up 2.4%).

We agree with the IMF that the NZD/USD is overvalued in a long-run sense. At current rates of US and NZ inflation, we estimate NZD/USD PPP "fair-value" to be around 0.6050. This means the currency is currently around 17% over-valued on this basis – bang in the middle of the IMF's estimated range. However, this doesn't mean a correction is likely anytime soon. Indeed, in a typical cycle, the NZD/USD spends 3-5 years "overvalued", with the currency usually topping out 20-25% above its long-run "fair-value". As such, we don't see the long-run "overvalued" status of the currency as an impediment to the drift higher we expect in NZD/USD in coming months.

With this morning's QSBO out of the way, it's really just commodity price updates – in the form of this afternoon's ANZ indices and Fonterra's latest dairy product auction on Wednesday morning (NZT) – left on this week's local data calendar. While both will be important tests of 'fundamental' support for the NZD, neither is likely to shift sentiment towards the currency one way or the other.

Rather, it is this afternoon's (4:30pm NZT) RBA interest rate decision that will set the early direction for the NZD this week. Opinion is still divided on whether the RBA will hike its cash rate to 4.25% or hold off until next month. Markets currently ascribe roughly a 60% chance of a 25 bps hike. If the RBA does raise rates, expect a knee-jerk spurt higher in NZD/USD, but with NZD/AUD likely to test 9½ year lows towards 0.7610.

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Foreign Exchange Technicals

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NZD/USD

Outlook:	Consolidation
ST Resistance:	0.7120 (ahead of 0.7190)
ST Support:	0.6965 (ahead of 0.6920)

The failure to sustain rallies towards 0.7150 suggests we are in for more range trading near-term. A daily close below 0.6965 would indicate the emergence of a new downtrend.

NZD/AUD

Outlook:	Sell a rally
ST Resistance:	0.7765 (ahead of 0.7795)
ST Support:	0.7615

The tentative uptrend ran out of steam after hitting strong headwinds around the 0.7800 region. As such, a test of support towards 0.7615 now looks likely.

Key Upcoming Events

	Forecast	Median	Last
Tuesday 6 April			
NZ, QSBO, Q1			+31
NZ, ANZ Comdty Prices ($NZ), March			+7.9%
Aus, RBA Policy Announcement	4.25%	4.25%	4.00%
US, FOMC Minutes, 16 Mar Meeting			
Wednesday 7 April			
NZ, Fonterra Monthly Auction			
Aus, Services PMI (AiG), March			48.3
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%
UK, CIPS Services, March		58.0	58.4
UK, Index of Services, January 3m/3m		+0.7%	+0.5%
Euro, PPI, February y/y		-0.4%	-1.0%
Euro, PMI Services, March 2nd est		53.7	53.7P
Euro, GDP, Q4 3rd est		+0.1%	+0.1%P
US, Fed's Bernanke/Hoenig Speak			
Germ, Factory Orders, February		-0.5%	+4.3%
Thursday 8 April			
Aus, Unemployment Rate, March	5.2%	5.3%	5.3%
Aus, Employment, March	+40k	+20k	flat

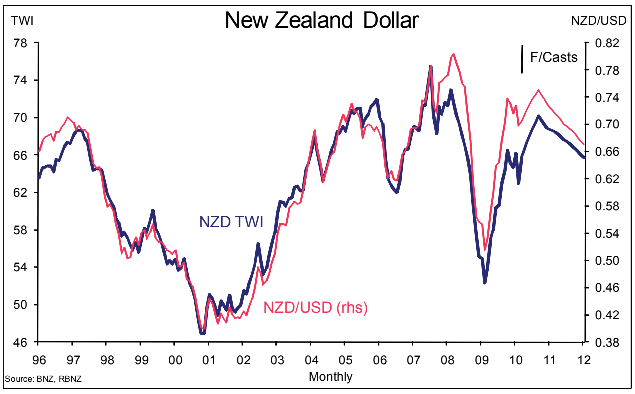
	Forecast	Median	Last
Thursday 8 April *continued...*			
Jpn, BOJ Economic Report			
Jpn, Machinery Orders, February		+3.7%	-3.7%
Jpn, Eco Watchers Survey (outlook), March		46.7	44.8
UK, BOE Policy Announcement	0.50%	0.50%	0.50%
UK, Industrial Production, February		+0.5%	-0.4%
Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
Euro, Retail Sales, February		flat	-0.2%
US, Jobless Claims, week ended 03/04		435k	439k
Germ, Industrial Production, February		+1.0%	+0.6%
Friday 9 April			
NZ, Crown Financial Statements, February			
Aus, Construction PMI (AiG), March			52.8
UK, PPI (core output), March y/y		+3.1%	+2.9%
US, Wholesale Inventories, February		+0.4%	-0.1%
Germ, Trade Balance, February s.a.		+€11.4b	+€8.0b
China, Business Climate Indicator, Q1			130.6
Saturday 10 April			
China, Trade Balance ($US), March			+$7.61b

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	3.00
1 mth	2.60	2.59	2.67	3.45
2 mth	2.63	2.67	2.69	3.33
3 mth	2.67	2.68	2.67	3.20
6 mth	2.89	2.84	2.86	3.17
GOVERNMENT STOCK				
11/11	3.79	3.82	3.69	3.89
04/13	4.58	4.62	4.45	4.46
04/15	5.22	5.21	4.99	4.83
12/17	5.73	5.71	5.46	5.23
05/21	6.01	5.99	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.41	3.39	3.46	-
BNZ 05/15	6.56	6.55	6.32	-
GEN 03/14	6.50	6.49	6.39	-
GEN 03/16	7.17	7.15	7.03	-
TRP 12/10	3.76	3.76	3.81	4.68
TRP 06/20	7.22	7.19	7.05	7.25
SWAP RATES				
2 years	4.28	4.28	4.11	3.88
3 years	4.73	4.73	4.57	4.44
5 years	5.26	5.25	5.09	5.01
10 years	5.94	5.91	5.78	5.68

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7028	0.7053	0.6947	0.5872
NZD/AUD	0.7627	0.7792	0.7657	0.8201
NZD/JPY	66.30	65.16	62.81	58.87
NZD/EUR	0.5211	0.5234	0.5096	0.4345
NZD/GBP	0.4595	0.4720	0.4591	0.3955
NZD/CAD	0.7039	0.7231	0.7147	0.7218
TWI	65.41	65.82	64.31	58.21

NZD Outlook



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