

19 April 2010

Inflation Defies Recession

- We pick 0.6% for Q1 CPI – on consensus but above RBNZ's 0.3%
- Consumer confidence edging lower
- Credit aggregates remain in the mire
- Concern over sustainability of tourism improvement
- Australian magnetism for NZ workers increases

All eyes this week will be on tomorrow's CPI outturn. It's all well and good pontificating on the health of the New Zealand economy, as defined by its growth indicators, but for the Reserve Bank, at least, the real concern is how the economy's progress translates into inflation.

From our perspective, inflationary pressures are currently well contained. When you have as much spare capacity in an economy as New Zealand currently has, it's really difficult for sellers to raise prices. And while the New Zealand dollar's fall from its peaks has been unhelpful, in an inflationary sense, the decline has been far from dramatic.

Be that as it may, inflation is far from dead and buried. Indeed, it concerns us that, despite having been through one of the nastiest recessions in many years, annual inflation only fell to 1.7% at its low point back in September 2009. With growth pushing higher, this must leave the central bank anxious about the way ahead. This anxiety will be compounded with what now looks to be an inevitable hike in GST, which will see annual headline inflation approach 5.0%. If this feeds into inflation expectations then actual inflation further out into the future could well be pushed higher than otherwise justified by economic fundamentals. Look for Alan Bollard to be wheeled out with gay abandon towards the end of year as he tries to ensure these expectations are well and truly capped. Keep an eye out for the Reserve Bank's inflation expectation series, published quarterly, to see

how Dr Bollard fares on this front. The two-year-ahead series is of most importance in this regard. And be aware, also, that the Bank itself puts some weight on this series.

It won't help expectations if we are correct about the outturn for the CPI this week, where we are picking a 0.6% increase in the headline index. This would take annual inflation to 2.3%, its highest since March 2009. Moreover, we are expecting another 0.7% for June.

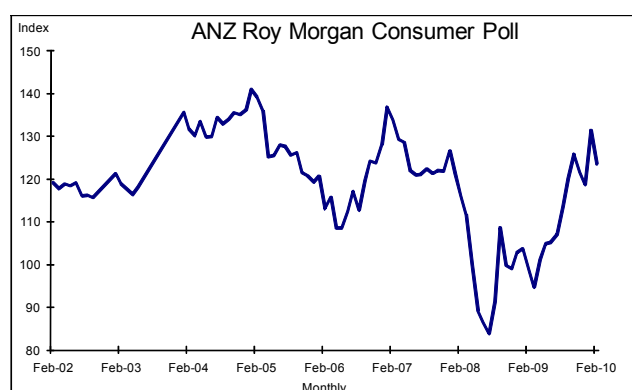
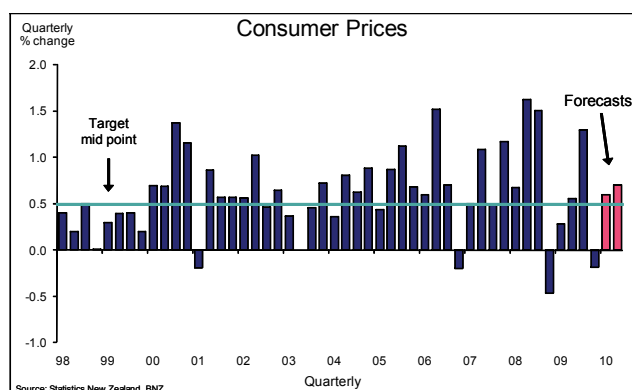
Our view is on consensus though, interestingly, significantly above the Reserve Bank's 0.3% forecast. The comparison is a bit unfair as we suspect that developments post the publication of the Bank's forecasts will also have had it thinking of a higher number.

That aside, the important thing to note here is that the RBNZ's 0.3% pick is consistent with it tightening June or July. A number such as we are forecasting would tend to pull more towards a June start, all other things being equal. A number significantly higher than our own pick would certainly weigh heavily on sooner rather than later.

By our reckoning, the biggest contributions to the March quarter outturn will come from rising fuel and food costs. We estimate that petrol prices rose around 7.5% for the quarter and food prices around 1.0%. Look also for the excise hike on cigarettes and tobacco, higher car prices, the normal annual reset in education costs and the ongoing, albeit modest, pressure from the housing sector.

In contrast, there are a number of seasonal items that tend to fall in price this quarter including clothing, footwear and international air transport, which should keep a cap on the overall number.

While CPI will be the "big" indicator for the week, there are other partials worthy of a look. On Thursday the



ANZ-Roy Morgan consumer confidence index makes an appearance. It's been drifting lower over the last couple of months and we wouldn't be surprised if it edged a tad lower again. Still, the overall reading is likely to be around the 120 mark which would tend to suggest that retail spending should pick up a head of steam as the year progresses.

The other indicator of household spending growth to be released during the week is credit card billings for March on Friday. We are looking for a bounce in March retail sales and this was supported by recent Electronic Card Transactions Data. Accordingly, we would expect to the billings data move in a similar direction.

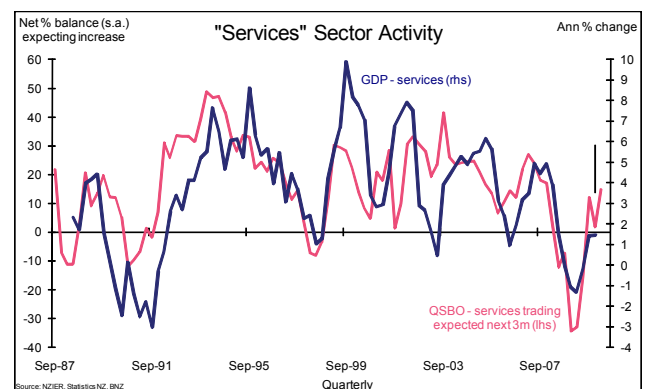
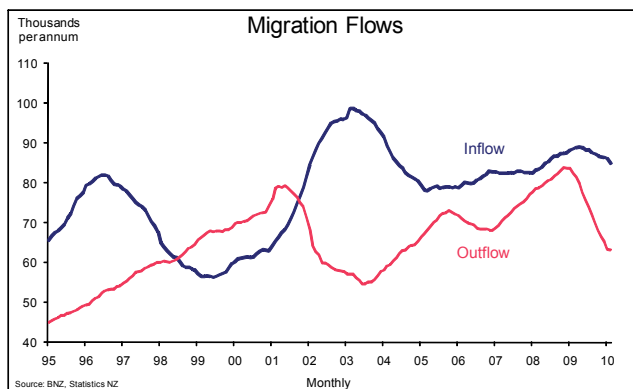
Last but not least will be Friday's migration data. We are looking for evidence that the stronger Australian economy is starting to have a bigger impact on New Zealanders headed offshore for employment. This is expected to see the positive impact on growth from net migration abate over the next twelve months. Meanwhile, our expectation is that March tourist inflows will look fairly good when compared with the previous March. Annual growth over

the last three months has averaged 5.2%. Of course the increase in outflows may match this, offsetting the positive GDP impact of the inflows.

Tourism inflows should, in theory, improve over the year as global growth picks up but anecdotal evidence on forward bookings for the industry looks very weak, so we remain cautious in our optimism for the sector. More generally, don't forget that April travel data could be significantly adversely affected by the Icelandic volcano with an unpronounceable name.

Of course, we've already had one piece of data out this morning – that was the BNZ-sponsored Performance of Services Index. This was a welcome start to the week with the index climbing to 57.3 from its shabby 47.1 a year earlier. A close look at the entrails of these data reveals a service sector that is relatively confident that the way ahead is brighter. In this vein, it fits with our own view that economic growth through 2010 will approach 3.0%.

stephen_toplis@bnz.co.nz



Domestic Interest Rates

New Zealand interest rates pushed a little lower last week as weak data and a continued lack of payside interest combined to lower yields somewhat. The major piece of data on the week was a weak retail sales number, which came in at -0.6% vs an expectation of +0.2%. That saw a small rally in the front futures contract and has left the OCR pricing a 50% chance of a 25bp hike for the June meeting, then 25bp per meeting through to the end of 2010.

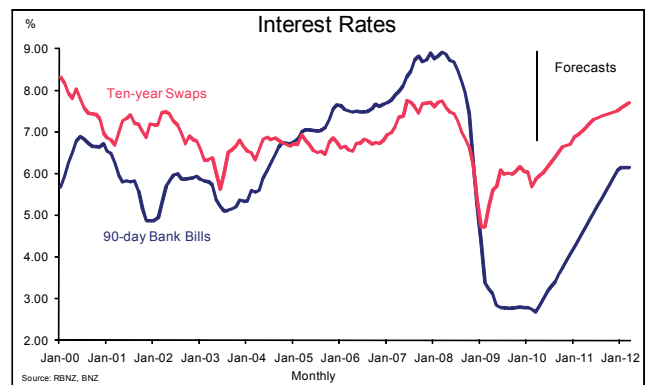
The bond market rallied somewhat on the week with a larger tender than in recent times issuing \$250m of 2021 bonds. We are now trading towards the bottom of recent ranges and with continued issuance it seems unlikely we will be able to follow offshore moves too far. The key piece of data on the week will be tomorrow's Q1 CPI number, which may provide some clues to the OCR announcement next week.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
9-Apr-10	2.67%	3.76%	5.70%	4.24%	5.88%	164
16-Apr-10	2.68%	3.73%	5.66%	4.21%	5.86%	165
Change (bps)	1	-3	-4	-3	-2	1

Reuters pgs BNZL BNZM

The swaps market was somewhat whippy on the week with a strong flattening bias early being reversed by steepening later in the week. The carry on the 2-yr swap suggests that it should sell off by roughly 2.75bp per week to be pricing the same track for the OCR, which indicates how far we have in effect rallied while trading water around the 4.20% level in 2-yr. The outright levels still seem to be good value to pay from here, but fresh paying interest is probably required for a significant sell off.

nick_webb@bnz.co.nz



Interest Rate Technicals

NZD 5yr Swap Rate

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

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, en route 5.85%.

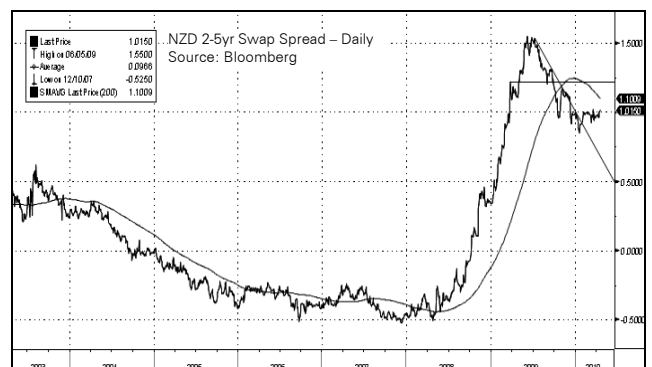


pete_mason@bnz.co.nz

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

The NZD was the weakest performing currency last week. Having spent most of the week trading inside a relatively tight 0.7090-0.7180 range, a spike in risk aversion on Friday dragged NZD/USD below 0.7080.

After starting the week at 2½ year highs above 76%, our risk appetite index (which has a scale of 0-100%) slumped to 70% on Friday. Risk aversion skyrocketed after fraud charges were filed against US banking giant Goldman Sachs for its marketing of sub-prime debt securities. Global equities plunged 1.1-2.0% in the wake of the news such that the MSCI World Equity Index ended the week down 0.1%, scuppering a six week rally. The more uncertain global backdrop also took a toll on commodity prices – the CRB index (a broad measure of commodity prices) slipped 1.2% on Friday.

Against a backdrop of sliding equities and rising risk aversion, investors sold “risk-sensitive” like the NZD in favour of “safe-haven” currencies like the USD and JPY. NZD/JPY slipped from above 66.40 to nearly 65.20, and NZD/USD skidded below 0.7080.

Last week’s local data was anything but NZD supportive. February’s decidedly lacklustre retail sales data and the

Reuters pg BNZFWDS

generally soft REINZ March housing report questioned the pace of NZ’s recovery, providing another excuse for the RBNZ to delay policy tightening – if it was looking for it. It seems markets are also conscious of this risk; traders now price just a 50/50 chance of a 25bps rate hike in June.

For this week, Tuesday’s Q1 CPI stands out as the highlight of an otherwise quiet data week. We are looking for a 0.6%q/q increase, which would set annual CPI inflation at 2.3%, from 2.0%. The RBNZ had 0.3% in its March MPS. While this seems a fair reflection of the underlying pulse, we’re conscious of the headline result being an upside nuisance for the Bank.

While an above expectations result from Tuesday’s CPI could see the NZD/USD retest resistance towards 0.7150, we suspect the more cautious global backdrop will keep the NZD under pressure early in the week. Initial support is eyed towards 0.7000. A convincing break through this level would open up 0.6960 as the next key support level.

mike_s_jones@bnz.co.nz

Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
 ST Resistance: 0.7150 (ahead of 0.7220)
 ST Support: 0.7000 (ahead of 0.6960)

The rejection of 0.7160 suggests we are in for more range trading in the near-term. A convincing break below 0.6960 would confirm the emergence of a new downtrend.



mike_s_jones@bnz.co.nz

NZD/AUD

Outlook: Consolidation
 ST Resistance: 0.7770 (ahead of 0.7805)
 ST Support: 0.7615 (ahead of 0.7555)

The failure to sustain dips below 0.7600 suggests downward momentum is fading. A daily close above 0.7770 would indicate the downtrend has run out of steam.



Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 19 April				Thursday 22 April			
US, Leading Indicator, March		+0.5%	+0.1%	US, Existing Home Sales, March	5.25m	5.02m	
Tuesday 20 April				US, PPI ex-food/energy, March y/y	+0.9%	+1.0%	
NZ, CPI, Q1	+0.6%	+0.6%	-0.2%	Can, BOC Qtly Policy Report			
Aus, RBA Minutes, 6 Apr Meeting				Friday 23 April			
UK, CPI, March y/y		+3.1%	+3.0%	NZ, External Migration, March s.a.			+1,060
Jpn, Tertiary Industry Index, February		-1.0%	+2.9%	NZ, Credit Card Billings, March			-0.3%
US, Bernanke/Geithner Testify, Re Lehman's				Aus, Stevens Speaks, Economic Conditions			
Germ, ZEW Sentiment, April		+45.1	+44.5	Aus, Terms of Trade, Q1			+2.7%
Germ, PPI, March y/y		-1.8%	-2.9%	Jpn, All Industry Index, February		-1.6%	+3.8%
Can, BOC Policy Announcement	0.25%	0.25%	0.25%	UK, Retail Sales vol., March	+0.6%	+2.1%	
Wednesday 21 April				UK, GDP, Q1 1st est	+0.4%	+0.4%	
Aus, Westpac Leading Index, February			+0.2%	US, Durables Orders, March	+0.2%	+0.9%	
UK, BOE Minutes, 7/8/ Apr Meeting				US, New Home Sales, March	325k	308k	
UK, Unemployment Rate (ILO), February		7.8%	7.8%	Euro, Industrial Orders, February	+1.0%	-1.6%	
Thursday 22 April				Germ, IFO Index, April	98.7	98.1	
NZ, ANZ-RM Consumer Confidence, April			121.8	Sunday 25 April			
Jpn, Merchandise Trade Balance, March	+¥991b	+¥650b		NZ, ANZAC Day			
Euro, PMI Manufacturing, April 1st est		56.7	56.6	Monday 26 April			
Euro, PMI Services, April 1st est		54.4	54.1	Aus, Holiday, ANZAC Day (observed)			

Historical Data

	Today	Week Ago	Month Ago	Year Ago		Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS					FOREIGN EXCHANGE				
Call	2.50	2.50	2.50	3.00	NZD/USD	0.7073	0.7169	0.7066	0.5686
1 mth	2.62	2.60	2.58	3.22	NZD/AUD	0.7672	0.7659	0.7717	0.7857
2 mth	2.65	2.64	2.63	3.23	NZD/JPY	65.06	66.83	63.95	56.38
3 mth	2.69	2.70	2.62	3.06	NZD/EUR	0.5248	0.5264	0.5219	0.4360
6 mth	2.88	2.89	2.84	3.00	NZD/GBP	0.4625	0.4644	0.4701	0.3846
GOVERNMENT STOCK					NZD/CAD	0.7184	0.7201	0.7176	0.6897
11/11	3.72	3.77	3.72	3.66	TWI	65.60	66.17	65.45	56.71
04/13	4.52	4.57	4.53	4.34	NZD Outlook				
04/15	5.14	5.21	5.11	4.79					
12/17	5.65	5.72	5.60	5.24	<p>Source: BNZ, RBNZ</p>				
05/21	5.92	6.01	6.53	-					
CORPORATE BONDS									
BNZ 09/10	3.41	3.39	3.41	4.41					
BNZ 05/15	6.53	6.52	6.38	6.99					
GEN 03/14	6.45	6.46	6.45	7.09					
GEN 03/16	7.13	7.13	7.07	7.65					
TRP 12/10	3.71	3.74	3.79	4.76					
TRP 06/20	7.11	7.11	7.12	7.52					
SWAP RATES									
2 years	4.20	4.25	4.18	3.68					
3 years	4.66	4.70	4.64	4.26					
5 years	5.21	5.22	5.17	4.83					
10 years	5.85	5.88	5.86	5.49					

Contact Details

BNZ Research

Stephen Toplis
Head of Research
+(64 4) 474 6905

Craig Ebert
Senior Economist
+(64 4) 474 6799

Doug Steel
Economist
+(64 4) 474 6923

Mike Jones
Strategist
+(64 4) 472 4767

Main Offices

Wellington
60 Harbour Quays
Private Bag 39806
Wellington Mail Centre
Lower Hutt 5045
New Zealand
Phone: +(64 4) 474 6145
FI: 0800 283 269
Fax: +(64 4) 474 6266

Auckland
80 Queen Street
Private Bag 92208
Auckland 1142
New Zealand
Phone: +(64 9) 976 5762
Toll Free: 0800 081 167

Christchurch
129 Hereford Street
PO Box 1461
Christchurch 8140
New Zealand
Phone: +(64 3) 353 2219
Toll Free: 0800 854 854

National Australia Bank

Peter Jolly
Head of Research
+(61 2) 9237 1406

Alan Oster
Group Chief Economist
+(61 3) 8634 2927

Rob Henderson
Chief Economist, Markets
+(61 2) 9237 1836

John Kyriakopoulos
Currency Strategist
+(61 2) 9237 1903

Wellington
Foreign Exchange
Fixed Income/Derivatives

+800 642 222
+800 283 269

Sydney
Foreign Exchange
Fixed Income/Derivatives

+800 9295 1100
+(61 2) 9295 1166

London
Foreign Exchange
Fixed Income/Derivatives

+800 333 00 333
+(44 20) 7796 4761

New York
Foreign Exchange
Fixed Income/Derivatives

+1 800 125 602
+1877 377 5480

Hong Kong
Foreign Exchange
Fixed Income/Derivatives

+(85 2) 2526 5891
+(85 2) 2526 5891

24 HOUR FOREIGN EXCHANGE SERVICE

Phone Toll Free 6am to 10pm NZT – Wellington Office
0800 739 707 10pm to 6am NZT – London Office – Sam Hehir

ANALYST DISCLAIMER: The person or persons named as the author(s) of this report hereby certify that the views expressed in the research report accurately reflect their personal views about the subject securities and issuers and other subject matters discussed. No part of their compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in the research report. Research analysts responsible for this report receive compensation based upon, among other factors, the overall profitability of the Markets Division of National Australia Bank Limited, a member of the National Australia Bank Group ("NAB"). The views of the author(s) do not necessarily reflect the views of NAB and are subject to change without notice. NAB may receive fees for banking services provided to an issuer of securities mentioned in this report. NAB, its affiliates and their respective officers, and employees, including persons involved in the preparation or issuance of this report (subject to the policies of NAB), may also from time to time maintain a long or short position in, or purchase or sell a position in, hold or act as advisors, brokers or commercial bankers in relation to the securities (or related securities and financial instruments), of companies mentioned in this report. NAB or its affiliates may engage in these transactions in a manner that is inconsistent with or contrary to any recommendations made in this report.

NEW ZEALAND DISCLAIMER: This publication has been provided for general information only. Although every effort has been made to ensure this publication is accurate the contents should not be relied upon or used as a basis for entering into any products described in this publication. Bank of New Zealand strongly recommends readers seek independent legal/financial advice prior to acting in relation to any of the matters discussed in this publication. Neither Bank of New Zealand nor any person involved in this publication accepts any liability for any loss or damage whatsoever may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this publication.

US DISCLAIMER: This information has been prepared by National Australia Bank Limited or one of its affiliates or subsidiaries ("NAB"). If it is distributed in the United States, such distribution is by nabSecurities, LLC which accepts responsibility for its contents. Any U.S. person receiving this information wishes further information or desires to effect transactions in the securities described herein should call or write to nabSecurities, LLC, 28th Floor, 245 Park Avenue, New York, NY 10167 (or call (877) 377-5480). The information contained herein has been obtained from, and any opinions herein are based upon, sources believed to be reliable and no guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose. Any opinions or estimates expressed in this information is our current opinion as of the date of this report and is subject to change without notice. The principals of nabSecurities, LLC or NAB may have a long or short position or may transact in the securities referred to herein or hold or transact derivative instruments, including options, warrants or rights with securities, or may act as a market maker in the securities discussed herein and may sell such securities to or buy from customers on a principal basis. This material is not intended as an offer or solicitation for the purchase or sale of the securities described herein or for any other action. It is intended for the information of clients only and is not for publication in the press or elsewhere.

National Australia Bank Limited is not a registered bank in New Zealand.