26 April 2010

Where's the Middle?

- No change in RBNZ stance, or rates, at April OCR meeting
- An eventual push to neutrality still beckons
- NBNZ survey to confirm solid growth outlook
- Residential permits up, non-residential down
- It's about time credit aggregates turned the corner

Where exactly is the middle of 2010? That's the question on everyone's lips as we head into the OCR review on 29 April. April certainly isn't. So there's zero reason to assume the Reserve Bank might start its tightening cycle this week. The point of interest is whether the RBNZ will point directly to June or July as its start point. Or, even, as an outside chance, stretch the meaning of the word middle and intimate a September kick off.

Our formal view is that June will mark the beginning of the RBNZ's push to see monetary settings return to neutrality but we'd put this as a 50/50 call that is very much data flow dependent.

What we can say is that recent data provide no reason whatsoever for the Reserve Bank to be in any hurry. Growth indicators remain contained, credit aggregates are very weak and inflation shows no sign of getting away from the Bank.

Sure Q4 GDP came in at 0.8%, which was a touch ahead of the RBNZ's 0.6% pick but all the indications are that Q1 GDP will fall well shy of the 0.9% the Bank has in its forecast path. Moreover, there remain significant question marks over the ability of the economy to grow at the roughly 1.0% per quarter pace the RBNZ anticipates right through to the end of next year. Drought conditions across much of the country will be a further hindrance in this regard.

Accordingly, inflation should not be a problem for the Bank in this environment. The annual CPI increase of 2.0% to Q1, 2010 was bang on RBNZ expectations and the Bank's future inflation path should be contained by the NZD sitting around 3.5% above expectations.

Having said this, the threat of rising inflation expectations, thanks largely to the spike in the headline CPI that will be associated with the inevitable hike in GST will make the RBNZ work hard for its money. If expectations get away on them, then inflation will most certainly become problematic.

Elsewhere, household spending remains muted, the unemployment rate shows little sign of abating any time soon, business investment activity is very soft and the housing market remains deflated.

All in all not a strong argument for a quick response, which is, of course, why an April hike is not being contemplated.

Nonetheless, we are of the view that the economy is slowly but surely staggering to its feet. This argues for a normalisation in rates in turn. With the huge spread between the cash rate and lending rates at the moment, we believe that the "new" neutral OCR rate is around 4.5%. That's still 200 basis points above where it now lies. Moreover, at the peak in the cycle one would expect rates to be slightly higher than neutral. This being so, there will eventually be plenty of work for the Bank to do and it won't want to leave it too long for fear of being too late.

The problem is, if the RBNZ doesn't go in April, as expected, what data is it likely to see before its June meeting that would justify it going then? Probably the most important pieces of information will be released in the first week of May with the Household Labour Force Data and Labour Cost Indices due out. The RBNZ is looking for the unemployment rate to drop back to 7.2%. If it falls further than this then it may be the green light for June. Conversely, however, if there is no drop, or worse still the rate actually heads higher, then the story behind the need to tighten might look somewhat questionable.

Retail trade data for the March quarter (14 May) is unlikely to be a deal breaker with only a small increase in real sales volumes anticipated and the indications are that housing market and credit data will remain muted.

Of course the 20 May Budget will be of critical importance to the RBNZ. If the rhetoric from Government is to be believed, the Budget will not be stimulatory so, again, should pose no concern to the Bank.

Between the June and July meetings the RBNZ gets to see: another GDP outturn, a further CPI result and the latest Quarterly Survey of Business Opinion. So, if the RBNZ remains in two minds at the time of its June meeting it might well find justification to pause further.

With all this uncertainty, not to mention, in addition, the ongoing shenanigans in European debt markets, it would seem to us that the most sensible thing the RBNZ could do is to give itself options. This being so, we would be surprised if the Bank gave any greater clarity as to its expected hike start date than it already has.

It won't affect the RBNZ's decision this week, but Wednesday's National Bank Survey will be no less interesting as a consequence. Frankly, we've been surprised by just how strong this survey has been and are looking for a downward correction to develop. If not, it may well be an indication that the economy is, in fact, picking up a head of steam well in excess of our expectations. There are seasonal adjustment concerns with the series so to put this in perspective, an own activity indicator of around 38 would be consistent with our view of the world. Anything in the mid 40s would tend to suggest, all other things being equal, that the RBNZ should move sooner rather than later. Much below 38 and it would be further indication that the RBNZ has time on its side.

Having said this, keep an eye on the impact of the agriculture sector on this survey. It has the ability to distort the survey either way. If drought concerns are dominating farmers expectations, then a much poorer than expected outcome may occur. Alternatively, soaring commodity prices could push it the other way. As ever, the devil will thus be in the detail.

With commodity prices in the ascendancy, be aware that Fonterra is soon due to announce its latest payout estimate for the 2009/10 season. We would not be surprised if a modest increase was announced. Of more interest will be end-May when the first forecast for next season is expected.

Soaring commodity prices will also be impactive on Thursday's Merchandise Trade release. We're looking for a monthly trade surplus of $475m but there is some risk that we may be underestimating export receipts.

Thursday also sees the working age population data that will be used in the 6 May, Household Labour Force release. We are looking for another solid increase which will help hold the unemployment rate at or near current levels.

Credit aggregates are due Thursday afternoon. Housing market indicators suggest that there will be nothing but a modest pick up in housing lending, at best. Lending to businesses remains extremely depressed thanks to copious amounts of spare capacity and the lack of need to invest. Agriculture lending should continue its consolidation.

Credit aggregates are lagging indicators of economic activity and, so, it is often said that the poor growth in these aggregates should not be seen as of something that the Reserve Bank should necessarily focus on. Be that as it may, one shouldn't forget that the economy has now been out of recession for over a year. Surely, by now, some sign of recovery in credit growth might be anticipated if, indeed, there was certainty that the current expansion has legs. Thus, do have a close look at these figures for signs of life.

Last up for the week is Building Consents on Friday. We'd look for a continuation in the upward trend in residential consents offset by further weakness in non-residential activity.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates had another relatively quiet week playing familiar ranges. The predominant theme was a general flattening of the curve as the front end underperformed. The futures market saw a good rally after the CPI number came in at 0.4%, less than the 0.6% expected by the market and for a short time largely priced out the chance of a June hike. However the rally didn't last and we saw some fairly bearish price action and the curve is left largely as it was at the start of last week, pricing 0% chance of a hike in April, around 50% in June and then 25bp per meeting through to the end of 2010. All eyes this week will be on the OCR review on Thursday – it may provide a stronger indication as to when the hiking cycle will begin.

The bond market was relatively quiet on the week with the front end fairly heavy. The tender was fairly well supported with $400m of total issuance taken in a tight range. We will likely continue to drift with offshore cues for the first half of the week, with the OCR review likely to dominate the later half.

	90 day bills	11/11 NZGS	12/17 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
16-Apr-10	2.68%	3.73%	5.66%	4.21%	5.86%	165
23-Apr-10	2.67%	3.77%	5.66%	4.25%	5.81%	156
Change (bps)	**-1**	**4**	**0**	**4**	**-5**	**-9**

The swaps market also had a strong flattening bias with the market looking to preposition for the coming hiking cycle and the curve flattening that will likely result. There was a reasonable rally in the short end following the weak CPI number, 2-yr swap traded 4.16%, but we failed to hold the rally and yields in 2-yr swap touched close to 4.30% on Friday before rallying back to close the week at 4.25%. This week will be dominated by the OCR review, with outright levels as low as they are, it seems unlikely we can rally too far before the announcement.

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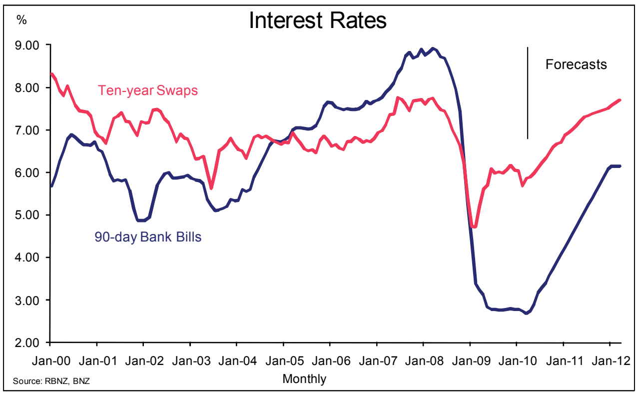

Interest Rate Technicals

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NZD 5yr Swap Rate

Outlook: Higher
MT Resistance: 5.86%
MT Support: 5.03%

The market is breaking higher in yield. We look for a move to 5.50% en route to medium term target of 5.85%. Only a move below 5.03% will negate this scenario.

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

Outlook: Rangebound
MT Resistance: +120
MT Support: +85

The trendline from mid 09 has been broken suggesting a near-term steepening. However expect resistance at +120 to hold.

Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD finished last week with a flourish. The combined support from firming risk appetite and a weaker USD saw NZD/USD finish the week around 0.7170, having started out closer to 0.7050.

A string of upbeat global data last week reinforced the notion the global economy is recovering strongly, conferring support to equity markets and 'growth-sensitive' currencies like the NZD. The S&P500 rose 2.1% over the week to 19-month highs. Meantime, our risk appetite index (which has a scale of 0-100%) increased to 74%, a touch below 2½ year highs. Strengthening risk appetite and optimism about the global recovery encouraged traders to invest in high yielding currencies like NZD and AUD, at the expense of "safe-haven" currencies like the USD and JPY.

Market sentiment received an additional leg-up on Friday from Greece's decision to activate the bailout package offered by the Eurozone and the IMF. The knee-jerk reaction to the announcement saw European equities jump 0.7-1.5% and EUR/USD bounce off 12-month lows around 1.3200. In the wake of the stronger EUR, NZD/USD climbed from 0.7100 to nearly 0.7180.

Stepping back from last week's moves, NZD/USD has spent the better part of 1½ months chopping about in a 0.7000-0.7200 range. The currency has been torn between an improving global backdrop on one hand, and the generally tepid pace of the NZ economic recovery on the other (with last week's tame March CPI figures the latest example). However, with the RBNZ's latest OCR review looming large this week, the chances of a break out of this range are probably greater than normal.

We suspect it will be a tricky meeting for the RBNZ to negotiate as it chooses what, or what not, to say. Keeping it brief, and reiterating "around the middle of the year" in respect of the first hike might seem a bit of a cop out, given we're breathing down on mid-year now. But then this approach would seem better than the Bank trying to signal a preference for either June or July, when either is probably still valid in the Bank's eyes, at this stage. If the RBNZ does chance some fine-tuning/elaboration in its text, we believe it will be in the direction of delay.

Such an outcome would provide a bit of a stumbling block for the NZD in the short-term. Still, we continue to expect any dips in NZD/USD towards 0.7000 to attract solid demand. The NZ economy still looks on track to grow at an annual average pace of 3.0% in 2010 and this stacks up relatively well compared to our trading partners. What's more, NZ commodity prices continue to go from strength to strength, which is helping to offset some of the negative effects of the high NZD and recent drought on NZ's export base. We're expecting Fonterra to confirm as much when they update their current season dairy payout forecast this week. Any upward revision – as appears to be the risk – would further shore up NZD sentiment.

All up, our valuation model suggests short-term 'fundamentals' are consistent with a NZD/USD "fair-value" range of 0.7250-0.7450. So, on this basis, the NZD/USD is still slightly "cheap".

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Foreign Exchange Technicals

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NZD/USD

Outlook: Consolidation
ST Resistance: 0.7215 (ahead of 0.7290)
ST Support: 0.7070 (ahead of 0.7000)

The market lacks direction at present with the currency firmly in range-trading mode. A convincing break through 0.7215 is needed to signal the start of a new uptrend.

NZD/AUD

Outlook: Consolidation
ST Resistance: 0.7800 (ahead of 0.7860)
ST Support: 0.7615 (ahead of 0.7555)

The failure to sustain dips towards 0.7600 suggests a climb towards 0.7800 is on the cards. A daily close above 0.7800 would suggest the cross has bottomed.

Key Upcoming Events

	Forecast	Median	Last
Monday 26 April			
Aus, Holiday, ANZAC Day (observed)			
Tuesday 27 April			
Aus, Producer Prices, Q1 y/y		-0.6%	-1.5%
UK, CBI Dist Trade Survey, April			+13
UK, BBA Home Loans, March		38.0k	35.2k
US, Shiller Home Price Index, February y/y			-0.7%
US, Consumer Confidence, April		53.5	52.5
Wednesday 28 April			
NZ, NBNZ Business Survey, April			+42.5
Aus, CPI, Q1		+0.8%	+0.5%
Jpn, Retail Trade, March y/y		+3.6%	+4.2%
US, FOMC Policy Announcement	0.25%	0.25%	0.25%
Thursday 29 April			
NZ, Household Credit, March y/y			+2.7%
NZ, WAP, Q1			
NZ, OCR Review	2.50%	2.50%	2.50%
NZ, Merchandise Trade, March	+$475m		+$321m
US, Jobless Claims, week ended 24/04		445k	456k
Euro, M3, March y/y		-0.1%	-0.4%

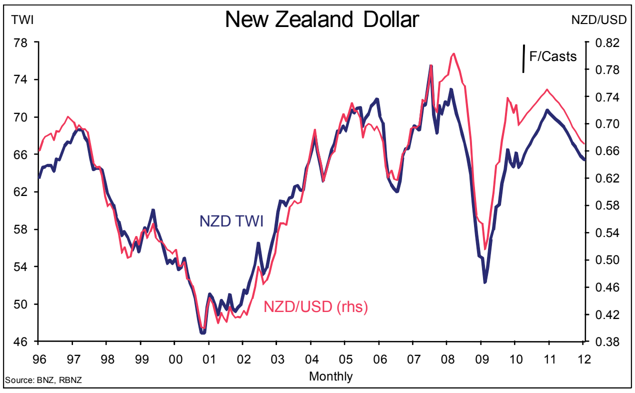
	Forecast	Median	Last
Thursday 29 April *continued...*			
Euro, Economic Confidence, April		99.4	97.7
Germ, Unemployment, April sa		8.0%	8.0%
Friday 30 April			
NZ, Building Consents, March (res, #)			+5.9%
Aus, Private Sector Credit, March		+0.4%	+0.4%
Jpn, Household Spending, March y/y (real)		+0.7%	-0.5%
Jpn, Unemployment Rate, March		4.9%	4.9%
Jpn, BOJ Outlook Report			
Jpn, Industrial Production, March 1st est		+0.8%	-0.7%
Jpn, BOJ Policy Announcement			0.10%
Jpn, BOJ Economic Forecasts (circa)			
Jpn, CPI, March y/y		-1.1%	-1.1%
US, GDP, Q1 saar 1st est		+3.4%	+5.6%
US, Mich Cons Confidence, April 2nd est		71.0	69.5P
US, Employment Cost Index, Q1		+0.5%	+0.5%
US, Chicago PMI, April		59.6	58.8
Euro, Unemployment Rate, March		10.0%	10.0%
Euro, CPI, Apr y/y 1st est.		+1.4%	+1.4%
Saturday 1 May			
China, PMI (NBS), April		55.6	55.1

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	3.00
1 mth	2.62	2.62	2.59	3.18
2 mth	2.65	2.65	2.67	3.12
3 mth	2.69	2.69	2.68	3.01
6 mth	2.88	2.88	2.84	2.98
GOVERNMENT STOCK				
11/11	3.72	3.72	3.82	3.70
04/13	4.52	4.52	4.62	4.40
04/15	5.14	5.14	5.21	4.86
12/17	5.65	5.65	5.71	5.30
05/21	5.92	5.92	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.37	3.41	3.39	4.37
BNZ 05/15	6.55	6.53	6.55	6.84
GEN 03/14	6.48	6.45	6.49	7.00
GEN 03/16	7.14	7.13	7.15	7.56
TRP 12/10	3.73	3.71	3.76	4.71
TRP 06/20	6.98	7.11	7.19	7.41
SWAP RATES				
2 years	4.20	4.20	4.28	3.64
3 years	4.66	4.66	4.73	4.21
5 years	5.21	5.21	5.25	4.75
10 years	5.85	5.85	5.91	5.40

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7069	0.7073	0.7053	0.5678
NZD/AUD	0.7669	0.7672	0.7792	0.7873
NZD/JPY	65.03	65.06	65.16	54.98
NZD/EUR	0.5239	0.5248	0.5234	0.4287
NZD/GBP	0.4621	0.4625	0.4720	0.3870
NZD/CAD	0.7176	0.7184	0.7231	0.6876
TWI	65.54	65.60	65.82	56.25

NZD Outlook



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