10 May 2010

Europe Concerns Impacting Market Liquidity

- Market ructions serious, as liquidity impinged
- Financial market moves, sentiment, crucial for this week
- NZ labour market results make recovery clearer
- This week's data reports likely positive enough
- RBNZ caught in the balance, as June MPS takes shape

How serious are these latest global ructions? That is the question. While the economic implications of a deeper Greek recession are moot for the world economy, it's the broader upheaval in financial markets that is most telling. Push has come to shove, with Greece simply a template of what many rich-world countries face, financially, over the coming many years.

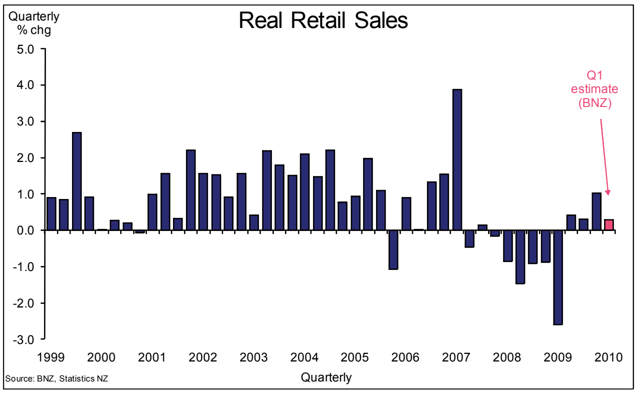
In the least, we need to take the concerns around Europe's public finances and banking system seriously, as they are, as we speak, materially disrupting the global liquidity New Zealand still heavily depends upon. Foreign funding through the money markets is suddenly problematic again. The risk premium for raising short-term money has risen.

In this sense, what's occurring feels a bit more like Lehman than Dubai. Crucial to this week, therefore, will be how global market sentiment holds together, or otherwise. Fingers crossed.

One of the ironies of these financial market disruptions is that they have arrived just when a lot of the economic data have been looking better and better, globally. US payrolls, from Friday, were but one example. The globe's PMI and PSI surveys for May also told of strengthening recovery.

And so it is with the New Zealand economy, with last week's Household Labour Force Survey (HLFS) affirming a clear turning point. The actual improvement is not as stark as suggested by the unemployment rate plunging to 6.0% and employment bounding 1.0% in the quarter. We believe the jobless rate will bounce back up to 6.5% in Q2, on 0.4% employment growth. Nonetheless, the trend is definitely improving.

Also, the HLFS jobs and hours results (along with those of Tuesday's QES) have us bumping up our Q1 GDP growth estimate to 0.6%, from 0.4%, and with upside risks still in place. The actual result isn't due until 24 June, however, and so there are many GDP partials to be witnessed in the interim.

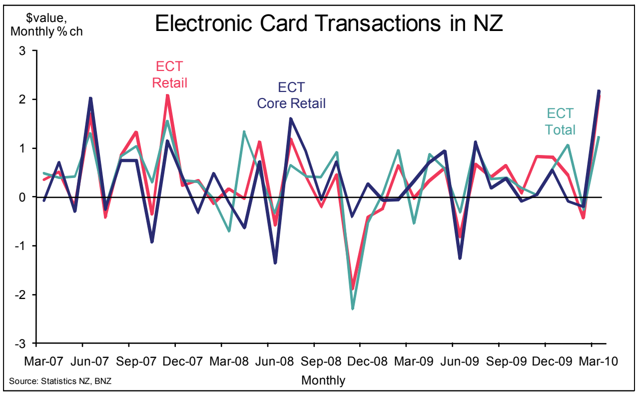


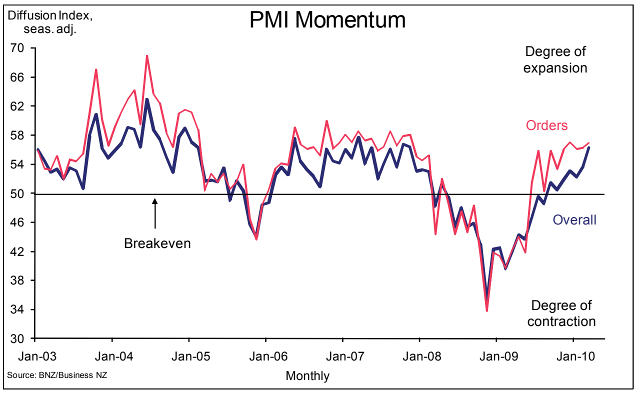
As for this week's local data releases, while only Friday's Q1 retail report is verging on anything "major", there are enough, in total, to keep the recovery story well in force, in our judgement.

In respect to retail sales, Friday's results for March are expected to bounce clearly from February's surprising fall. It seems just a matter of checking the degree. We're looking for 1.5%, overall, and 1.8% ex-auto (with upside risk), just slightly stronger than market expectations.

Even so, this would only just rescue Q1 volumes. We are picking 0.3% volume growth in total, while real ex-auto spending falls 0.5%. For Q1, as a whole, therefore, it'll probably be a mixed report for the retail sector.

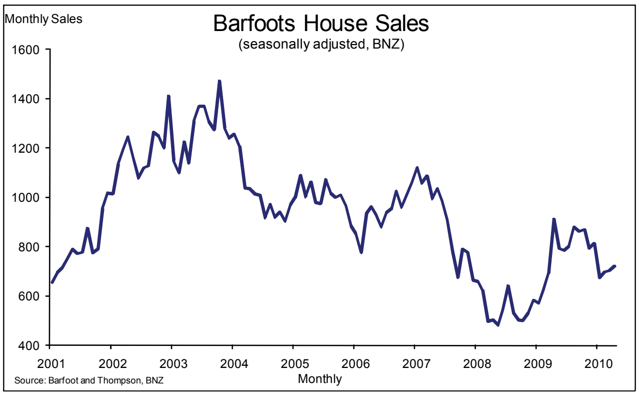
Better news may well come from April's electronic card transactions, due tomorrow. Generally speaking, they should better reflect the trend, following March's big bounce from the weakness of January/February. But do beware a spike in April's transactions – given a likely





last- gasp rush to buy cigarettes, given the late-month hike to tobacco tax, and advance Rugby World Cup tickets, as opening web-based sales commenced in earnest.

This week also delivers a further update on the housing market. We've already seen the choppy cum cautious results of this morning's QVNZ report. And we can't imagine Friday's REINZ report for April will be any more definitive, especially having seen the so-so results of last week's housing statistics from Auckland-based realtor, Barfoot and Thompson.



For the record, we expect Friday's REINZ home sales to be in the range of 4,600 to 4,900 to fit with our belief that stability is emerging, albeit at very subdued levels.

In between, Thursday delivers April's BNZ Performance of Manufacturing Index (PMI) as well as food prices. We expect the PMI to persist in clearly expansive territory, much like we saw with its March reading of 56.3, seasonally adjusted.

For the food price index, we are agnostically picking a 0.2% increment. Any big moves, up or down, however, could be significant for Q2 CPI arithmetic – against the backdrop of the RBNZ being a little edgy about the headline pressures over the remainder of the year, related to various policy imposts.

By and large, then, we expect this week's data to support the strengthening recovery we're expecting for the NZ economy. The bigger question is how the world is looking, and the financial markets off the back of it.

So, just when the local labour market data tilted the case for a first OCR hike firmly into June, the clouding global situation gives further pause for thought. It would be a bold RBNZ to downplay the clear signals of a domestic upturn. It would be a bolder one to hike in the heart of what could turn out to be another serious phase of global economic and financial disruption.

One thing's for sure. Our central bankers will be certainly earning their money over the coming weeks, as they formulate their Monetary Policy Statement for 10 June publication.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand INTEREST rates had a very volatile week on the back of strong employment data and the ongoing sovereign debt issues that continue to plague Europe. Thursday's extraordinary unemployment print of 6.0% against an expectation of 7.3% blew the market out of the water. However late last week the Greece story took the driving seat, as the fear of contagion initiated a flight to quality and pushing kiwi rates lower. The OIS curve is now pricing approximately a 60% chance of a 25 bps hike in June, it should be noted that after the employment data and prior to the Greece escalation, the market had a 50% chance of a 50 bps hike in July.

Shorter dated government bonds traded heavily after the surprise unemployment number, but still out-performed relative to swap, with the strong flattening theme in kiwi yields. Last week's small tender of $100m of 21s was successfully taken out with a bid to cover ratio of 5:1, as there seems to be strong demand for longer dated bonds.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
30-Apr-10	2.73%	4.69%	5.91%	4.40%	5.82%	142
7-May-10	2.92%	4.65%	5.79%	4.53%	5.86%	133
Change (bps)	19	-4	-12	13	4	-9

The kiwi swaps market sold off sharply after the employment data, with a large flattening bias. The 2-year swap trading 18 bps higher to a high of 4.64%, leaving the curve 11 bps flatter overall. The Greece driven rally then pushed swaps lower steepening the curve from the short end, 2-year swap closing the week at 4.53%. The flattening pressure has been relentless over the past month; 2s10s is now marked at 129bps, almost 40 bps flatter than a month ago. We feel that the back end of the curve looks too low from a historical standpoint and hence favour a borrowed position. We see the new range in the 2-year swap being 4.50 - 4.70%.

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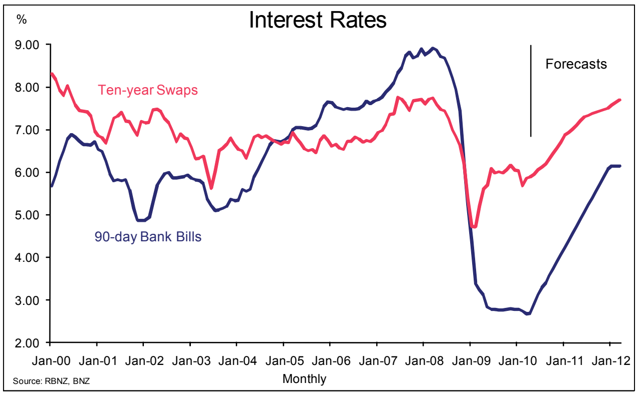

Interest Rate Technicals

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NZD 5yr Swap Rate

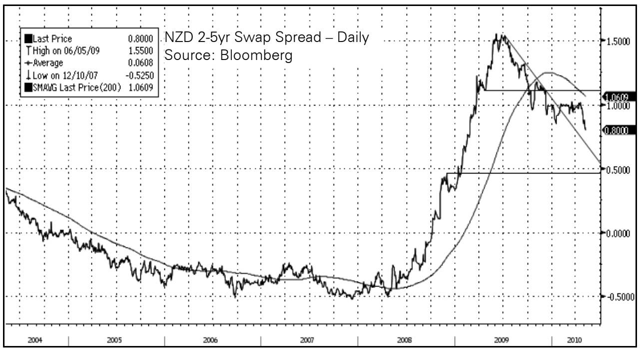
Outlook: Higher
MT Resistance: 5.86%
MT Support: 5.03%

The market continues to move higher. Any pullbacks should be held by previous trendline and we expect push up towards 5.86% resistance.

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

Outlook: Rangebound
MT Resistance: +110
MT Support: +46

We saw some flattening occur last week. This has been unconvincing and we expect the range trade to continue. Only a break below trend line around 65 would confirm a flattening trend.



Foreign Exchange Market

Reuters pg BNZWFWDS

It was a real rollercoaster ride for the NZD last week. While firming expectations of a June OCR hike kept NZD/USD well supported over the early part of the week, a slump in risk appetite saw the currency tumble to 0.7150 by Friday.

Last week's NZ Q1 employment report was exceptionally strong, no buts. Employment grew 1.0% in the quarter, and the unemployment rate fell to 6%, blowing the market's 7.3% forecast right out of the water. With the labour market now clearly responding to the NZ economic recovery, markets moved to fully price an OCR hike in June. As a result, NZ-US 3-year swap spreads widened to 335bps (from 310bp at the start of the week), pitching NZD/USD to nearly 0.7300, and NZD/AUD above 0.8050 for the first time since January.

However, the positive NZD sentiment evaporated later in the week as global financial markets went into panic mode.

Fears contagion from Greece's fiscal crisis could evolve into the global credit crisis mark II sent markets into a tailspin. Risk aversion sky-rocketed and global equities tumbled. Our risk appetite index (which has a scale of 0-100%) almost halved over the week, falling from 65% to 33.5%. Meanwhile, the MSCI World Equity Index tumbled 8.2% – the largest weekly decline since October 2008. Not even Friday's surging US employment figures (290,000 vs. 190,000 expected) could sway markets' negative mood.

Soaring risk aversion prompted a stampede back into "safe-haven" currencies like the USD and the JPY, at the expense of "growth-sensitive" currencies like the NZD. NZD/JPY slipped to around 65.00 and NZD/USD skidded to 0.7150.

Still, it's worth noting that the NZD held up better than most last week. Indeed, on a trade-weighted basis, the currency hardly moved. Not only did the plunging EUR drive NZD/EUR to 2½ year highs above 0.5700, but NZD/GBP rose to fresh 30-year highs above 0.4900 as the UK election failed to produce a clear winner. Despite the global turbulence, local 'fundamentals' remain generally supportive of the currency and macro and real money accounts remain keen buyers on dips.

For this week, we suspect developments in Europe will continue to provide most of the direction for the NZD. Gyrations in equity market sentiment, as a broader gauge of risk appetite, will be key in this regard as investors digest the package of support measures recently announced by the ECB and the European Commission. The current proposal from the Commission would see a €600b facility set up to provide loans and loan guarantees to needy countries, with the ECB also expanding its liquidity operations. Time will tell whether the support package will provide an effective circuit breaker to the markets' contagion fears. Early indications are positive, if the 2.5% gain in S&P500 futures is anything to go by. Against this background, we suspect NZD/USD dips below 0.7150 will be short-lived this week.

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Foreign Exchange Technicals

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NZD/USD

Outlook:	Consolidation
ST Resistance:	0.7330 (ahead of 0.7440)
ST Support:	0.7100 (ahead of 0.7010)

The rejection of 0.7300 means the uptrend has stalled for now. In the absence of a daily close below 0.7100, expect some consolidation within familiar ranges.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8090 (ahead of 0.8200)
ST Support:	0.7965 (ahead of 0.7900)

The break through resistance at 0.7960 means the uptrend is now firmly established. However, the daily RSI indicates the currency is severely "overbought" hence some consolidation is expected near-term.

Key Upcoming Events

	Forecast	Median	Last
Monday 10 May			
Aus, NAB Business Survey, April			
Jpn, BOJ Minutes, 6/7 Apr Meeting			
UK, BOE Policy Announcement	0.50%	0.50%	0.50%
Germ, Trade Balance, March s.a.		+€14.0b	+€12.6b
China, Trade Balance ($US), April		-$0.55b	-$7.24b
Tuesday 11 May			
NZ, Electronic Card Transactions, April			+1.2%
Aus, Federal Budget			
UK, RICS Housing Survey, April		+10%	+9%
UK, Industrial Production, March		+0.3%	+1.0%
UK, BRC Retail Sales Monitor, March y/y			+6.6%
China, Industrial Production, April y/y		+18.5%	+18.1%
China, CPI, April y/y		+2.7%	+2.4%
China, PPI, April y/y		+6.5%	+5.9%
China, Fixed Investment (Urban), April ytd y/y		+26.0%	+26.4%
China, Retail Sales, April y/y		+18.2%	+18.0%
Wednesday 12 May			
Aus, Housing Finance, March	-4.0%	-2.0%	-1.8%
UK, Unemployment Rate (ILO), March		8.0%	8.0%

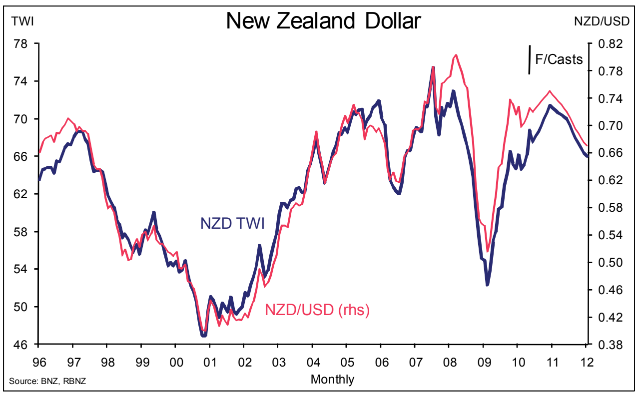
	Forecast	Median	Last
Wednesday 12 May continued...			
UK, BOE Inflation Report			
UK, Trade Balance, March		-£2.5b	-£2.1b
Euro, Industrial Production, March		+1.0%	+0.6%
Euro, GDP, Q1 1st est		+0.1%	flat
US, International Trade, March		-$40.0b	-$39.7b
Thursday 13 May			
NZ, BNZ PMI (Manufacturing), April			56.3
Aus, Unemployment Rate, April	5.3%	5.3%	5.3%
Aus, Employment, April	+20k	+25k	+20k
Jpn, Eco Watchers Survey (outlook), April	47.0		
Euro, ECB Monthly Bulletin			
Friday 14 May			
NZ, Retail Trade, March	+1.5%	+1.2%	-0.6%
NZ, REINZ Housing Data, April			
NZ, Retail Trade, Q1 vol s.a.	+0.3%	+0.4%	+1.0%
US, Industrial Production, April		+0.6%	+0.1%
US, Retail Sales, April		+0.2%	+1.9%
US, Business Inventories, March		+0.4%	+0.5%
US, Mich Cons Confidence, May 1st est		73.5	72.2

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	2.50
1 mth	2.66	2.62	2.60	2.88
2 mth	2.80	2.68	2.64	2.85
3 mth	2.92	2.76	2.70	2.92
6 mth	3.17	2.99	2.89	2.91
GOVERNMENT STOCK				
11/11	3.92	3.89	3.77	3.70
04/13	4.65	4.69	4.57	4.56
04/15	5.14	5.23	5.21	5.15
12/17	5.57	5.67	5.72	5.67
05/21	5.79	5.91	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.55	3.43	3.39	4.28
BNZ 05/15	6.76	6.57	6.52	7.08
GEN 03/14	6.70	6.54	6.46	7.15
GEN 03/16	7.31	7.14	7.13	7.78
TRP 12/10	3.93	3.77	3.74	5.08
TRP 06/20	7.10	6.95	7.11	7.72
SWAP RATES				
2 years	4.55	4.40	4.25	3.56
3 years	4.95	4.82	4.70	4.18
5 years	5.38	5.28	5.22	4.87
10 years	5.88	5.82	5.88	5.70

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7205	0.7288	0.7169	0.6038
NZD/AUD	0.8002	0.7896	0.7659	0.7829
NZD/JPY	66.54	68.45	66.83	59.60
NZD/EUR	0.5569	0.5462	0.5264	0.4423
NZD/GBP	0.4851	0.4757	0.4644	0.3965
NZD/CAD	0.7436	0.7408	0.7201	0.6939
TWI	68.10	67.97	66.17	58.53

NZD Outlook



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