17 May 2010

Will the Budget Propose Inflation-Linked Bonds?

- Government accounts to look not so bad
- NZ deficits/debt modest by developed-world standards
- But vulnerabilities and uncertainties remain
- As Wednesday's Financial Stability Report should show
- Secondary data will take backseat, but worth a look

All the action, these days, seems to be in balance sheets, financial and banking systems, and the state of one's government accounts. This week we get the latest updates on such things in New Zealand with the six monthly Financial Stability Report issued by the RBNZ Wednesday, followed by the Government's Budget on Thursday. Both will make for interesting reading.

The Budget will be the main event. Indeed, it is the most keenly awaited for years (we know this because the Treasury is turning people away from their usual 'lock-up' for media and analysts; it will be a full house).

Overall, we expect the fiscal accounts to look not so bad as before, underpinned by an improving economic outlook. We anticipated smaller deficits, over time, leading to net debt rising at a slower pace and a not-so-high bond programme.

We expect the Treasury to lift its economic projections, particularly over the coming year, from those in half-year update published last December. Back then Treasury forecast 2.4% economic growth in the year to March 2011. We suspect this is where the biggest change to the Treasury's growth track will come. Look for something now in excess of 3%.

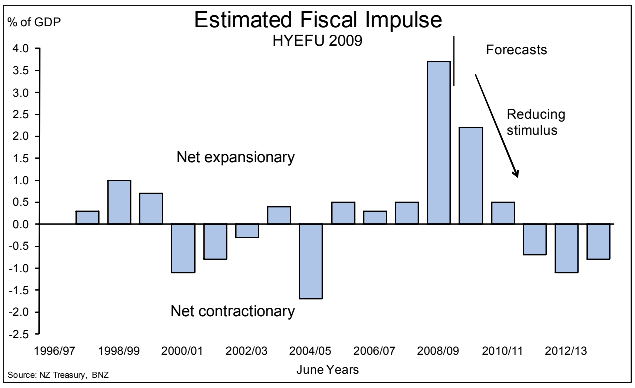
This may not seem a particularly big change.
But, importantly, it would lift the economic and tax base that applies to the full forecast horizon, assuming, as we think will be the case, only minor changes to the growth outlook beyond the first year.

In addition, higher world prices for many of our export commodities are likely to lift NZ's terms of trade above Treasury's previous central forecast. To be fair, this has not come as a complete surprise given the Treasury recognised in their half-year update that 'higher terms of trade are a distinct possibility'. Still, better terms of trade are likely to be incorporated into the central forecast, further boosting nominal income growth and the tax base.

As for policy announcements, there should be plenty to chew on. But we do not think there will be any major surprises given the clear signals from the Government over recent months.

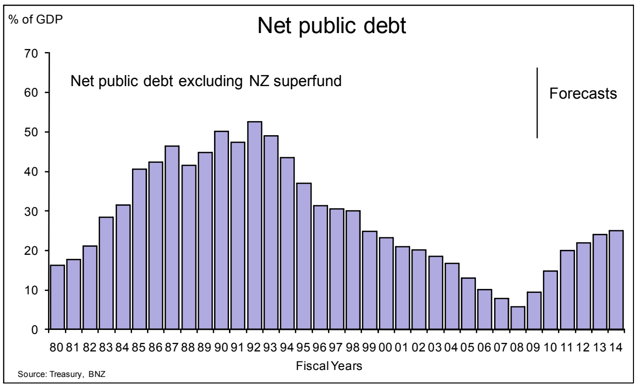
Tax changes will be a feature. We believe the core changes will be relief on personal tax, higher GST and the removal of depreciation allowances on property investment (which we built into our macro forecasts, officially, last month).

Don't look for too much in additional spending, with the $1.1 billion per annum (plus inflation) spending cap in place. Health, education and science will likely get the lion's share. Beyond that there will be an emphasis on redirecting money from bureaucracy and spending to increasing the nation's supply potential (straightening the road for Dr Bollard's truck driver, if you will). We await the details, but overall the changes are likely to be broadly give-and-take, although probably erring on the side of a net stimulus. Even so, it is highly likely that the overall degree of stimulus will be less than has been over the past two years when the economy was in, or recovering from, recession. In the outer years, the tendency will be for fiscal contraction, at least to some degree.



So expect to still see many years of deficits forecast, but lessening from the recent levels of around 4% of GDP. The brighter side is that surpluses should return a little sooner than the 2016/17 fiscal year projected in the half-year update, as the stronger economic outlook shores up the Government's accounts.

The corollary of lower deficits is that public debt will rise over the coming years, but not by as much as previously projected. The half-year update had net debt rising from 9.5% of GDP in 2008/09, to 29% of GDP by 2013/14, and peak at just over 30% in 2015/16. Look for something closer to 25% by the end of the projection period.



This is all significant, as New Zealand looks around at the truly awful fiscal situations in most other parts of the (developed) world.

It is also worth noting that NZ's net public debt is not particularly large in an historical context. A rise to 25% of GDP would only see net debt back to where it was in the late 1990s and half what it was in 1992, when it peaked above 50% of GDP. Of course, net debt is even lower when the assets from the NZ super fund are included (with a forecast peak closer to 15% of GDP). The Government's balance sheet has been used to support the economy through a weak period, similar to previous recessions. Vigilance is now required to prevent future issues.

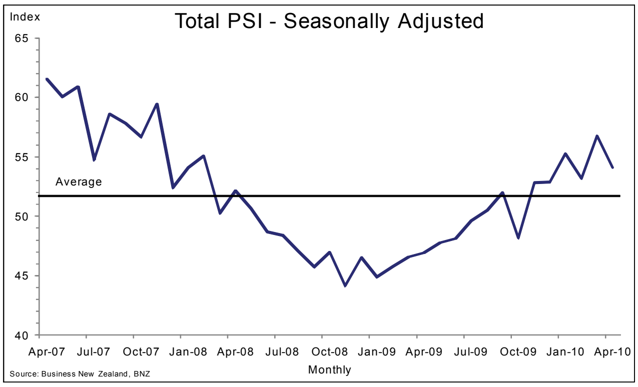
Lower debt projections, in turn, will take some pressure off the bond programme in coming years. Further pressure will come off the future bond programme from changes this year. Remember the NZDMO has already increased the 2009/10 bond programme by $2 billion to $12.5 billion, effectively pre-funding future borrowing requirements. All this should see a reduction from the total borrowing requirement of $43 billion over the four years to 2013/14 projected in the half-year update. Focus will be on the size of the bond programme but also whether the DMO decides to issue new inflation-linked bonds. These may make sense given global fears of inflation.

Of course, the Budget is merely an outline of where we are headed. Things can, and do, change. Surprises come along and forecasts are changed. Indeed, the economic forecasts underlying the Budget projections would have been finalised before the unexpected (by all and sundry) very large drop in Q1 unemployment. On the other side, the intensification of fears around European sovereign deficits and debt muddies the outlook for world growth. All this reinforces the fact that we should keep an eye on the big picture rather than get too hung up on any particular forecast.

Speaking of the big picture, Wednesday's Financial Stability Report (FSR) from the RBNZ will give the latest snapshot. This should be a generally positive report on the health of NZ's financial system and how it has coped with the ills of recent years. We would expect the FSR to note ongoing world economic recovery but also highlight the many risks still lurking particular around sovereign debt issues in the developed world.

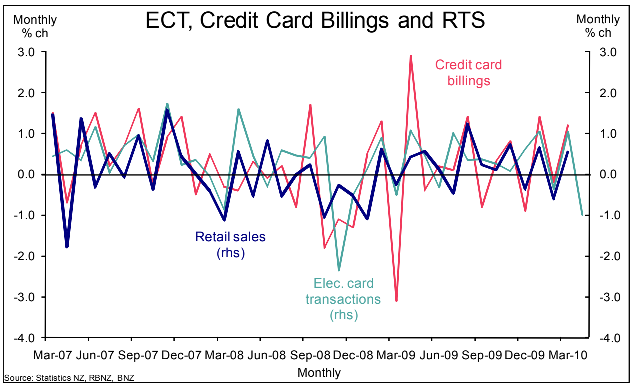
In the FSR, the RBNZ is again likely to highlight NZ's vulnerabilities to adverse developments in offshore markets, given we continue to live beyond our means. However, the Bank might well note the early signs of movement in the right direction in this regard. A considerably smaller current account deficit, indications of less dis-saving by households and subdued credit growth are likely to get a mention, even if in the context of more needing to be done. For currency watchers, keep an eye out for any comments that suggest a stronger NZD would impede this rebalancing. However, disappointment awaits those looking to the FSR to give certainty on whether the RBNZ will start lifting interest rates on 10 June or not.

On the data front, it is mainly second tier stuff this week, but worth a look nonetheless. Today's BNZ-Business NZ Performance of Services Index remained positive on average, although a bit mixed, as you might expect with such a grouping of many and varied businesses. Overall, the services sector remains net optimistic with its seasonally adjusted reading of 54.1 in April remaining well above the series average of 51.8, although a touch back from the 56.7 recorded in March.



Tuesday brings the typically uneventful Q1 producer and capital goods prices. For the record, both are likely to be subdued with weak undertones coming from domestically-driven prices and strong NZD dampening most external prices. Higher commodity prices are the exception that should give some lift to producer prices.

Amid Thursday's Budget hubbub, don't forget the afternoon's ANZ-RM consumer confidence index that should remain at healthy levels. However, do not automatically assume this will translate into materially higher spending as consumers appeared to be rediscovering the virtues of saving. Something last week's soft Q1 retail sales, plunge in April's electronic transactions data, and still subdued housing market data attest too. This Friday's credit card data will probably reinforce this impression.



Friday also brings April's tourism and migration data. Bear in mind that the data will be distorted by the major disruption to Northern Hemisphere air travel following a volcanic eruption in Iceland (an effect that will continue into May given the closure of UK air space today as more ash drifts across from Iceland). Also, a relatively early Easter meant more arrivals in March at the expense of April. Still, overall visitor arrivals should be similar to last year, reflecting underlying strength. Meanwhile, we expect further softening in net migration.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates have been very whippy over the past week. As we continue to move closer towards the beginning of the hiking cycle yields are trying to grind higher. However, the sovereign debt issues emanating from Europe are keeping a lid on kiwi rates. Yields ended the week lower with a reasonable steepening bias. More of the strengthening coming from the front end of the curve as the short positions in the market were keen to take some risk off the table with the concerns that the proposed bail out package in Europe might not be enough, hindering the plans to begin the tightening cycle in NZ. The current OIS curve is pricing in a 68% chance of a 25 bps hike for the June meeting, and about 120 bps priced in for the rest of the year.

NZ government bonds rallied over the past week strengthening from the flight to quality that continues to persist from the dire situation in Europe. Good demand for longer dated bonds has meant they have outperformed relative to swap. This was reflected in the tender with the NZGS 15s being under subscribed in favour of the 21s. This week the bond market will look to Thursday's Budget, as this will give us an idea of the Governments' fiscal position and its intentions surrounding bond issuance going forward.

Meanwhile, NZ swaps have been choppy, subject to the aforementioned. With many participants in the market positioning themselves on the short side, after the upbeat Bollard comments and the promising employment data from the previous weeks, some were prepared just to pare some of their risk back as the European sovereign weighs on the global outlook. The 2-year swap traded a 10bps range over the week, trading as high as 4.61% before closing the week at 4.52%. The curve steepened approximately 6bps overall with 2s10s currently marked at 138.5bps. We see 2-year swap in a 4.45 - 4.65% range for the meantime.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
7-May-10	2.92%	4.65%	5.79%	4.53%	5.86%	133
14-May-10	2.90%	4.69%	5.80%	4.52%	5.91%	139
Change (bps)	**-2**	**4**	**1**	**-1**	**5**	**6**

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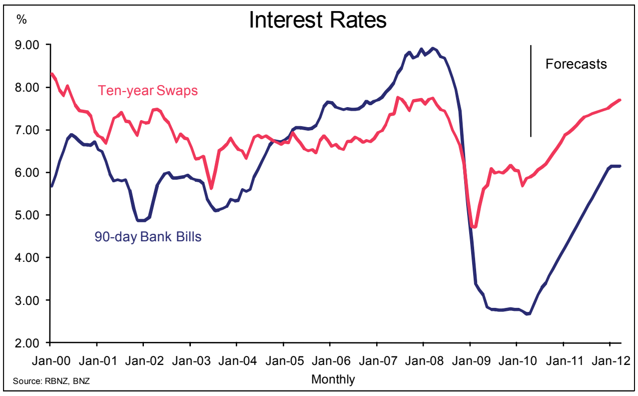

Interest Rate Technicals

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NZD 5yr Swap Rate

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

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

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

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

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

The NZD/USD spent most of last week in a downward trajectory. Having started the week around 0.7300, NZD/USD slipped below 0.7100 on Friday. Still, on a trade-weighted basis, the NZD was more or less unchanged over the week.

Initial optimism about the EU-IMF's emergency aid package faded over the second half of last week. Not only did policy makers caution the deal is only a temporary fix, but investors worried harsh fiscal austerity measures will stymie the tentative economic recovery underway in Europe. Global stocks surrendered some of the week's early gains and risk aversion marched higher. As a result, 'safe-haven' currencies like the USD and JPY returned to favour, and investors trimmed positions in 'growth-sensitive' currencies like the NZD and AUD.

Nevertheless, with the contrasting economic fundamentals between NZ and Europe increasingly obvious, both NZD/EUR and NZD/GBP surged to new highs last week, helping to limit more general NZD losses. NZD/EUR climbed to 2½ highs above 0.5750, while NZD/GBP peaked above 0.4900 – the highest since June 1979.

For this week, the Budget looms large as key NZD event risk. We expect some improvement in Thursday's edition, in respect to lessening deficits, from recent levels of around 4-5% of GDP, and a slower uplift in (net) debt from moderate beginnings. The latter should afford a mild reduction in the Treasury's bond issuance programme (in which, watch for any announcements about index-linked bonds).

While the Budget has potential to be mildly NZD/USD positive, we suspect developments in European sovereign debt markets will remain the bigger driver of the currency for now. Any further slippage in equities and risk appetite could see NZD/USD test support towards 0.6970.

Nevertheless, positive NZD fundamentals – including accelerating NZ growth, lofty commodity prices, and widening interest rate spreads – should keep the NZD cross rates well supported over the week. Most notably, NZD/EUR looks set to push higher still, as concerns over anaemic European growth continue to weigh on EUR/USD.

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Foreign Exchange Technicals

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NZD/USD

Outlook: Consolidation
ST Resistance: 0.7160 (ahead of 0.7230)
ST Support: 0.7000 (ahead of 0.6970)

Upward momentum has faded. A daily close below 0.6970 would suggest a downward correction towards 0.6800 is on the cards.

NZD/AUD

Outlook: Consolidation
ST Resistance: 0.8060 (ahead of 0.8110)
ST Support: 0.7900 (ahead of 0.7860)

The daily RSI still indicates the currency is "overbought" so further consolidation is expected near-term. However, momentum will remain positive while the currency trades above 0.7860.

Key Upcoming Events

	Forecast	Median	Last
Monday 17 May			
Jpn, Machinery Orders, March		+6.3%	-5.4%
US, NAHB Housing Index, April		20	19
US, Empire Manufacturing, May		+30.00	+31.86
Tuesday 18 May			
NZ, PPI Outputs, Q1 y/y	-0.7%	-2.0%	-3.8%
Aus, RBA Minutes, 4 May Meeting			
Jpn, Tertiary Industry Index, March		-1.5%	-0.2%
UK, CPI, April y/y		+3.5%	+3.4%
US, Housing Starts, April		650k	626k
US, PPI ex-food/energy, April y/y		+0.9%	+0.9%
Euro, Trade Balance, March		+€5.0b	+€2.6b
Germ, ZEW Sentiment, May		+47.0	+53.0
Wednesday 19 May			
NZ, RBNZ Financial Stability Report			
NZ, NBNZ Regional Trends, Q1			+1.2%
Aus, Labour Price Index, Q1	+0.8%	+0.8%	+0.6%
Aus, Consumer Sentiment - Wpac, May			116.1
Jpn, GDP, Q1 1st est		+1.4%	+0.9%P

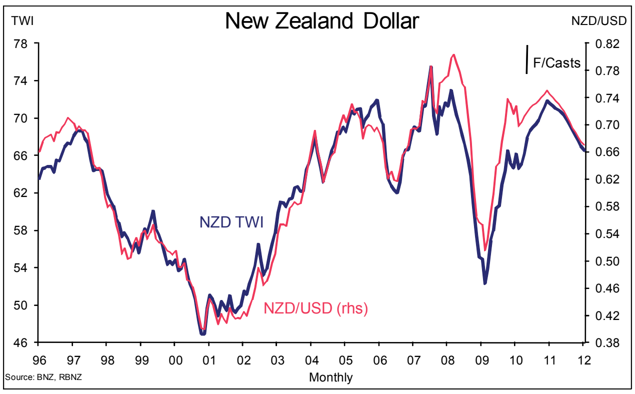
	Forecast	Median	Last
Wednesday 19 May *continued...*			
UK, BOE Minutes, 5/6 May Meeting			
US, FOMC Minutes, 27/28 Apr Meeting			
US, CPI ex food/energy, April		+1.0%	+1.1%
Thursday 20 May			
NZ, Budget			
NZ, ANZ-RM Consumer Confidence, May			121.9
UK, Retail Sales vol., April		+0.2%	+0.4%
US, Philly Fed Index, May		+21.6	+20.2
US, Leading Indicator, April		+0.2%	+1.4%
Germ, PPI, April y/y		+0.4%	-1.5%
Friday 21 May			
NZ, External Migration, April s.a.			+980
NZ, Credit Card Billings, April			+1.2%
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%
Euro, PMI Manufacturing, May 1st est		57.4	57.6
Euro, PMI Services, May 1st est		55.6	55.6
Germ, GDP, Q1 2nd est		+0.2%	+0.2%P
Germ, IFO Index, May		101.9	101.6

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	2.50
1 mth	2.67	2.66	2.62	2.84
2 mth	2.85	2.80	2.65	2.84
3 mth	2.90	2.92	2.69	2.76
6 mth	3.14	3.17	2.88	2.83
GOVERNMENT STOCK				
11/11	3.92	3.92	3.72	3.52
04/13	4.67	4.65	4.52	4.37
04/15	5.13	5.14	5.14	4.94
12/17	5.55	5.57	5.65	5.40
05/21	5.78	5.79	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.58	3.55	3.41	4.04
BNZ 05/15	6.62	6.76	6.53	6.78
GEN 03/14	6.60	6.70	6.45	6.86
GEN 03/16	7.19	7.31	7.13	7.49
TRP 12/10	3.93	3.93	3.71	4.83
TRP 06/20	7.12	7.10	7.11	7.41
SWAP RATES				
2 years	4.50	4.55	4.20	3.41
3 years	4.89	4.95	4.66	4.01
5 years	5.35	5.38	5.21	4.69
10 years	5.88	5.88	5.85	5.49

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7059	0.7205	0.7073	0.5861
NZD/AUD	0.7975	0.8002	0.7672	0.7814
NZD/JPY	65.16	66.54	65.06	55.67
NZD/EUR	0.5715	0.5569	0.5248	0.4345
NZD/GBP	0.4859	0.4851	0.4625	0.3861
NZD/CAD	0.7310	0.7436	0.7184	0.6905
TWI	67.91	68.10	65.60	57.03

NZD Outlook



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