24 May 2010

Offshore Concerns Dominate

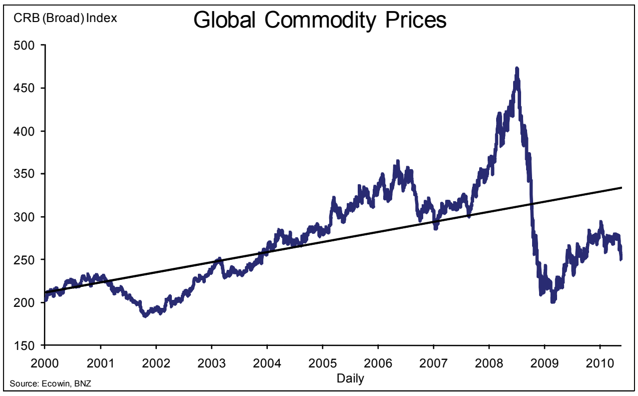
- All eyes on the Eurozone's demise
- But don't ignore China in the process
- Potential surge in inflation expectations worrying
- Dairy payout expectations remain lofty
- Drought struck north gets a dunking

The machinations of offshore markets are likely to be the central focus for economy watchers over the week ahead though there is a smattering of domestic data that should not be overlooked.

The big focus offshore is clearly the ongoing fascination with the demise of the Eurozone. Officialdom throughout he region is doing its best to put on a brave face and apply bandages to weeping wounds, where and when appropriate, but the reality is that massive sovereign debt issues will almost guarantee that Europe is destined for a protracted period of sub-par growth both relative to its own history and relative to the rest of the world. Every time that the economies, particularly of the more beleaguered states, poke their heads above the parapets, Governments will be forced to shoot them down by taking away more than their fair share of any gains made. What a stark contrast between this and New Zealand where the Government and Opposition have the luxury of being able to argue over where the state should be cutting taxes and where it should be expanding spending.

Not only are matters fiscal constraining Europe but so too the existence of the Euro. Currencies can play a major role in assisting countries facing significant imbalances to adjust. Fixed currencies don't provide the same assistance. What Greece, Portugal and Spain desperately require are much lower exchange rates. It may appear that they are achieving this with the slump in the Euro but, in large part, this provides no assistance whatsoever. To start with, a significant proportion of the trade that these countries do is with other Eurozone states on which the drop in the Euro has no direct impact at all. As for the adjustment with countries outside of Europe, this is helpful at the margin but don't forget that the more competitive countries in Europe, such as Germany and France, also get these benefits so, again, there is limited relative assistance.

Immediately, for New Zealand businesses, it is not the real economy impact of what is going on in Europe that is of concern but, rather, the flow on effect into financial market pricing – both interest rates and the currency. On the interest rate front, heightened concern about the stability of global banking systems is again pushing up the



cost of short term funding to the NZ banking system. As ever, these increased costs will find their way through to borrowers as well.

Having said this, further down the yield curve rates are being pressured upwards by heightened risk and ongoing concerns about the demand for funding from sovereigns but downward by the expectation that the current shenanigans will have an adverse impact on growth. Currently, the downside pressures are winning the battle.

For the NZD there is also a mixture of upside and downside. Heightened global risk aversion has seen a significant drop in the NZD versus the USD and Yen. In contrast, the currency has trended higher against the EUR and found some strength against the AUD.

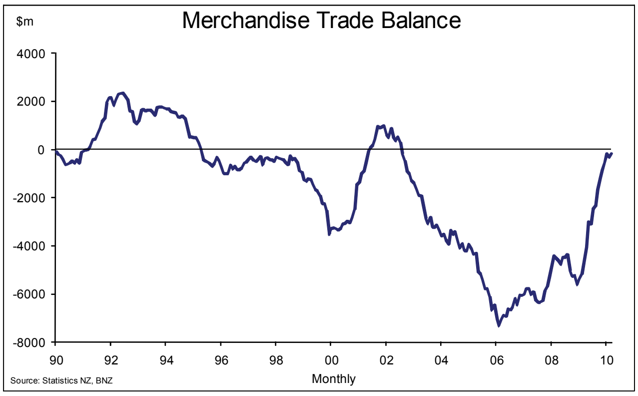
It is important to realise that, while all the recent media attention has been on Europe, there are changes afoot closer to home that are probably equally as influential on NZD developments. In particular, we refer to the significant tightening in monetary and fiscal policy that is occurring in China and the negative impact that it is having on global commodity prices in conjunction with the negative signals from Europe. For many it has passed under the radar screen but the CRB index of global commodity prices has fallen almost 10.0% in the last month. And the commodities that have been afflicted most have been those that Chinese demand significantly impacts. This, in large part, explains why the NZD has moved higher against the AUD. (As an aside, the MSCI Global stock index is also down over 10% month to date).

Against this backdrop, it is notable that New Zealand dairy prices appear to be hanging in there at this stage. This being so, there is great interest in what Fonterra's first stab at next season's payout will be. This is anticipated later this week or Monday 31 May at the latest. We would be surprised if next year's forecast is any lower than this year's. The year after may be more problematic, however.

One has to be very careful given the mixed nature of the NZD's progress over the last month not to generalise about the impact it might be having on economic growth, the domestic pricing structure and the Reserve Bank's response to such. It is particularly noteworthy that the New Zealand dollar Trade Weighted Index still sits at 65.3 – that's 1.4% above where the RBNZ had assumed it might be when it put together its March Monetary Policy Statement. Consequently, the recent "slump" in the currency does not portend a knee-jerk reaction from the RBNZ.

While the international action is most attention grabbing, a glance at the snippets available domestically this week, will also be worthwhile starting with the inflation expectations series released by the Reserve Bank on Tuesday. This is a series that has little popular following but still weighs heavily on the minds of Reserve Bankers. This week's numbers are unlikely to shed much light on matters but going forward the series will be very enlightening. With GST going to 15.0%, emissions trading charges to hit the price of fuel and energy, ACC costs rising and the price of fags already higher, annual CPI inflation will conceivably push up through 5.0%. This in itself is not a problem if it is seen as being transitory. But if behaviours change as a consequence then all bets are off. In this regard, the central bank will be watching two-year ahead inflation expectations with great interest. We'd recommend you do the same. One thing's for sure, Governor Bollard will be wheeled out with gay abandon over the next year or so as he does everything within his power to convince all and sundry that what we are about to see is a price blip not a return to higher generalised inflation.

Thursday sees merchandise trade figures for the month of April. These monthly figures are inherently extremely volatile so it's really difficult to say anything particularly



sensible about them. Nonetheless, our core view is that the annual trade balance will again improve modestly such that the annual reading moves into surplus for the first time since April 1995. The combination of weak imports (thanks to the equally weak domestic economy) coupled with soaring export commodity prices has seen a massive improvement in this balance which was recording a $7.0 billion deficit as recently as Q1 2006.

On Friday we get to see further information on the state of the domestic economy. The holiday season may adversely affect building permit data but we expect to see a continuation in the broadly improving trend in this series. In contrast, it's hard to envisage any marked improvement in the credit aggregates for the month as businesses remain shy of investment activity and household interest in the property market remained sidelined pre budget.

Perhaps the best news for much of the country this week will be heaven-sent. It's raining; it's expected to rain for some time and it'll be warmish rain too. Provided it doesn't get too extreme, for the drought affected north this is all good news. Not enough to compensate for the cut in production that has already occurred but, potentially, enough to set the next season up for a much better start than otherwise looked to be the case.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates rallied strongly over the course of a volatile week, where offshore concerns outweighed a generally positive budget. The rates market was pulled along by FX and equity markets being sold heavily and a consequent strong rally in safe havens such as government bonds. As a result, the Australian market has rallied so far that their interbank future market is pricing a chance of cuts to their cash rate, with around 10bp priced in by October 2010. The NZ short end has moved as a result, with a June hike now priced at around 50%, with slightly less than 25bp per meeting through to the end of the year now priced.

NZ government bonds were well bid on the global news, rallying and steepening over the course of the week. The budget was generally seen as positive for the bond market with NZ forecast to return to surplus three years earlier than previously signalled, hence reducing the expected long term supply of the bonds. Further news was the expected introduction of a March 2019 maturity bond and the expected issue of another inflation linked bond. For the coming week the limited data flow means the bond market will likely be taking its lead again from offshore.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
14-May-10	2.90%	4.69%	5.80%	4.52%	5.91%	139
21-May-10	2.89%	4.42%	5.62%	4.29%	5.78%	149
Change (bps)	**-1**	**-27**	**-18**	**-23**	**-13**	**10**

The swaps market followed along with the major rally in the futures and bond markets, rallying and steepening sharply. There seemed to be some stopping out from borrowed swap positions as the curve repriced the expected hiking cycle significantly. We feel the NZ economy still seems in good shape and these current levels present a good opportunity for fixing floating rate risk, although the volatility will likely remain elevated for some time to come.

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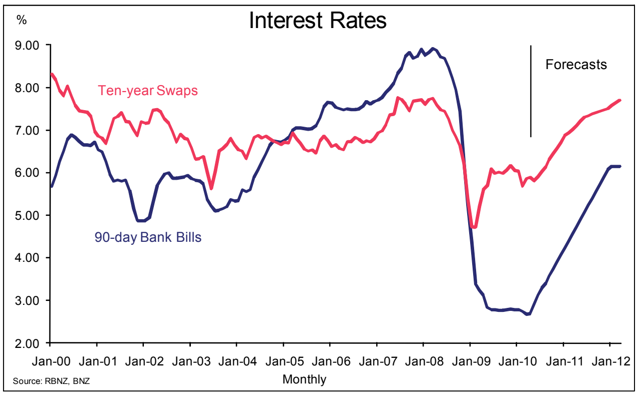

Interest Rate Technicals

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NZD 5yr Swap Rate

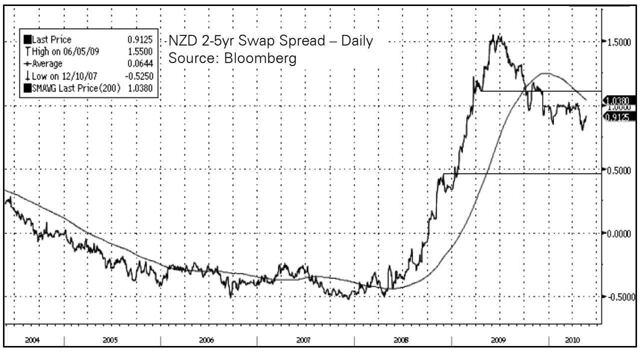
Outlook: Higher
MT Resistance: 5.86%
MT Support: 5.03%

Last week's rally pushed down towards support. It still appears corrective and we maintain a move higher in yield towards 5.86% resistance. Only a move below 5.03% will question this.

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 positively melted last week. Having started the week above 0.7050, NZD/USD dived to 9-month lows below 0.6650 as gloom about contagion from the European sovereign debt crisis took hold. It was the biggest weekly drop since October.

The 2010 NZ Government Budget provided the only bright spot for the NZD. While NZD/AUD was propelled to 7-month highs in its wake, the positive effects on NZD/USD were quickly gazumped by offshore factors.

Global markets were sent into a tailspin on fears that not only is the European debt crisis spreading, but policy makers will impose harsh regulations to cope with it. Indeed, a surprise announcement from Germany that it will ban 'naked' short-selling (essentially selling a financial instrument without owning or borrowing it) on certain securities inspired widespread panic. Equities and commodity prices fell sharply and investors' risk appetite dried up. The MSCI World Equity Index plunged 4.5% last week and our index of risk appetite (which has a scale of 0-100%) fell to 33%, from as high as 63% only three weeks ago.

Against this backdrop, momentum and short-term speculative accounts took flight from "risk-sensitive" currencies like the NZD, and returned to "safe-haven" currencies like the USD and JPY. From above 65.00, NZD/JPY slipped almost 7% last week to 10-month lows below 60.00.

Still, after sliding for most of the week, the NZD/USD stabilised on Friday. Acting to soothe investors' frayed nerves, European policy makers said the EUR was "not in danger", and Germany approved its share of the €750b euro-region emergency fund. Combined with Friday's fierce rally in US financial stocks (the S&P500 rose 1.5%), these factors helped risk appetite improve and 'growth-sensitive' currencies like the NZD tentatively recover. NZD/JPY jumped to 61.50 from below 60.00 and NZD/USD was dragged up to nearly 0.6800.

Historical economic data are clearly taking a back seat to financial market turbulence at the moment. And this week's NZ batch of data is not top-tier in any case. As such, the global backdrop will remain the most important driver of the NZD/USD this week. In this regard, keep a close eye on equity markets and commodity prices as the key gauges on the extent to which Europe's debt crisis is spilling over into wider concerns about global growth. Further falls would pose clear risks to the robust global recovery most expect.

All up, we suspect some consolidation is due for NZD/USD. While Friday's cautious improvement in risk appetite bodes well for further recovery in NZD/USD, we suspect a push through 0.7000 will be a bridge too far in the near-term given the headwinds from still fragile sentiment and negative momentum. But we're once again living in uncertain times. The only thing we can really be sure of is that NZD/USD volatility will remain elevated for some time yet.

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Foreign Exchange Technicals

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NZD/USD

Outlook: Consolidation
ST Resistance: 0.6920 (ahead of 0.6965)
ST Support: 0.6660 (ahead of 0.6595)

While the downtrend appears to be abating, momentum indicators are still firmly negative. A daily close above 0.6830 is needed to confirm the downtrend has stalled.

NZD/AUD

Outlook: Buy a dip
ST Resistance: 0.8200 (ahead of 0.8275)
ST Support: 0.8050 (ahead of 0.8000)

The daily RSI indicates the currency is "overbought" so some consolidation is expected near-term. Momentum will remain positive while the currency trades above 0.7935.

Key Upcoming Events

	Forecast	Median	Last
Monday 24 May			
Aus, New Motor Vehicle Sales, April y/y			+19.2%
Jpn, BOJ Economic Report			
Jpn, Cabinet Office Monthly Economic Report, May			
Jpn, All Industry Index, March		-0.7%	-2.3%
US, Existing Home Sales, April		5.65m	5.35m
Tuesday 25 May			
NZ, RBNZ Survey of Expectations, May (2-yr ahead)			+2.7%
UK, BBA Home Loans, April		37.0k	34.9k
UK, Index of Services, March 3m/3m		+0.2%	+0.4%
UK, GDP, Q1 2nd est		+0.3%	+0.2%P
Euro, Industrial Orders, March		+2.5%	+1.5%
US, Chicago Fed Nat Activity Index, April			-0.07
US, Consumer Confidence, May		59.0	57.9
US, Shiller Home Price Index, March y/y		+2.5%	+0.6%
Wednesday 26 May			
Aus, Building Work Done, Q1	+4.0%	+4.0%	+2.6%
Aus, Westpac Leading Index, March			+0.5%
Jpn, BOJ Minutes, 30 Apr Meeting			
US, Durables Orders, April		+1.5%	-1.3%
US, Fed's Bullard Speaks, Road to Econ Recover			
US, New Home Sales, April		425k	411k

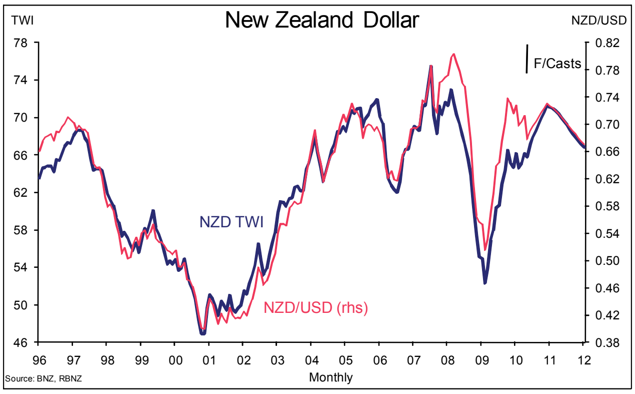
	Forecast	Median	Last
Wednesday 26 May ***continued...***			
US, Bernanke Speaks, Central Bank Indep.			
Thursday 27 May			
NZ, Merchandise Trade, April	+$536m	+$455m	+$567m
Aus, Private New Capex, Q1	-1.0%	+2.5%	+5.5%
Jpn, Merchandise Trade Balance, April		+¥700	+¥949b
UK, CBI Dist Trade Survey, May			+13
US, Fed's Lacker Speaks, Regulatory Response			
US, GDP, Q1 saar 2nd est		+3.4%	+3.2%P
US, Jobless Claims, week ended 22/05		455k	471k
US, Fed's Bullard Speaks, Policy Challenges			
Friday 28 May			
NZ, Building Consents, April (res, #)			-0.4%
NZ, Household Credit, April y/y			+2.7%
US, Personal Spending, April		+0.3%	+0.6%
US, Chicago PMI, May		61.3	63.8
US, Mich Cons Confidence, May 2nd est		73.4	73.3
Jpn, Retail Trade, April y/y		+3.6%	+4.7%
Jpn, Household Spending, April y/y (real)		+2.6%	+4.4%
Jpn, CPI, April y/y		-1.1%	-1.1%
Jpn, Unemployment Rate, April		5.0%	5.0%
Germ, Retail Sales - vol (circa), April			-2.4%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.50	2.50	2.50	2.50
1 mth	2.70	2.67	2.62	2.75
2 mth	2.79	2.85	2.65	2.78
3 mth	2.88	2.90	2.69	2.77
6 mth	3.06	3.14	2.88	2.80
GOVERNMENT STOCK				
11/11	3.71	3.92	3.72	3.66
04/13	4.42	4.67	4.52	4.57
04/15	4.93	5.13	5.14	5.19
12/17	5.38	5.55	5.65	5.72
05/21	5.62	5.78	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.51	3.58	3.37	7.50
BNZ 05/15	6.54	6.62	6.55	8.68
GEN 03/14	6.37	6.60	6.48	7.25
GEN 03/16	7.00	7.19	7.14	7.65
TRP 12/10	3.79	3.93	3.73	7.00
TRP 06/20	6.95	7.12	6.98	6.95
SWAP RATES				
2 years	4.29	4.50	4.20	3.55
3 years	4.72	4.89	4.66	4.18
5 years	5.20	5.35	5.21	4.92
10 years	5.78	5.88	5.85	5.76

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6760	0.7059	0.7069	0.6151
NZD/AUD	0.8129	0.7975	0.7669	0.7858
NZD/JPY	60.98	65.16	65.03	58.27
NZD/EUR	0.5387	0.5715	0.5239	0.4384
NZD/GBP	0.4672	0.4859	0.4621	0.3861
NZD/CAD	0.7180	0.7310	0.7176	0.6893
TWI	65.42	67.91	65.54	58.46

NZD Outlook



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