

31 May 2010

Are We Changing Our Ways?

- Strong residential construction growth is on track
- In line with our, and RBNZ, forecasts
- Non-residential construction lagging
- Credit data hint at changing behaviours

We have long expected residential building construction to play a major role in the economic recovery. So we were pleased to see a large increase in April's residential building consents, released last Friday.

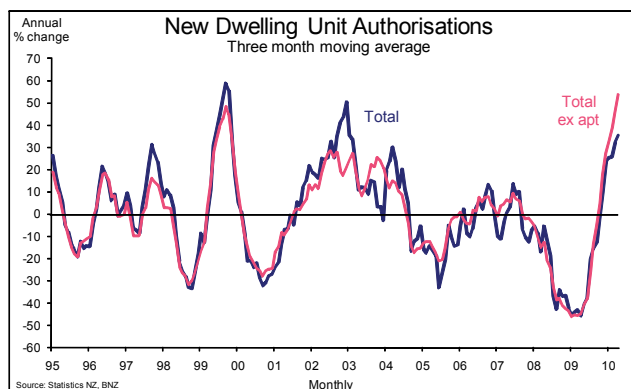
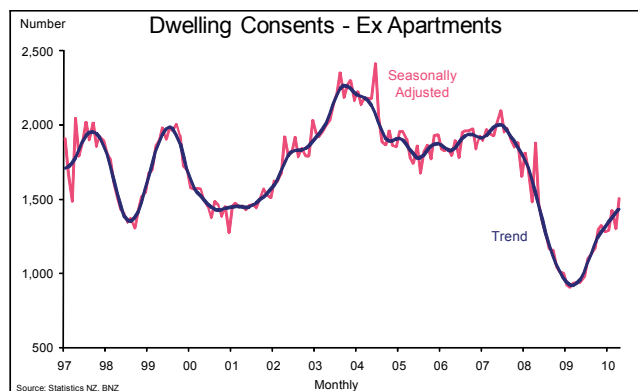
Prior to these data, there were signs of a flattening trend in the number of consents issued. This was starting to question the degree of strength that we have built in to our forecasts for residential construction, and thus for overall economic growth, through 2010.

A soft result in April would have had us revising down our near-term residential construction forecasts. Not so. The 8.5% jump in residential building consents in April, on a seasonally adjusted basis, keeps our strong view intact. The even stronger 15.5% jump in ex-apartment residential consents in April reinforces the positive outlook.

Still, there is a note of caution. Building consents have been particularly volatile over recent months.

One reason for the heightened volatility in monthly building consents over the past few months has been the timing of holidays. In particular, Waitangi Day and ANZAC day unusually both fell on a weekend this year, effectively giving local councils an extra day to process consents in February and April.

This holiday effect has given a very strong 'up-down-up' pattern to ex-apartment consents in February (+10.5%), March (-8.6%) and April (+15.5%). We have no doubt the



headline figures for April overstate the underlying strength in building consents. We expect May consents to pullback from April's 'extra-day' level.

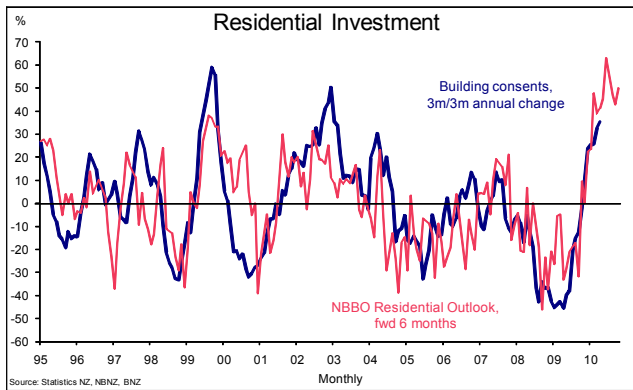
Importantly, though, making a rough adjustment for the extra processing days in February and April, we still think there is currently a strong positive monthly trend.

On an annual basis, April's residential building consent numbers are up 39%. Growth is even stronger, well above 50% on a year ago, when looking at consents on a floor area basis. This growth will show up in actual building work done over coming months.

This positive growth message is a similar one from firms in the building sector. In April, a net 50% of building sector firms in the NBNZ business survey expected an improvement in residential construction over the next 12 months.

Keep an eye out for May's survey, due at 3pm, this afternoon. Changes to building depreciation tax rules announced in the Budget may well dampen building firm's recent enthusiasm. Even so, with most responses to the May survey likely received before the 20 May Budget, it is probably too early to gauge any effect yet. It is one worth watching. Having said this, the decision not to ring fence property losses may actually provide a boost to the residential sector.

Overall then, we'll stick with our strong forecast for real residential construction. We expect it to be near 30% higher in the second half of 2010 compared to the same period in 2009. This will see real residential construction rise around 25% for the full year to March 2011. A view that aligns very closely with the RBNZ's forecast for residential investment, published in its latest MPS.



This would be a vast improvement on the latest national accounts figures that show residential construction falling 1.0% in the year to Q4 2009. Following the NBNZ confidence survey, the next real test of the strong view will come on 8 June, when we get the building work up in place data for Q1. We are looking for a significant lift in residential construction to set the tone for the rest of the year.

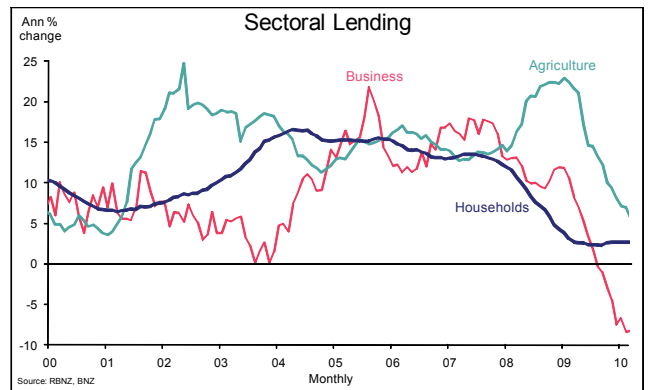
In contrast, non-residential construction is expected to remain relatively weak through 2010. April's consents data did nothing to alter this view. Despite strong increases in the public sector dominated categories like health and education buildings, weakness elsewhere pulled overall non-residential building consents down.

Overall, the \$1.2b of non-residential building consents issued in the first four months of 2010 is significantly down on the \$1.6b for the same period last year. Measured by floor area, the percentage decline is similar. The largest dollar value declines were in offices and admin buildings, hostels and boarding houses, and industrial buildings.

Farm building consents were also well down on a year ago. Tight cash flow and drought conditions for many over the past year stalled new dairy conversions and other on-farm investment. The value of consents issued for farm buildings fell to \$172m in the year to April 2010, compared to \$330m in the year prior.

Fonterra's positive first forecast for the 2010/11 season, announced last week, might well bring some previously delayed dairy farm conversions back on the agenda.

Our estimates suggest the announced forecast of \$6.60 per kilogram of milksolids, plus a distributable profit of 30 to 50 cents a share, will pump at least \$600m more into the dairy industry over the coming year and potentially more than \$1b with any half decent production rebound from drought. The chances of which have increased significantly over the past week or so, with considerable rain across much of the country. More of it please, but not all at once!



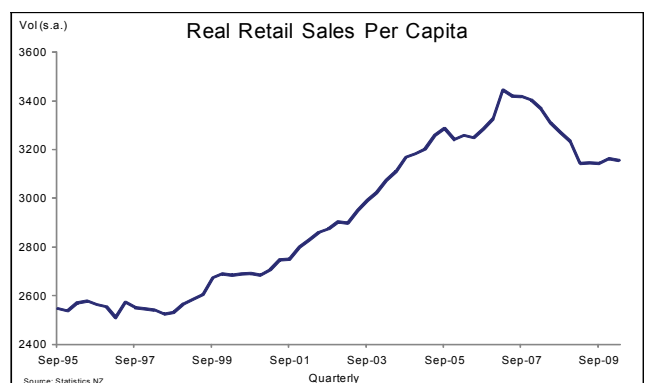
Even so, we do not expect a return to the helter-skelter dairy conversion days of a couple of years back. Indeed, some farmers might well use their enhanced cash flow to retire some debt, given the extreme volatility in the dairy market over recent years.

The latest credit aggregates suggest this is already occurring, even with improved cashflows, on average, through the latter part of the 2009/10 season. Total agricultural borrowing has been essentially flat over the past eight months, although still up 4.5% on a year ago.

Households are certainly showing more restraint in borrowing and spending. Total household lending grew 0.2% in April, to post a paltry 2.7% lift over the past year. This is similar to lending growth in the year before that, but looks truly anaemic in comparison to the six years of double digit growth during the boom. Consumer credit actually contracted by 3.1% over the past year, following a 1.7% contraction in the year before that. Some households are clearly paying back some debt.

This change in consumer behaviour ties in with other data like retail sales and imports.

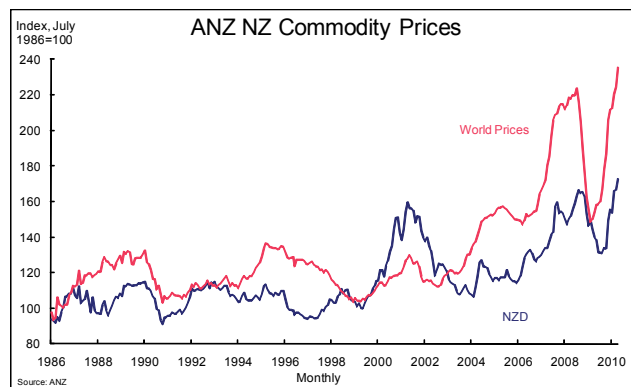
Looking at the volume of retail sales, on average per person, shows a marked decline over recent years. On average, we are buying 8.3% less than the peak spending period of three years ago. We are now buying about the same amount of stuff that we were more than five years ago.



This, of course, fits with subdued imports. And, in turn, the first annual trade surplus since 2002 that we saw in April's merchandise trade data released last week.

We suspect we will see more subtle shifts in spending behaviour over the coming year as Budget changes dissuade consumption and encourage savings, at least at the margin. Of course, to the extent that the various tax changes do bring about a behavioural shift in household spending and saving decisions, it will have an impact on the extent that the RBNZ needs to raise interest rates.

For this week, we will be closely watching the results of the next Fonterra dairy auction due to be run overnight Tuesday. Global dairy prices have increased strongly this year. But there are some headwinds developing. New concern around the global growth outlook, as a result of the European debt crisis (not helped overnight by Fitch's cut to Spain's sovereign credit rating), and a possible slowdown in China are unhelpful. So too will be the sharp jump in US milk production in April and the soon-to-be-released EU dairy intervention stocks. The combination of these factors may see global dairy prices give up some of their recent gains. It would certainly be a strong result if dairy prices were to hold their value, or push higher, given the global backdrop.



Any decline in dairy prices is more likely to show up in the real time dairy auction than the monthly ANZ commodity price indices due out on Wednesday afternoon. These, being a broad measure of prices for NZ export commodities, might well push on to new record highs.

Last up this week, we have the wholesale trade survey due Friday. Q1 nominal wholesale sales should extend their Q4 recovery. We'll be sifting through the detail for signs of an improvement in sales volumes, given that we think wholesale trade made a solid positive contribution to Q1 GDP growth.

doug_steel@bnz.co.nz

Domestic Interest Rates

New Zealand interest rate markets steadied over the last week as global markets calmed and volatility came off significantly. The major move on the week was a flattening of the swaps curve, which seemed to be the markets' preferred way of expressing bearish sentiment following the wild swings we had seen. The OIS/futures market is now pricing around a 60% chance of a hike to the OCR in next week's announcement. Notably, the bills curve has priced less aggressively down the line, with only around 100bps of total hikes now priced through to the December meeting.

The Government bond market continued to track offshore moves with the still skittish nature of the market holding a bid in and keeping yields down. However, the tender saw a poor bid to cover ratio and suggested that investors are looking for a back up in yields before picking up more stock. It is likely we will continue to take our lead from offshore for the coming week.

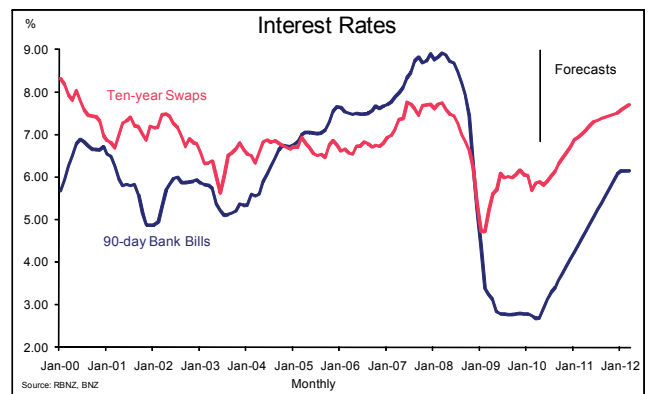
The dominant theme in the swaps market was the flattening of the curve as the swaps market followed the theme and quietened down significantly on the week before. The interbank market has remained fairly quiet, but there has been a small pick up in payside interest as we approach the start of the hiking cycle. We still feel these are good levels to lock in borrowing costs,

Reuters pgs BNZL BNZM

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
21-May-10	2.89%	4.42%	5.62%	4.29%	5.78%	149
28-May-10	2.98%	4.38%	5.55%	4.32%	5.72%	140
Change (bps)	9	-4	-7	3	-6	-9

particularly with the uncertainty surrounding the coming hiking cycle and the global outlook. The coming week will likely be more of the same with the RBA's decision tomorrow likely the biggest market mover.

nick_webb@bnz.co.nz



Interest Rate Technicals

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.

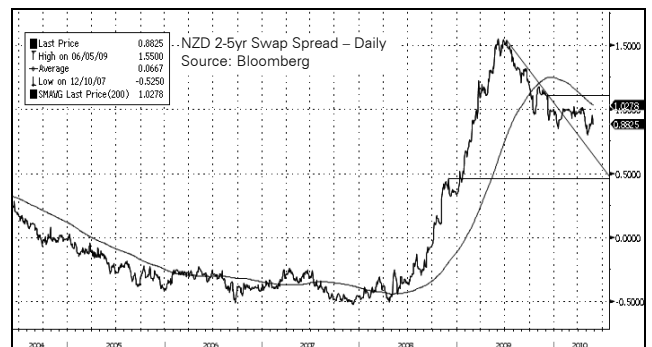


pete_mason@bnz.co.nz

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

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

We expect the range trade to continue. Risks remain for a move towards support at +46.



Foreign Exchange Market

The NZD spent most of last week consolidating in a 0.6600-0.6850 range.

A tentative stabilisation in the European sovereign debt crisis paved the way for a small recovery in risk appetite. The steady stream of bad news out of Europe slowed to more of a trickle, calming fears about contagion. What's more, markets took heart from attempts by peripheral European countries to reign in their whopping budget deficits. Indeed, Portugal announced a further €15b of austerity measures last week.

Combined with the OECD's upbeat take on the global economic recovery (its 2010 global growth forecast was revised up to 4.6%), this helped equity markets and commodity prices stabilise. The S&P500 rose 0.2% over the week and the CRB index (a broad measure of global commodity prices) climbed 1.3%. Our risk appetite index (which has a scale of 0-100%) rose from 32% to 36.6% – albeit still well below the long-run average of 50%.

Reduced pessimism about the global recovery and a modest improvement in investors' risk appetite helped shore up sentiment towards "growth-sensitive" currencies like the NZD/USD. In fact, on a trade-weighted basis, the NZD pushed slightly higher (led by gains in NZD/EUR) as investors' focus gradually returned to NZ's relatively solid economic fundamentals.

Reuters pg BNZFWDS

Looking ahead, the NZ data calendar looks fairly thin over the coming week. Today's May NBNZ Business Survey may see confidence come off its highs given growing concern about Europe's plight. But more important for NZD trends will be this week's updates on global prices for NZ's commodity exports. The results of Fonterra's latest online auction and the broader ANZ commodity price index will both be released on Wednesday.

Globally, it's a much more exciting week. Not only is a slew of global data due (culminating in Friday's US non-farm payrolls), but central bank policy announcements from the RBA (on-hold expected) and the Bank of Canada (25bps hike expected) will provide a useful update on officials' take on the European debt crisis. We also suggest keeping a close watch on banks' short-term funding spreads for a guide on the extent to which European concerns are feeding global contagion fears.

All up, we suspect a bit more consolidation is due for NZD/USD this week. Should upcoming data continue to restore optimism about the global recovery, we'd expect further recovery in risk appetite to underpin 'growth-sensitive' currencies like the NZD. Still, failing clear strength in this week's commodity price data, we suspect the 0.6950-0.7000 region will cap the topside in the short-term.

mike_s_jones@bnz.co.nz

Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
 ST Resistance: 0.6860 (ahead of 0.6965)
 ST Support: 0.6660 (ahead of 0.6610)

While the downtrend appears to be abating, momentum indicators are still firmly negative. A daily close above 0.6880 is needed to confirm the downtrend has stalled.



NZD/AUD

Outlook: Consolidation
 ST Resistance: 0.8100 (ahead of 0.8180)
 ST Support: 0.7945 (ahead of 0.7890)

The uptrend is starting to look exhaustive and the failure to break convincingly above 0.8200 suggests a correction towards 0.7950 is on the cards.



Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 31 May				Wednesday 2 June			
NZ, NBNZ Business Survey, May			+49.5	NZ, ANZ Comdty Prices (\$NZ), May			+3.8%
Aus, Private Sector Credit, April	0.5%	+0.5%	+0.5%	NZ, Fonterra Monthly Auction, June			-0.8%
Aus, Business Inventories, Q1	+0.1%	+0.5%	+0.2%	Aus, GDP, Q1	+0.7%	+0.6%	+0.9%
Aus, Current Account, Q1	-\$16.6b	-\$16.4b	-\$17.5b	US, Pending Home Sales, April		5.0%	+5.3%
Aus, Company Profits, Q1	1.0%	3.0%	+2.2%	Euro, PPI, April y/y		+2.6%	+0.9%
Jpn, Industrial Production, April 1st est		+2.5%	+1.2%	Thursday 3 June			
US, and UK Holiday				Aus, Services PMI (AiG), May			52.3
Euro, CPI, May y/y 1st est.		+1.7%	+1.5%	Aus, International Trade, April	-\$1.5b	-\$0.8b	-\$2.08b
Euro, M3, April y/y		-0.3%	-0.1%	Jpn, Capital Spending, Q1 y/y		-9.6%	-17.3%
Euro, Economic Confidence, May		100.6	100.6	UK, CIPS Services, May		55.7	55.3
Can, GDP, Q1 saar		+5.9%	+5.0%	US, ADP Employment, May		+65k	+32k
Tuesday 1 June				US, Fed's Hoenig, Rosengren and Lockhart Speaks			
Aus, Building Approvals, April	-5.0%	-5.0%	+15.3%	US, ISM Non-Manuf, May		55.7	55.4
Aus, Manufacturing PMI (AiG), May			59.8	US, Factory Orders, April		1.7%	+1.1%
Aus, RBA Policy Announcement	4.50%	4.50%	4.50%	US, Jobless Claims, week ended 29/05		453k	460k
Aus, Retail Trade, April s.a.	-0.3%	+0.3%	+0.3%	US, Productivity (non-farm), Q1 saar 2nd est		3.4%	+3.6%P
UK, CIPS Manuf Survey, May		57.9	58.0	Euro, Retail Sales, April		+0.1%	0.0%
US, ISM Manufacturing, May		59.0	60.4	Friday 4 June			
Euro, Unemployment Rate, April		10.0%	10.0%	NZ, Wholesale Trade, Q1 (\$) s.a.			+1.9%
Can, BOC Policy Announcement		0.50%	0.25%	US, Non-Farm Payrolls, May		+508k	+290k
China, PMI (NBS), May		54.5	55.7	Euro, GDP, Q1 2nd est		+0.2%	+0.2%P

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	2.50	NZD/USD	0.6771	0.6760	0.7288	0.6151
1 mth	2.71	2.70	2.62	2.75	NZD/AUD	0.8011	0.8129	0.7896	0.7858
2 mth	2.86	2.79	2.68	2.78	NZD/JPY	61.63	60.98	68.45	58.27
3 mth	2.93	2.88	2.76	2.77	NZD/EUR	0.5515	0.5387	0.5462	0.4384
6 mth	3.11	3.06	2.99	2.80	NZD/GBP	0.4692	0.4672	0.4757	0.3861
GOVERNMENT STOCK					NZD/CAD	0.7122	0.7180	0.7408	0.6893
11/11	3.66	3.71	3.89	3.66	TWI	65.80	65.42	67.97	58.46
04/13	4.37	4.42	4.69	4.57	NZD Outlook				
04/15	4.87	4.93	5.23	5.19	New Zealand Dollar				
12/17	5.31	5.38	5.67	5.72					
05/21	5.54	5.62	6.53	-	Source: BNZ, RBNZ				
CORPORATE BONDS									
BNZ 09/10	3.55	3.51	3.43	7.50					
BNZ 05/15	6.55	6.54	6.57	8.68					
GEN 03/14	6.42	6.37	6.54	7.25					
GEN 03/16	7.02	7.00	7.14	7.65					
TRP 12/10	3.83	3.79	3.77	7.00					
TRP 06/20	6.95	6.95	6.95	6.95					
SWAP RATES									
2 years	4.30	4.29	4.40	3.55					
3 years	4.71	4.72	4.82	4.18					
5 years	5.17	5.20	5.28	4.92					
10 years	5.70	5.78	5.82	5.76					

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.