

8 June 2010

The First Hike is the Hardest

- OCR hike likely this week
- As GDP/CPI pressing on RBNZ expectations
- Albeit we cut our Q1 GDP estimate to 0.4%
- On this morning's disappointing manufacturing, construction
- Global risks more an issue for extent of OCR hikes

Even though the short working week is chocked full of data, it will likely play second fiddle to the RBNZ June Monetary Policy Statement on Thursday and developments offshore.

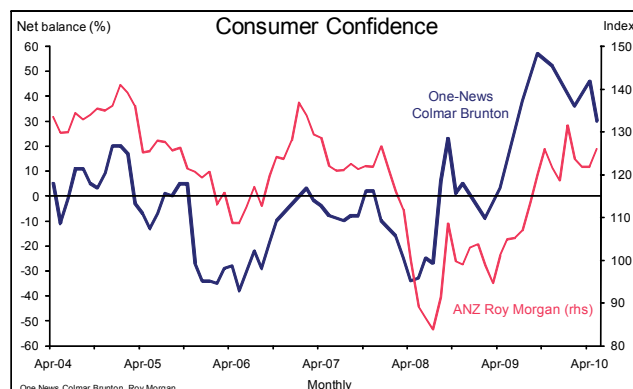
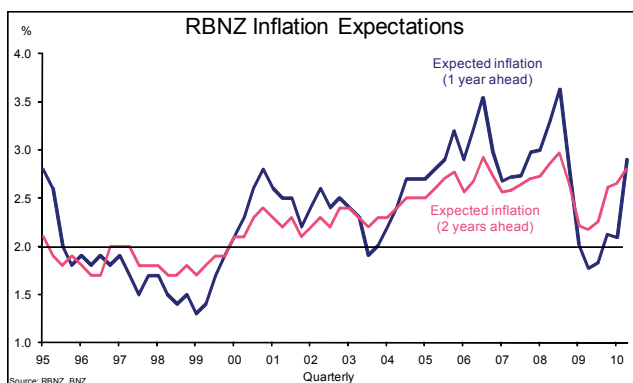
We finally get the answer to a key question in NZ financial markets over recent months – will the RBNZ hike or not in June?

Fundamentally, we think the time has come for the RBNZ to start lifting interest rates. Back in late April, the bank said it expected to be removing policy stimulus over coming months. The proviso was as long as 'the economy continues to evolve as projected'.

Since then, domestic news, on balance, has been stronger than RBNZ expectations. In particular, the labour market is not as slack as anticipated (remember the very sharp drop in the Q1 unemployment rate to 6.0%, from 7.1% in Q4) and commodity prices are higher than expected. We reckon world prices for NZ export commodities are, on average, around 10% higher than the RBNZ had factored in to its forecasts.

Meanwhile, long-term inflation expectations have crept to an uncomfortable level. Surveyed two-year-ahead inflation expectations have pushed up to 2.8% in Q2, adding to longer term expectations of around 3% implied by the bond market.

The RBNZ also now know the details of the 2010 Budget. At the margin, the Reserve Bank probably had a tad more



near-term austerity factored in than the Budget is likely to deliver. The key point is that the fiscal path is now clearer.

These developments are probably enough to convince the RBNZ to lift 25bps in June, rather than waiting until July. However, a hike this Thursday is no certainty.

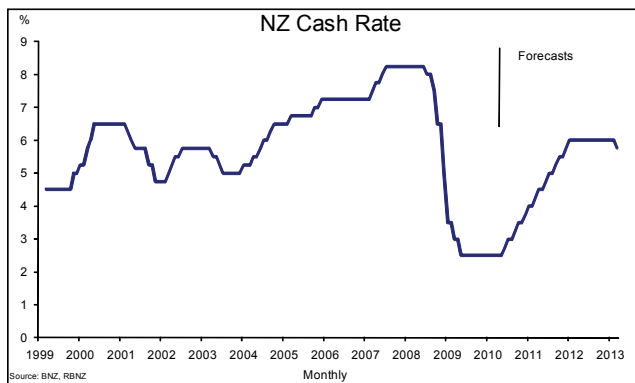
Domestic spending, property markets, and credit growth all remain subdued despite generally buoyant levels of business and consumer confidence.

The latter might even be running out of puff, with a dip in the post-Budget Colmar-Brunton survey published last week. On this measure, consumer confidence has eased to its lowest level since April last year, but is still at an upbeat level in an historical context.

Despite pockets of still-subdued domestic data, the bigger risks to the economy still appear to be from overseas. Global financial risks have increased, with Hungary the latest European economy to come under the spotlight. RBNZ Governor Bollard might yet be put off by these clouds. To, in the least, buy some time before starting to hike.

Still, most of the global data point to a generally improving world economy. Indeed, there appears to be a growing gulf between the real economy and financial risks. Something encapsulated by the communiqué from the G20 Finance Ministers and Central Bank Governors meeting over the weekend which including statements like 'the global economy continues to recovery faster than anticipated', but also 'the recent volatility in financial markets reminds us that significant challenges remain'.

All this will be weighed up by the RBNZ. We suspect recognition of global risks and the accompanying pinch higher in funding costs will again result in the RBNZ



talking down the extent of the tightening required this cycle. So, the problems overseas seem more an issue for the extent of the tightening foreseen, rather than preventing some stimulus starting to be removed very soon.

In recent statements, the RBNZ have been at pains to point out that the extent of tightening this time around is unlikely to be as much as in the past. In fact, in the April OCR review, it was no accident that the talking down of the probable extent of tightening required was saved for the closely followed last paragraph.

We expect further commentary along these lines regardless of whether the RBNZ hikes or not. But, if the RBNZ does hike rates on Thursday, we are sure it will emphasise that considerable stimulus remains in place.

The likely currency reaction to any policy change is always a consideration. At the margin, the RBNZ may welcome the recent dip in the NZD and see it as an opportunity to get the tightening cycle underway while the currency is a little out of favour.

It is even tempting to point to the recent slide in the NZD as a fundamental reason to hike rates. A lower NZD now, will drive tradeable inflation higher down the track. The biggest boost might well come at a time when other factors, like the hike in GST, are already pushing headline CPI inflation well above the target band. This might be so, but, despite the recent dip, the TWI remains higher than the RBNZ had factored in.

Beside the RBNZ statement, there is plenty of data to mull over during the week. Kicking off with the data we have already seen this morning for building work put in place and manufacturing data.

The volume of building work rose 0.7% in Q1, a touch on the weak side of our expectations. The composition was more surprising. We anticipated a larger increase in residential building that the 2.0% gain recorded and a bigger fall in non-residential building that the 0.8% decline published. Even so, the balance was thereabouts.

Not so for this morning's manufacturing survey. The 2.7% drop in sales volumes was not a great headline, even if

it was driven by a 10.7% drop in the combined meat and dairy sector. Excluding the meat and dairy sector, manufacturing sales volumes rose 0.9%.

Production is what matters for GDP and it is always a tricky exercise to deduce production levels from the sales and stock information in the manufacturing survey.

Sifting through the details we think that manufacturing production probably rose in the quarter, despite the drop in sales. But, the lift is less than what we had previously factored in.

All this, has us revising down our Q1 GDP forecast to 0.4% from our initial 0.6% pick.

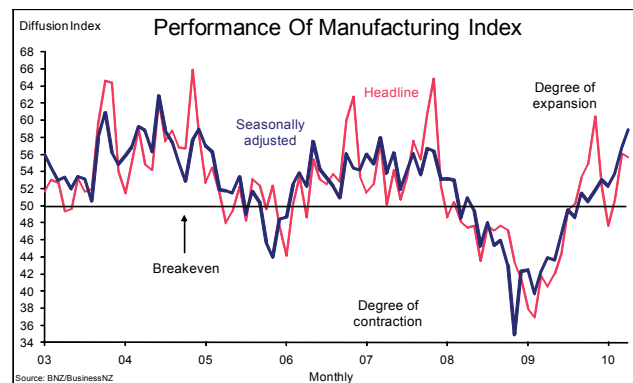
Next, we wait for Thursday's data blockbuster. If the RBNZ statement wasn't enough on the day, we get the BNZ-BusinessNZ Performance of Manufacturing Index and electronic transactions for May along with the terms of trade and trade volume data for Q1.

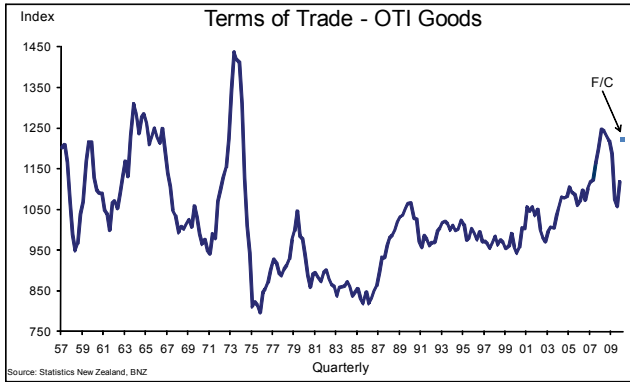
May's Performance of Manufacturing Index should remain strong enough, although we would not be surprised if it dipped a little from April's 58.9 (s.a.), given the bounce in the NZD/AUD cross exchange rate and rising concerns around the outlook for global growth. This would suggest that manufacturing production will probably rise in Q2, pushing on from the small rise that looks to have occurred in Q1.

We expect a bounce in the electronic transactions data for May, following a slump in April. A lack of a pick up would seriously question whether real consumer spending grew at all in Q2.

Watch for a very strong lift in the terms of trade as higher export commodity prices filter through to the official statistics. The 9% gain we have forecast for Q1 terms of trade would bring the level to within a whisker of the peak reached in early 2008. Remember that the 2008 level was the highest terms of trade since 1974.

Do not expect such fireworks from trade volumes, we expect both export and import volumes to be close to flat in Q1. Flat import volumes in Thursday's trade data will reflect the generally subdued domestic demand picture to





date, while the manufacturing data this morning keeps us cold on the prospects for export volume growth. Keep an eye on them, though, as any variation to our forecasts could have further implications for Q1 GDP.

After the Thursday's data torrent, don't overlook May food prices due on Friday. We suspect these will bounce back from their dip in April, as much along seasonal lines as anything. Even so, they will be an important input in Q2 CPI.

doug_steel@bnz.co.nz

Domestic Interest Rates

New Zealand interest rates sold off and flattened over the course of the past week as sentiment pushed towards the RBNZ hiking the OCR on Thursday by 25 basis points.

By the end of the week the futures/OIS market was pricing nearly an 80% chance of a hike on Thursday, with slightly more than 100bps of hikes now priced through to the end of 2010. We still feel it is likely that the RBNZ will choose to hike this week, with the local data sufficiently strong to begin the hiking cycle, albeit with a little trepidation with the global outlook increasingly shaky.

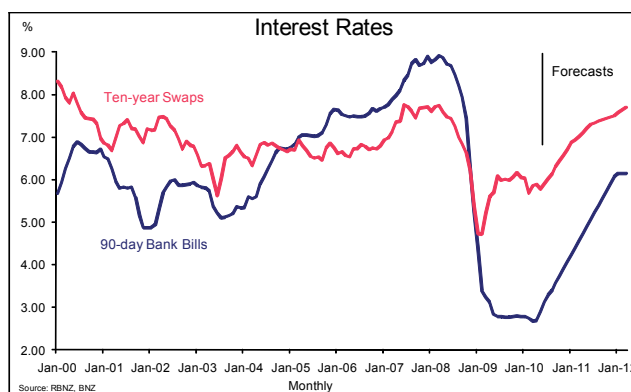
The government bond market sold off slightly over the week. As sentiment recovered somewhat the safe haven of NZ government bonds was slightly less sought after. The tender was reasonably well supported but in small size with demand seemingly still somewhat muted. The poor US non-farm payrolls number on Friday night has seen a strong bid for government bonds offshore and should translate to a rally to start this week. The MPS on Thursday should dominate later in the week.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
28-May-10	2.98%	4.38%	5.55%	4.32%	5.72%	140
4-Jun-10	2.99%	4.45%	5.60%	4.39%	5.73%	134
Change (bps)	1	7	5	7	1	-6

Reuters pgs BNZL BNZM

The swaps market saw the most action over the past week as the flattening continued – the 2-year swap selling off 7 basis points while the 10-year swap eased off just 1 basis point. This seemed to be the preferred method of expressing bearish sentiment in the market with the market looking for a hike on Thursday. Positioning for the meeting will likely prove to be the primary market mover, although jitters from offshore will still play their part. The market is likely to be fairly illiquid and volatile as a result, with relatively small parcels pushing prices a long way.

nick_webb@bnz.co.nz



Interest Rate Technicals

NZD 5yr Swap Rate

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

This week's rally pushed the 5-year swap rate down towards support. It still appears corrective and so 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

Escalating worries about the global backdrop saw NZD/USD plunge to levels close to 10-month lows last week. 'Growth-sensitive' currencies like NZD and AUD came off the boil sharply over NZ's Queen's Birthday weekend as global risk appetite again came under pressure. There was a sea of red ink in stock markets around the world thanks to heightened concerns over the global economic outlook. Not only did Friday's US non-farm payrolls report disappoint those looking for a rapid turnaround in the US labour market, but the news out of Europe only seems to get worse. Markets have now pegged Hungary as the next country likely to experience difficulties with debt refinancing and, if German media reports are anything to go by, the German Constitutional Court is weighing the possibility of withdrawing its share of the EU-IMF bailout package. From highs of nearly 75% in April, our risk appetite index (which has a scale of 0-100%) has plunged to around 35%, coinciding with the roughly 7 cent 'correction' we have witnessed in NZD/USD.

There's no doubt that the outlook for the NZD has become a lot more uncertain in recent weeks. In addition to the existing debate about whether China will successfully cool its overheating economy without a slump in growth, we now have the uncertainty about the fallout for the rest of the world from Europe's debt problems. We're not expecting either of these issues to be resolved anytime soon, so expect volatility in NZD/USD to continue in coming months. It's worth noting that, at this stage, a solid recovery is still expected in both the global and

Reuters pg BNZFWDS

NZ economies this year. However, we do have to acknowledge the potential for Europe's debt problems to escalate further. As such, we could see a broad trading range in NZD/USD of 0.6400-0.7200 in coming months.

In the short-term, key direction for the NZD will continue to come from equity market sentiment and global appetite for risk. However, there are also some key local events to watch out for this week, most notably the RBNZ's interest rate decision on Thursday.

We think the time has come for the RBNZ to start raising interest rates. Domestic data has been stronger than expectations and long-term inflation expectations have crept to an uncomfortable level. These developments are probably enough to convince the RBNZ to lift 25bps in June, rather than waiting until July. However, a hike in June is no certainty given ongoing international concerns.

Should the RBNZ hike rates as we expect (markets are currently 70% priced for such), and this week's economic data remain consistent with ongoing economic repair, we'd expect to see some support for the currency. However, given current heightened demand for "safe-haven" currencies like the USD, we suspect any such support will mainly come through the NZD cross rates. The key level to watch on NZD/USD is May's low of 0.6560. A daily close below this level would pave the way for a deeper correction towards 0.6400.

mike_s_jones@bnz.co.nz

Foreign Exchange Technicals

NZD/USD

Outlook: Sell a rally
 ST Resistance: 0.6720 (ahead of 0.6890)
 ST Support: 0.6560 (ahead of 0.6480)

The downtrend has resumed and momentum indicators are negative. A daily close below 0.6560 would pave the way for a deeper correction towards 0.6400.



NZD/AUD

Outlook: Consolidation
 ST Resistance: 0.8190 (ahead of 0.8230)
 ST Support: 0.8010 (ahead of 0.7940)

The failure to break convincingly above 0.8200 suggests we are in for more range-trading in the near-term. Buy a dip towards 0.7950.



mike_s_jones@bnz.co.nz

Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Tuesday 8 June				Thursday 10 June			
NZ, Building Work Put In Place, Q1 vol s.a.			+0.7%	NZ, Terms of Trade, Q1	+9.3%	+6.2%	+5.7%
NZ, Manufacturing Sales, Q1 vol s.a.			+3.1%	NZ, BNZ PMI (Manufacturing), May			58.9
NZ, Crown Financial Statements, April				NZ, Monetary Policy Statement	2.75%	2.75%	2.50%
NZ, Manpower Survey, Q3			+14	NZ, Electronic Card Transactions, May			-1.7%
Aus, NAB Business Survey, May			+13	Aus, Employment, May	+25k	+20k	+34k
Jpn, Eco Watchers Survey (outlook), May			49.9	Jpn, GDP, Q1 2nd est		+1.0%	+1.2%P
UK, BRC Retail Sales Monitor, May y/y			-0.2%	UK, BOE Policy Announcement	0.50%	0.50%	0.50%
Germ, Industrial Production, April		+0.7%	+4.0%	US, International Trade, April		-\$41.0b	-\$40.4b
Germ, Trade Balance, April s.a.	+€17.0b	+€17.2b		Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
Wednesday 9 June				Friday 11 June			
Aus, Housing Finance, April	+2.0%	-2.0%	-3.4%	UK, Industrial Production, April		+0.4%	+2.0%
Aus, Consumer Sentiment - Wpac, June			108.0	US, Mich Cons Confidence, June 1st est		74.5	73.6
Aus, RBA Stevens Speaks				US, Business Inventories, April		+0.5%	+0.4%
Jpn, Machinery Orders, April		+1.7%	+5.4%	US, Retail Sales, May		+0.1%	+0.4%
UK, Trade Balance, April		-£3.0b	-£3.7b	China, Industrial Production, May y/y		+17.0%	+17.8%
US, Beige Book				China, CPI, May y/y		+3.0%	+2.8%
US, Wholesale Inventories, April		+0.5%	+0.4%				

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	0.6587	0.6771	0.7205	0.6249
1 mth	2.79	2.71	2.66	2.76	NZD/AUD	0.8132	0.8011	0.8002	0.7867
2 mth	2.95	2.86	2.80	2.74	NZD/JPY	60.22	61.63	66.54	61.60
3 mth	2.96	2.93	2.92	2.69	NZD/EUR	0.5528	0.5515	0.5569	0.4477
6 mth	3.21	3.11	3.17	2.73	NZD/GBP	0.4553	0.4692	0.4851	0.3916
GOVERNMENT STOCK					NZD/CAD	0.6989	0.7122	0.7436	0.6999
11/11	3.68	3.66	3.92	3.77	TWI	65.20	65.80	68.10	59.63
04/13	4.35	4.37	4.65	4.80	NZD Outlook				
04/15	4.84	4.87	5.14	5.47					
12/17	5.28	5.31	5.57	6.02	<p>Source: BNZ, RBNZ</p>				
05/21	5.50	5.54	6.53	-					
CORPORATE BONDS									
BNZ 09/10	3.57	3.55	3.55	4.26					
BNZ 05/15	6.51	6.55	6.76	7.44					
GEN 03/14	6.37	6.42	6.70	7.43					
GEN 03/16	6.97	7.02	7.31	8.07					
TRP 12/10	3.94	3.83	3.93	4.57					
TRP 06/20	6.89	6.95	7.10	7.95					
SWAP RATES									
2 years	4.29	4.30	4.55	3.69					
3 years	4.67	4.71	4.95	4.39					
5 years	5.13	5.17	5.38	5.23					
10 years	5.66	5.70	5.88	6.14					

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.