28 June 2010

Crucial Commodity Support

- Today's business survey will set the tone
- Will global woes offset good news on export prices?
- As re-rising NZD also restrains local growth hopes
- We expect residential consents rose further in May
- But credit figures were likely sedate, again

This afternoon's NBNZ business survey is the up-front highlight of New Zealand's data week. This will serve as a neat summary of recently strong cross currents. While global concerns will no doubt weigh on this June survey, brightening times in the commodity sector might well be enough to keep the overall results in solid territory. On balance, however, we wonder if there might be a small retracement given that we saw exactly that in our own confidence survey (as compiled and published by Tony Alexander).

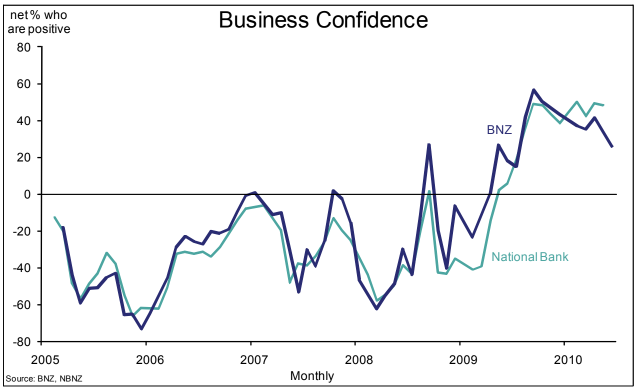
We wrote about the overall robustness in trading-partner demand in last week's Markets Outlook. On balance, the consensus assessment and view has actually strengthened over the last couple of months.

However, we would concede that risks around this story are beginning to tilt back to the downside, given the sense of immediate difficulty now confronting the major economies.

Last week's bad news on US home sales, for example, underscored that judgement on the strength and durability of any recovery should be reserved until stimulus measures are unwound – in this case the April end to the US first home-buyer grants. Everyone knew there would be a hangover, just not as big as looks to be the case.

Also, to help tame huge budget deficits, the US government is curtailing its scheme of extended unemployment benefits. This scheme was employed to catch the increasing number of unemployed who were rolling off the regulation-length dole, as the duration, not just the size, of joblessness rose. This created a shadow dole queue, in addition to the formal one, which required a lot of taxpayer funds.

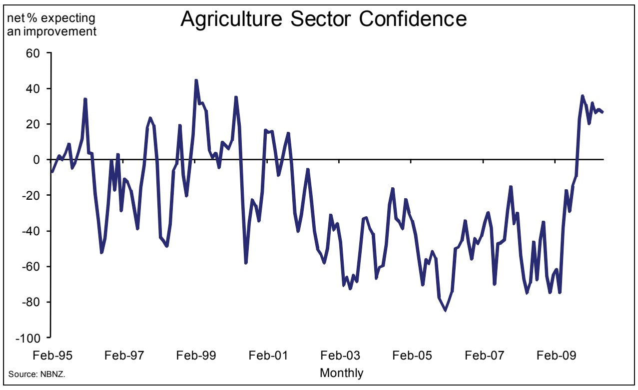
Another removal of stimulus to bear in mind is the reversal, at year's end, of the income tax cuts implemented by the Bush administration in 2003, as originally outlined. While it won't be sold as a tax hike, it effectively will be, come 1 January 2011. Reneging on the reversal would simply increase the US budget deficit.



Meanwhile, there is more and more confirmation from various European nations that they will be biting the bullet to try to bring their deficits and debt back from the brink. It demands inevitably graunching changes, by way of restrained public spending and policies to increase revenue (read: higher taxes). Last week's UK emergency Budget had these in spades. And that the French Government has increased its retirement age, and taxes, speaks of how desperate the situation has become. It's not exactly something that will win votes.

In this vein, however, we would also point out that while many might reasonably fret about the economic consequences of fiscal consolidation, the alternative would ultimately be that much worse.

The alternative (if we can really call it that) is of simply running up bigger bills and IOU's. It's not even about the issue of lumbering the next generation of taxpayers with the burden. The more immediate issue is whether the financial markets will keep lending the money to governments, when their fiscal outlook reeks of inevitable default. Would you?



Yes, governments can resort to printing money to pay for the shortfall. But this would simply open up another, bigger, can of worms, via inflation and a de-based currency. Think South America over recent decades. Much worse, think Germany's Wiemar Republic of the 1920s. The foreign "investor" still loses, just in a different way.

On the other hand, periods of restraint by governments have a habit of coinciding with improved private sector performance. This is partly because it improves business confidence about the medium-term but also in that it allows the financial markets to feel less nervous about lending to the governments in question, which has the effect of lowering the country's interest rates.

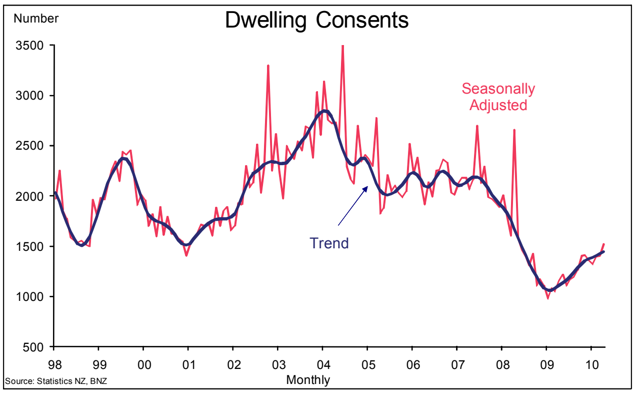
Anyway, it will be interesting to see if the latest global issues doing the rounds have had any bearing on this afternoon's NBNZ business survey.

And even if it does, whether New Zealand's improving primary sector picture (as we reiterated in last week's Rural Wrap, entitled *On the Up, Down on the Farm*) will be enough to keep the survey's overall numbers solid.

We say this with international dairy prices continuing to hold onto this year's strong gains. And that the export price robustness is about more than just dairy prices – something we expect Thursday's ANZ commodity indices to confirm.

We've certainly detected improved confidence in the farming sector, in general – even if it's not obviously translating into sales and activity for the moment.

Of course, one thing keeping NZ commodity producers on edge is the NZ dollar. Having taken a bit of a hit last month, it has pretty much regained all of the strength



it had just before the fall. This re-strengthening of the currency looks set to take the shine off local currency export prices (perhaps even in Thursday's data).

The only other local economic statistics to note for this week are Tuesday morning's building consents and credit aggregates.

For consents, we expect the number for residential construction built upon April's nice bounce. If not, then we'll start to wonder if the watery gain in Q1 residential construction – as was registered in last week's GDP accounts – was not a once-off disappointment. On non-residential building consents we're more surely cautious about what the next batch will deliver.

As for Tuesday afternoon's credit aggregates, also for May, these are likely to be another sombre batch all round. It will be testimony to the slow, albeit increasingly better founded, economic recovery that's coming through, as last week's GDP results showed.

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Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates had another fairly quiet week. The market had a plethora of domestic data to provide some much needed guidance and direction most notably the GDP print; however with no big surprises the market has failed to really move with any great conviction. As expected, domestic GDP increased +0.6% for the quarter, and +1.9% yoy. The very front of the yield curve continues to price an 85% chance of a 25bps hike in the OCR in July with an additional 50bps priced in until the end of the year.

The bond market had a fairly tame week, strengthening 5-8 bps across the curve . The market continues to move in beat with the swap market, while keeping a close eye on offshore developments. There was a notable pick up in offshore demand last week. The market seems to be well supported here given the recent issues abroad, but with limited supply weighing in, further gains will be limited.

The swaps market had another steady week with a small rally across the curve on very thin liquidity as the market

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
18-Jun-10	3.11%	4.37%	5.52%	4.30%	5.59%	129
25-Jun-10	3.08%	4.33%	5.48%	4.25%	5.51%	126
Change (bps)	-3	-5	-4	-5	-7	-3

followed the gains made in offshore rates. The curve rallied 10-13 bps and was left a touch flatter overall with the 2s10s spread closing at 126 bps. The front to mid part of the curve continues to see some flattening pressure with offshore investors looking to receive our attractively high forward starting rates. This week will be much the same, with all eyes on offshore markets (and the World Cup) with a couple of domestic data pieces to supplement.

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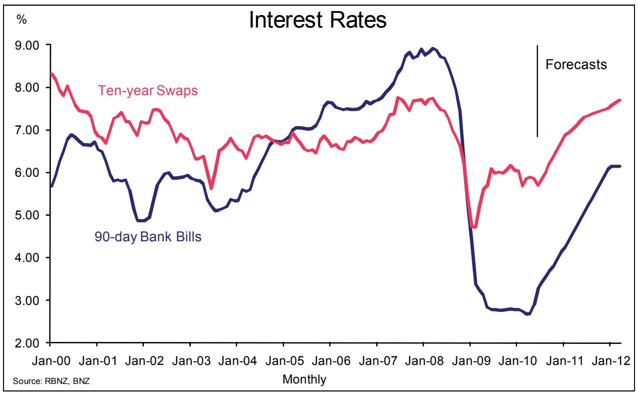

Interest Rate Technicals

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NZD 5yr Swap Rate

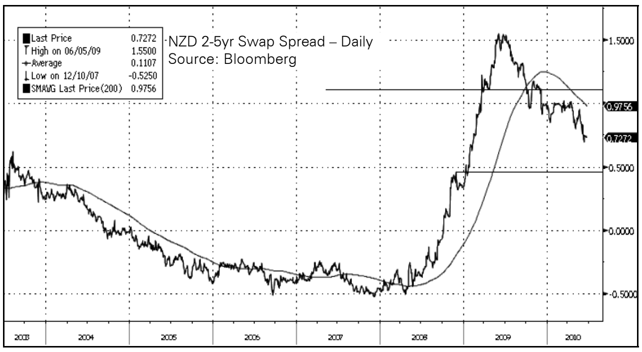
Outlook: Higher
MT Resistance: 5.86%
MT Support: 4.95%

We maintain a move higher in yield towards 5.86% resistance. However, the market is tracking the downward sloping trendline. If the market does not move higher this week then we will question this scenario.

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

Reuters pg BNZWFWDS

The NZD/USD climbed to a six-week high above 0.7150 last week, in spite of the still unfriendly global backdrop.

Last week's NZD/USD gains mean the currency has now recovered nearly all of late May's sharp losses. While concerns over contagion from Europe's debt woes have abated somewhat, global sentiment is still fragile. Indeed, the S&P500 slumped 3.6% last week and our risk appetite index (which has a scale of 0-100%) is sitting around 40% – well below the long-run average of 50%.

So, while a mild improvement in the global backdrop has played a role in the NZD's recent recovery, positive domestic fundamentals have contributed relatively more. Last week's GDP and Balance of Payments data were certainly good enough to keep the NZ recovery story firmly on track. March quarter GDP growth met expectations for a 0.6%q/q expansion (1.9%y/y), while Balance of Payments figures for the same period showed the annual current account deficit shrinking further, to $4.46b (or 2.4% of GDP). This week's ANZ commodity price index is likely to show NZ's export prices holding up at levels close to record highs.

Reflecting NZ's comparatively bright economic prognosis, the NZD's interest rate advantage has continued to widen, supporting the resurgence in NZD/USD. At 320bps, NZ-US 3-year swap spreads are now more than 40bps above April's low of 280bps. Further widening would appear to be in store if we are right in our view the RBNZ will raise the OCR a further 100bps this year (markets are pricing a less aggressive 75bps).

Looking ahead, this afternoon's NBNZ business survey is the up-front highlight of New Zealand's data week. While global woes will no doubt weigh on this, brightening times in the commodity sector might well be enough to keep the overall results solid.

However, given the more general dearth of market-moving local data, we suspect the fortunes of the NZD will rest with offshore markets this week. In particular, a slew of important US data releases (culminating in Friday's non-farm payrolls) will shed some light on whether recent fears over the strength of the US recovery are justified. The USD has come under fresh downward pressure of late, as currency markets' focus has shifted away from equity market performance towards signs of fading momentum in the US economic upturn. Indicative of such, the 1-month correlation between NZD/USD and the S&P500 has faded to 'only' 65%, from as high as 93% around a fortnight ago.

We wouldn't rule out a move towards 0.7250 on NZD/USD in coming sessions should US recovery fears continue to undermine the USD and risk appetite hold up. A break of key resistance at 0.7160 will be required first. Short-term support on NZD/USD is eyed on dips towards 0.7030.

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Foreign Exchange Technicals

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NZD/USD

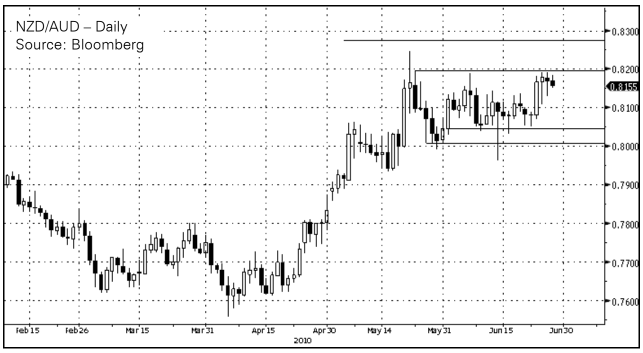
Outlook:	Buy a dip
ST Resistance:	0.7200 (ahead of 0.7305)
ST Support:	0.7030 (ahead of 0.6965)

The breach of the 0.7021 resistance level saw momentum indicators turn positive. A daily close above the 200-day moving average at 0.7130 would pave the way for a climb towards 0.7250.

NZD/AUD

Outlook:	Consolidation
ST Resistance:	0.8200 (ahead of 0.8275)
ST Support:	0.8050 (ahead of 0.8005)

Momentum factors favour the upside, but resistance at 0.8200 has proved too great a hurdle to date. Play the 0.8050-0.8200 range.



Key Upcoming Events

	Forecast	Median	Last
Monday 28 June			
NZ, NBNZ Business Survey, June			+48.2
Jpn, Retail Trade, May y/y		+4.8%	+4.9%
US, Personal Spending, May		+0.1%	flat
US, Chicago Fed Nat Activity Index, May		0.32	0.29
Euro, M3, May y/y		+0.3%	-0.1%
Tuesday 29 June			
NZ, Household Credit, May y/y			+2.7%
NZ, Building Consents, May (res, #)			+8.5%
Jpn, Industrial Production, May 1st est		flat	+1.3%
Jpn, Unemployment Rate, May		5.0%	5.1%
US, Shiller Home Price Index, April y/y		+3.5%	+2.3%
US, Consumer Confidence, June		62.9	63.3
Euro, Economic Confidence, June		98.1	98.4
Wednesday 30 June			
Aus, Private Sector Credit, May	+0.3%	+0.3%	+0.2%
UK, GDP, Q1 3rd est		+0.3%	+0.3%P
US, ADP Employment, May		+60k	+55k
US, Chicago PMI, June		59.0	59.7

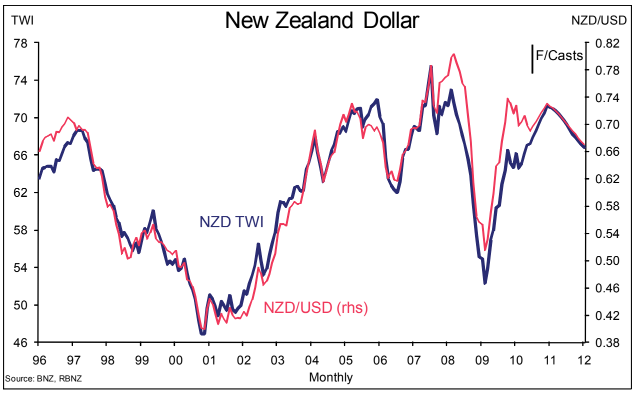
	Forecast	Median	Last
Wednesday 30 June			
Euro, CPI, Jun y/y 1st est.		+1.5%	+1.6%
Germ, Unemployment, June s.a.		7.7%	7.7%
Thursday 1 July			
NZ, ANZ Comdty Prices ($NZ), June			+2.9%
Aus, Building Approvals, May	+0.4%	flat	-14.8%
Aus, Retail Trade, May s.a.	-0.5%	+0.2%	+0.6%
Jpn, Tankan (lge manuf), Q2		-3	-14
UK, BOE Credit Conditions Survey, Q2			
UK, CIPS Manuf Survey, June		57.5	58.0
US, Pending Home Sales, May		-14.4%	+6.0%
US, Construction Spending, May		-0.7%	+2.7%
US, ISM Manufacturing, June		59.0	59.7
Germ, Retail Sales, May		+0.4%	-0.5%
China, PMI (NBS), June		53.3	53.9
Friday 2 July			
US, Non-Farm Payrolls, June		-110k	+431k
US, Factory Orders, May		-0.5%	+1.2%
Euro, Unemployment Rate, May		10.1%	10.1%

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.75	2.75	2.50	2.50
1 mth	2.89	2.90	2.71	2.77
2 mth	3.00	3.00	2.86	2.79
3 mth	3.13	3.05	2.93	2.76
6 mth	3.37	3.37	3.11	2.82
GOVERNMENT STOCK				
11/11	3.78	3.77	3.66	3.90
04/13	4.34	4.37	4.37	4.90
04/15	4.81	4.84	4.87	5.54
12/17	5.26	5.29	5.31	6.06
05/21	5.49	5.52	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.61	3.63	3.55	4.30
BNZ 05/15	8.68	6.43	6.55	7.40
GEN 03/14	6.22	6.28	6.42	7.19
GEN 03/16	6.71	6.83	7.02	7.98
TRP 12/10	4.01	4.03	3.83	4.65
TRP 06/20	6.75	6.82	6.95	7.93
SWAP RATES				
2 years	4.25	4.31	4.30	3.92
3 years	4.57	4.63	4.71	4.67
5 years	4.98	5.05	5.17	5.42
10 years	5.51	5.60	5.70	6.20

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7149	0.7111	0.6771	0.6426
NZD/AUD	0.8172	0.8068	0.8011	0.7983
NZD/JPY	63.85	64.25	61.63	61.82
NZD/EUR	0.5777	0.5718	0.5515	0.4605
NZD/GBP	0.4748	0.4787	0.4692	0.3893
NZD/CAD	0.7400	0.7249	0.7122	0.7294
TWI	68.46	68.06	65.80	60.78

NZD Outlook



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