5 July 2010

Rational Expectations Suggest RBNZ on Right Track

- Global market optimism further dented
- NZ swap rates, TWI, have eased to reflect
- While NZ export prices withstand world woes
- QSBO to confirm local momentum, but how much?
- As June's housing undertones weaken
- We expect Friday's electronic transactions improved

Is the RBNZ really lining up a pause – so soon in its long-signalled rate-hike cycle – in order to take stock of increasing global turbulence and signs of a slower recovery domestically, especially in housing? We think most probably not.

Why not a pause? Well, while it might sound like a good idea, it would certainly lose the RBNZ all of its initiative with the market pricing, when this is already under pressure. More to the point, we don't believe things have changed that much to make the June MPS redundant. Where the recent news is most important, in our judgement, is that it clouds the OCR path going into 2011.

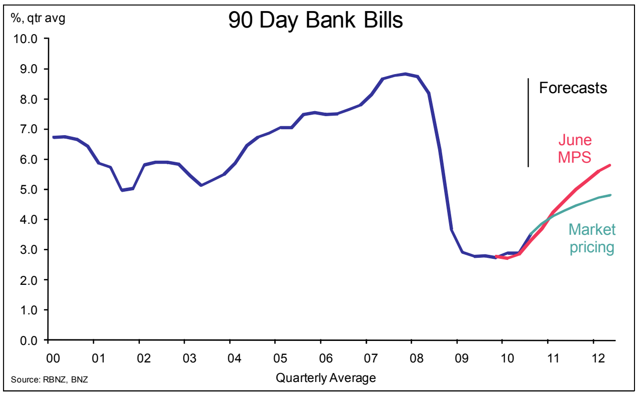
While we fully appreciate the seriousness of the global market turmoil, it's unclear at this stage what it means for global growth and inflation let alone for the NZ economy in both respects. This needs to be assessed rationally, not emotionally – by the RBNZ as much as analysts. We should not fall into the Greenspan trap of being unduly influenced by correcting equity markets and politically-driven events, however awful they appear at the time.

In this vein, even if we can anticipate international growth expectations to reverse some of their recent gains, overall, there have already been a lot of cushioning factors coming into play domestically.

For example, local swap rates have continued to ease over the last week or two, to now reflect an OCR path substantially softer than that propounded by the June MPS. This is why NZ term mortgage rates have just been reduced by the main banks, by around 50 basis points. This was not in the June MPS forecasts.

Actual monetary conditions are also easing already in that the exchange rate is falling in sympathy with global concerns. It's down on its trade-weighted peak of about two months ago. So it continues to do its shock-absorber work.

Yet New Zealand's commodity export prices remain firm. They have not followed the global commodity indices lower as far as we can see it. The NZ dairy sector is still

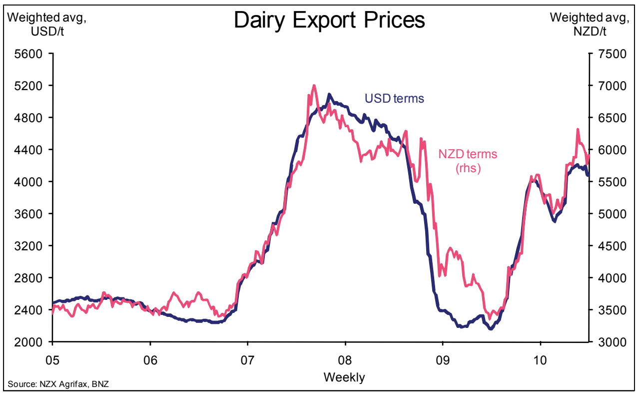


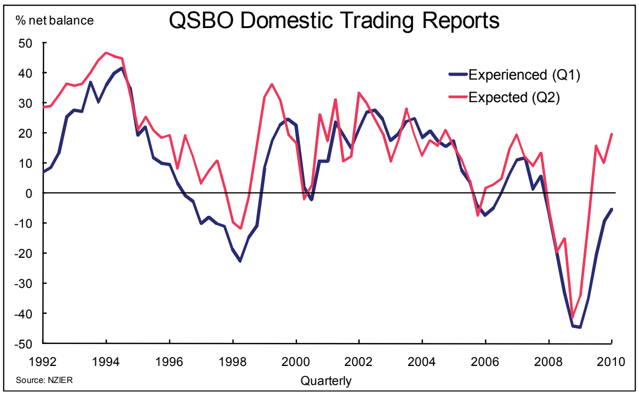
achieving relatively high prices, according to the weekly schedules right up to late last week. And so we'd be surprised to see any material weakness in Fonterra's next monthly auction, which is due to take place in the early hours of this Wednesday morning (NZT).

But it's not just dairy prices. We also note the relative robustness in many of New Zealand's other key primary-sector export price measures over recent weeks. Export revenue has been further upheld by the softened currency.

In any case, the dominant driver of the Bank's long-stated process of removing slack in short-term interest rates is not so much international factors, but domestic GDP and CPI considerations, as a general rule. And on this score there still seems enough for the RBNZ to keep nudging its cash rate higher over the coming months, as we expect tomorrow's Quarterly Survey of Business Opinion (QSBO) will justify.

The likelihood of a solid June quarter QSBO should not be any surprise, as the more frequent business surveys have remained so over recent months. Where it





will be specifically important, however, is in what is says about the degree of GDP pick-up in Q2/Q3.

For this, the QSBO trading-condition reports for the three months just gone, and expectations for the coming three months, will be instrumental. We expect these to strengthen to slightly positive territory, and into the twenties, respectively, in order to be consistent with the 0.8%/1.5% sequence we have for GDP growth over Q2 and Q3 of this year.

The other important indicators will be around the labour market. These will test whether the Q1 HLFS really did confirm a genuinely sharp turning, from a point of much less slack than in Q4. We were not convinced by the degree of it. So the QSBO "difficulty in finding staff" variables will be our first port of call to compare, followed by its direct employment series.

Also bear in mind QSBO pricing intentions will probably be starting to reflect the impending GST hike. Strictly speaking, they shouldn't – as the GST is not increased until 1 October, and the pricing intentions are asked of for the next three months, which takes us to September. But this didn't seem to prevent a rise in pricing intentions, as per last week's monthly NBNZ business survey. So any up-shift in the QSBO versions should also not be dismissed as "just a GST thing".

This is a reminder of something else the RBNZ will be a bit nervous about – the CPI path – even if GDP growth doesn't quite live up to its expectations. In the background, there is also the issue of the economy's speed limit for the near term, and the true degree of existing slack, which is where the QSBO capacity indicators will have plenty to say.

While domestic growth indicators seem robust, overall, that's not to say everything is recovering well. We always thought this would be an unusually slow recovery. And so far this looks to be the case.

We also thought the biggest question marks over the recovery would be the performance of the household sector. And so it is not any great surprise to see further evidence of the housing market continuing to struggle.

This was clear in last week's June-month listings and asking-price data, as published by realestate.co.nz. And this morning's statistics from Barfoot and Thompson (B&T), hammer the point home. While their headline figures looked stale enough, the undertones suggested things are actually becoming worse.

For example, we judge June's sales slumped a seasonally adjusted 15%, to the lowest level since February 2009. It's verging on recessionary again.

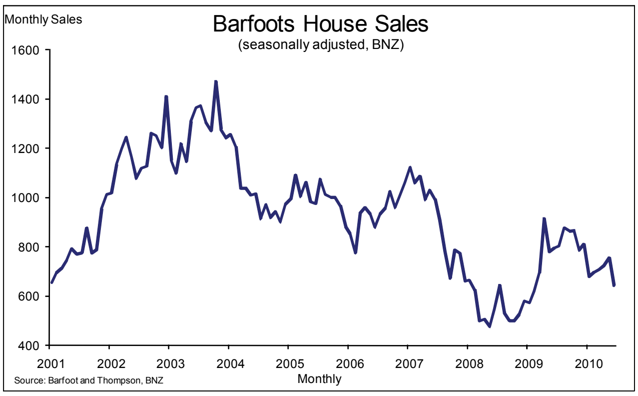
And while the slippage in Auckland-area sale prices (to $523k, from May's $543k) seemed partly owing to composition and seasonal impacts, we'd emphasise the word partly. Compared to a year ago, prices were about flat, when a "natural" increase might have been expected given the sales composition shift toward higher-end properties. Again, the undertones don't feel very good.

And it's not as though we can blame any flood of listings. Indeed, B&T listings, if anything, looked to be peaking in June, quite early in the piece, at relatively low levels. A relative lack of new listings would normally be expected to prop prices (as it did last year). That it isn't suggests the underlying problem is an obvious lack of demand, as reflected in weak sales.

This ongoing news of a soft housing market certainly corroborates our recent moves to downgrade the recovery we expect for the construction sector (as set out in our research article of last week, entitled *Low-Rise Construction*).

The other sore spot in the economy has clearly been around consumer spending. We still believe a gradual improvement is in train, on the way to strong gains through the second half of this year – albeit reliant on the 1 October tax cuts.

Still, we'll get an immediate examination of this thesis from Friday's electronic card transactions. For June, we expect these to register a reasonable advance, following the choppiness around a weak trend so far this year.



craig_ebert@bnz.co.nz

Domestic Interest Rates

Reuters pgs BNZL BNZM

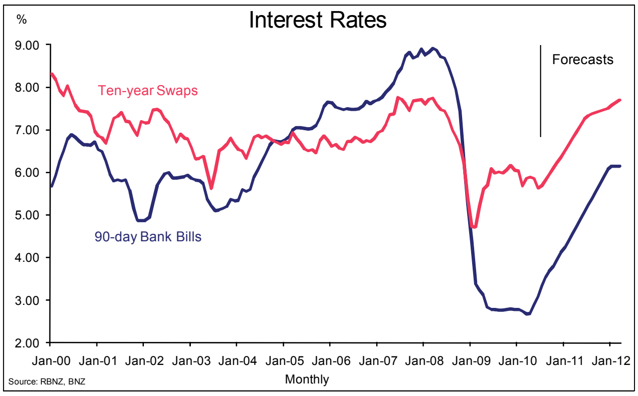
New Zealand Interest rates saw a decent rally over the week, as sentiment surrounding the global recovery turned ugly, which weighed on the market. Yields made significant gains across the curve early in the week on very light volumes. However, they bounced off their lows to close out the week, leaving the curve steeper in shape. The very front end of the curve has pared back some of the pricing of a 25 bps hike at the next RBNZ meeting later this month, now at 79% probability.

The bond market had a quiet week once again, moving in line with the moves offshore and the kiwi swaps market. The tender on Thursday went pretty poorly, with weak bid to cover ratios across all maturities. With supply weighing on the market, extended gains in bonds will be limited providing global market sentiment doesn't spiral out of control.

The swaps market had a fairly volatile week, rallying hard, to break recent ranges as receivers were lining up to receive, particularly the mid curve. This section continues to out-perform on the back of receiving interest in the forward starting structures such as 1y1y and 2y1y. The 2-year swap managed to push as low as 4.07%, triggering some stops along the way with thin liquidity and light volume. Later in the week some pay-side interest began to emerge, possibly due to the fact that a couple of the domestic banks had lowered their fixed 2-year mortgage rates below 7% and as a result their balance sheets looking to pre-hedge some of their mortgage flow. The mortgage book flow is something to keep an eye on should there be a possible wave of fixing interest.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
25-Jun-10	3.08%	4.33%	5.48%	4.25%	5.51%	126
2-Jul-10	3.18%	4.22%	5.41%	4.15%	5.46%	131
Change (bps)	**10**	**-11**	**-6**	**-10**	**-5**	**5**

james_d_chin@bnz.co.nz



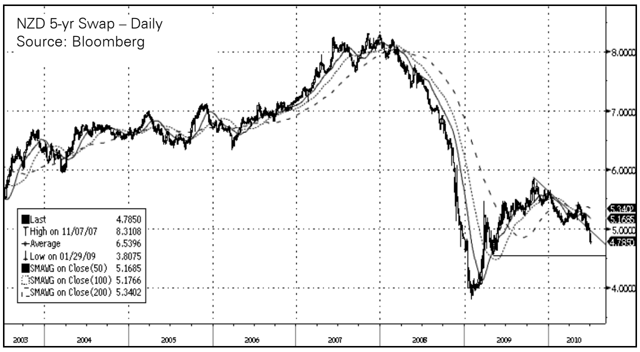
Interest Rate Technicals

jarrad_bourke@bnz.co.nz

NZD 5yr Swap Rate

Outlook: Lower
MT Resistance: 4.95%
MT Support: 4.53%

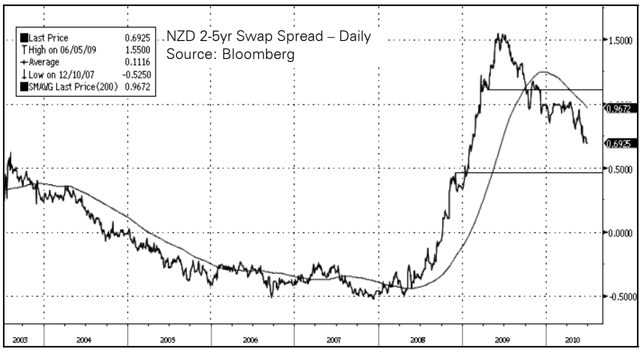
A minor backup in yields last week but previous targets remain in tact. Any pullbacks should find resistance at previous trendline currently around 4.95% before the lower target of 4.53%.



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

NZD/USD finished even weaker on Friday, closing near 0.6880, to finish the week down 3.67%. Fears that global growth is faltering had leverage-currencies falling against safe-haven currencies like CHF and JPY. The US data were weak (and not just in Friday's payrolls). China's PMI slowed more than expected, while European countries committed to fiscal austerity. All of this took its toll on risk assets and risk currencies. Given this backdrop it was no surprise AUD and the NZD were the two worst performing primary currencies last week. Sentiment was further dented by weakness in global commodities with the CRB index falling 0.68%.

The NZD had started the offshore session on Friday on an encouraging note. However, this did not last long with the generally poor US data, falling Financials and commodities all weighing on the local currency. While some Asian buying was noted , the weight of " risk off " sentiment saw the NZD eventually breach the 0.6900 mark to close near its lows. Given the general attitude to risk right now it is hard to see the NZD/USD back above the 0.7050 region, short term.

The local data week is dominated by Tuesday morning's Quarterly Survey of Business Opinion. We expect this to be generally solid, as other business surveys have been of late. It will be particularly important, however, for testing the degree of GDP pick-up in Q2/Q3, as well as whether spare resources are being soaked up. In this respect, the "difficulty in finding staff" series will be important, given the volatility in the "official" labour market data over recent quarters. Also bear in mind QSBO pricing intentions will probably be starting to reflect the impending (1 October) GST hike. Fonterra's Wednesday morning (NZT) dairy auction will also be worth watching. Will prices withstand the recent global wobbles, including around China?

The local market will also be keeping a watching brief across the Tasman this week with the RBA rate decision on Tuesday. While the RBA is expected to keep rates on hold the market will pay close attention to see if the RBA shares any of the market's concerns that global growth is starting to taper off.

For the week ahead, US numbers become infrequent after today's Independence Day holiday, with only the ISM Services report on Wednesday of any note. In Europe, Thursday brings policy meetings for both the BoE and ECB. We expect no changes to be announced in either the price or quantity of money (via QE programmes).

After beginning Q3 on something of a high note, it remains to be seen whether the EUR and GBP can sustain their very impressive recent performance. EUR/USD1.2450 still provides an important technical pivot, above which the Single Currency looks well bid on continued short covering, with potential up to the 1.27-1.28 area before its decline then resumes.

mike_s_jones@bnz.co.nz

Foreign Exchange Technicals

mark_lawler@bnz.co.nz

NZD/USD

Outlook: Sell
ST Resistance: 0.6975 (ahead of 0.7105)
ST Support: 0.6795 (ahead of 0.6590)

Selling any periods of strength continues to be the most profitable trade. A retest of the recent 0.6800 low appears to be the most likely initial target and may even extend to the crucial 0.6600 level.

NZD/AUD

Outlook: Consolidation with upward bias.
ST Resistance: 0.8260 (ahead of 0.8395)
ST Support: 0.7980 (ahead of 0.7785)

Momentum appears to favour a break out of recent range trading highs. Look for a weekly close above 0.8260 to confirm moves higher in the cross.

Key Upcoming Events

	Forecast	Median	Last
Monday 5 July			
Aus, Services PMI (AiG), June			47.5
Aus, TD Inflation Gauge, Jun y/y			+3.7%
UK, CIPS Services, June		55.0	55.4
US, Independence Day (Observed)			
Euro, Retail Sales, May		+0.3%	-0.9%
Tuesday 6 July			
NZ, QSBO, Q2	+20		+22
Aus, RBA Policy Announcement	4.50%	4.50%	4.50%
Aus, International Trade, May	+$0.35b	+$0.50b	+$0.13b
US, ISM Non-Manuf, June		55.4	55.4
Euro, PMI Services, June 2nd est			56.4P
Wednesday 7 July			
NZ, Fonterra Monthly Auction, July			-3.5%
Aus, Construction PMI (AiG), June			53.2
Euro, GDP, Q1 3rd est		+0.2%	+0.2%P
Germ, Factory Orders, May		+0.3%	+2.8%

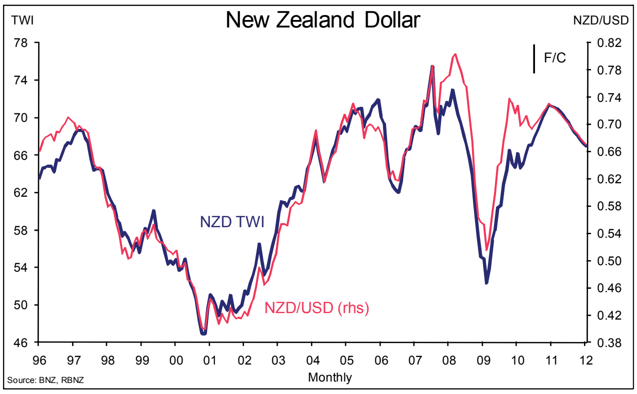
	Forecast	Median	Last
Thursday 8 July			
Aus, Employment, June	flat	+15k	+27k
Aus, Unemployment Rate, June	5.2%	5.2%	5.2%
Jpn, Eco Watchers Survey (outlook), June			48.7
Jpn, Machinery Orders, May		-3.0%	+4.0%
UK, Industrial Production, May		+0.4%	-0.4%
UK, BOE Policy Announcement	0.50%	0.50%	0.50%
US, Jobless Claims, week ended 02/07		460k	472k
Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
Germ, Industrial Production, May		+0.9%	+0.9%
Germ, Trade Balance, May s.a.		+€13.5b	+€13.4b
Friday 9 July			
NZ, Electronic Card Transactions, June			+0.2%
UK, PPI (core output), Jun y/y		+5.1%	+4.4%
UK, Trade Balance, May		-£3.0b	-£3.3b
US, Wholesale Inventories, April		+0.4%	+0.4%
China, Business Climate Indicator, Q2			132.9

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	2.75	2.75	2.50	2.50
1 mth	2.96	2.89	2.79	2.77
2 mth	3.02	3.00	2.95	2.79
3 mth	3.16	3.13	2.96	2.76
6 mth	3.40	3.37	3.21	2.82
GOVERNMENT STOCK				
11/11	3.74	3.78	3.68	3.90
04/13	4.22	4.34	4.35	4.90
04/15	4.70	4.81	4.84	5.54
12/17	5.17	5.26	5.28	6.06
05/21	5.41	5.49	6.53	-
CORPORATE BONDS				
BNZ 09/10	3.65	3.61	3.57	4.30
BNZ 05/15	6.32	6.28	6.51	7.40
GEN 03/14	6.09	6.22	6.37	7.19
GEN 03/16	6.59	6.71	6.97	7.98
TRP 12/10	4.02	4.01	3.94	4.65
TRP 06/20	6.69	6.75	6.89	7.93
SWAP RATES				
2 years	4.15	4.25	4.29	3.92
3 years	4.44	4.57	4.67	4.67
5 years	4.85	4.98	5.13	5.42
10 years	5.46	5.51	5.66	6.20

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.6883	0.7149	0.6587	0.6426
NZD/AUD	0.8175	0.8172	0.8132	0.7983
NZD/JPY	60.37	63.8500	60.22	61.82
NZD/EUR	0.5479	0.5777	0.5528	0.4605
NZD/GBP	0.4528	0.4748	0.4553	0.3893
NZD/CAD	0.7317	0.7400	0.6989	0.7294
TWI	65.94	68.46	65.20	60.78

NZD Outlook



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 Waterloo Quay
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	+800 642 222
Fixed Income/Derivatives	+800 283 269

Sydney

Foreign Exchange	+800 9295 1100
Fixed Income/Derivatives	+(61 2) 9295 1166

London

Foreign Exchange	+800 333 00 333
Fixed Income/Derivatives	+(44 20) 7796 4761

New York

Foreign Exchange	+1 800 125 602
Fixed Income/Derivatives	+1877 377 5480

Hong Kong

Foreign Exchange	+(85 2) 2526 5891
Fixed Income/Derivatives	+(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