

12 July 2010

## RBNZ Can't Be Super Relaxed on Inflation

- NZ Q2 inflation likely modest to middling
- But RBNZ can't be relaxed about CPI outlook
- Reinforcing case for paring OCR stimulus
- Housing market pausing for fair-value thought
- May's retail sales expected so-so, with 0.8%
- Can June's PMI maintain its recovery pulse?

While we believe Friday's Q2 CPI will undershoot the Reserve Bank's moderate expectations, the Bank will probably not see much, if any, relief in forward inflation. Relative price pressures can only edge up from here, having been simply laid low, rather than killed, by the recent recession. And with supply expansion hampered, it will likely not take much of a GDP expansion to bring inflation risk back on the radar. With this in mind, the RBNZ would not want to run policy too easy, for too long. It's never about just GDP.

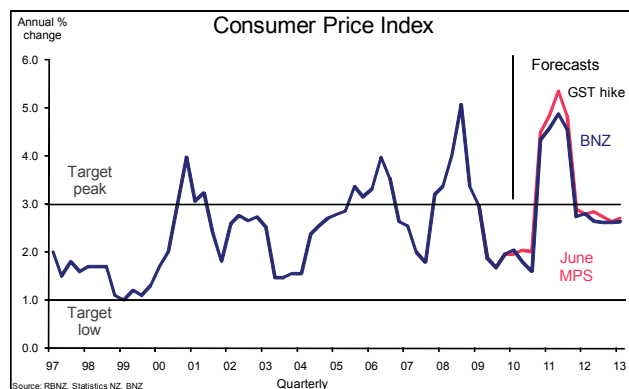
As for the June quarter CPI, we're picking a headline quarterly increase of 0.3%. This would moderate annual inflation to 1.8%, from 2.0%. The RBNZ has judged a 0.5% increment for Q2, which would leave annual inflation at 2.0%. The market's median expectations are 0.5%, for 1.9% y/y. So there is room for some relief, in our view, while the core inflation measures will probably still be running a bit below mid-range as well.

Do note, however, that tomorrow's June Food Price Index could yet fine-tune expectations on the Q2 CPI. We don't know what the market expects for the FPI, but we're anticipating a 0.9% bounce-back, following general weakness over recent months.

Even so, food prices will have fallen about 1.0% in Q2, compared to Q1 – a major force in hobbling the overall Q2 CPI advance. The other downward pressure will likely come from ongoing price falls in the CPI categories priced off the still-strong exchange rate. These largely-cyclically impacts will also be flattering the headline CPI, as will seasonally lower airfares.

However, also bear in mind the hike to the tobacco excise tax at the end of April, will likely have added 0.2 points to Q2 inflation (even though there was a lot of product imported early, apparently, which should have avoided the increased excise tax, as it is an import tax, not a sales tax).

Steering through these ups and downs we believe the rates of core CPI inflation will be about as subdued as they were in Q1. As a general rule these were running



at or, probably more arguably, below the middle of the implicit 1.0 to 3.0% target band.

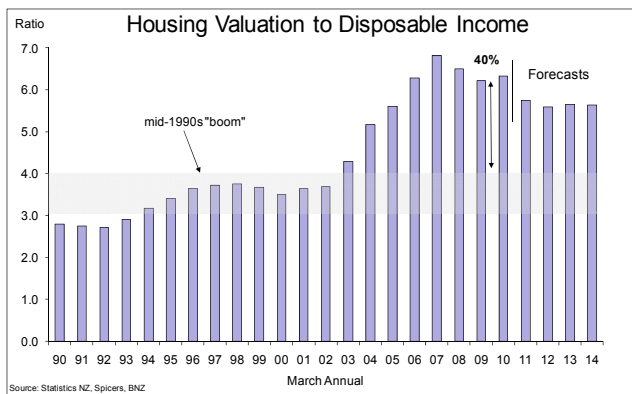
In keeping with this, we expect housing costs inched up only modestly in the March quarter. This includes rents. Many have expected these to be ramping up, on supposed housing shortages, made worse by Budget measures that allow landlords less depreciation. We were never convinced by these arguments, and so believe rents will increase only incrementally. We might be horribly wrong. But some proof will be in the pudding, Friday.

Overall, then, we anticipate a relatively mild Q2 CPI result (albeit with a fair few ups and downs in the components). However, the inflation track from here looks far from slack.

Underlying inflation is now more likely to rise, than fall. Sure, demand growth looks moderate, at best. However, the supply side of the economy is also being hampered by a number of factors. Poor productivity is one. Slower population growth, by way of collapsing immigration, is another. And while there are patent signs of spare capacity at present, we need to bear in mind new investment is relatively low. So, potentially, it won't take much of a demand rebound to tighten things up again.

With this in mind, increases to a number of government charges can only up the ante on the CPI front, on the risks they become a factor in price and wage setting behaviour.

As mentioned, tobacco tax has added about 0.2 to the Q2 CPI (and with a bit more to dribble into Q3, as an averaging impact). On 1 July we had the ETS impacts of about a 5% increase to electricity prices and three-cent lift in fuel prices (although the latter was entirely offset within a week by lower international crude prices). At the



same time ACC charges were increased, principally on motor vehicle licensing fees (with the actuaries seemingly pushing for more cost recovery). The biggie, of course, will be the 1 October increase to the GST.

Perhaps these government tax imposts will hit disposable income, and thus spending, more than we appreciate? Then again, it will take a lot for these to offset the stimulus from the 1 October reductions to personal tax rates, which we judge the greater. What we know for sure is that this raft of government policy changes will make the upcoming data extremely difficult to interpret.

For the moment, however, some of it's relatively straightforward. Consumer spending, for instance, is subdued. We saw this in last week's electronic card transactions. And so Wednesday's retail trade results for May will only be important if they are extremely strong, or negative. For the record, we're picking an unspectacular retail advance of 0.8%, overall – just a fraction above market expectations – while we're at 0.6% for the ex-auto measure, in line with the market.

The real question for the spending indicators is whether they pick up a bit of steam over the coming months, as we expect (albeit mainly as consumers spend up a bit ahead of the GST rise, but also helped fundamentally by pre-spending of the tax cuts).

As for the housing market, it is, like consumer shopping to date, subdued for the meantime. The latest evidence of this was in the Quotable Value NZ monthly housing report, published over the weekend. Like-for-like prices were still slipping a bit, according to QVNZ commentary, and there remained a stand-off between unrealistic sellers and cautious buyers. The only consolation, of sorts, was that there was not any flood of properties for sale.

We expect similar themes for Wednesday morning's housing report from the Real Estate Institute, with more weakness registered in its nationwide sales. So much for the May Budget clearing up supposed uncertainty about taxation issues. Indeed, in the end, the Budget's housing measures were much less draconian than feared.

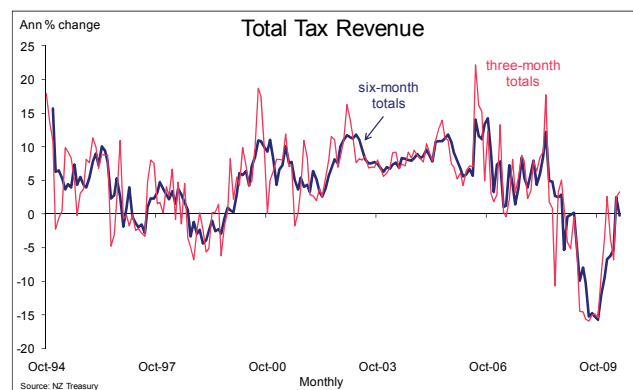
We are not surprised by the lack of pick-up in the housing market. And much of this relates to our judgement that house prices remain well above any long-term fair-value metric one cares to look at. This includes the well-documented tendency of home prices to run at approximately three times the level of household income - over time, and across countries. Not relevant to New Zealand? Think again. We broadly followed this rule of thumb for the many years to about 2003. Then something went nuts. It still looks a bit nutty.

Anyway, there's more to the economy than the housing market, and even retail spending. This is why Thursday's BNZ Performance of Manufacturing Index will be the more interesting piece of news for us this week. We're relying on the manufacturing sector to help drive GDP growth underfoot. And so we'd be disappointed if June's PMI slows any further than it did in May, with its seasonally adjusted 54.5.

As for this morning's Crown accounts, they were about as expected for the eleven months to May. While there looked to be some positive surprise on the tax revenue side, it was mainly owing to a bump of GST payments that are likely to reverse out in June, according to the Treasury.

Indeed, the more interesting information from the Treasury arguably came last week, when it published its Monthly Economic Indicators. This found the officials admitting growth risked being not as robust as it thought in the June quarter. Recall the Budget forecast 0.8% for this, following the 0.8% it estimated for Q1 (when it actually increased 0.6%). Generally speaking, the Treasury took the opportunity to highlight the slow pace of recovery – a view we still take.

Nonetheless, this does not necessarily mean the RBNZ can be super relaxed about inflation. Indeed, we might yet be surprised by how much inflation bubbles to the surface over the next year or two. Of course, it's no reason for the Bank to run tight policy. However, the real risk of inflation certainly warns against the RBNZ running policy too slack, for too long. In this regard, we prefer to stay with our core OCR view – of a stream of 25 point hikes – for the meantime.



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## Domestic Interest Rates

New Zealand interest rates had a subdued week, rallying initially to start the week before bouncing back into their recent ranges on light volumes and thin liquidity. The market took its lead from offshore moves particularly in Australia. Thursday brought about another strong employment data result from across the ditch just two days after the RBA decided to keep its cash rate on hold, which put pressure on our rates to grind higher. The very front end of our curve sees an 85% chance of a 25 bps hike in two weeks time.

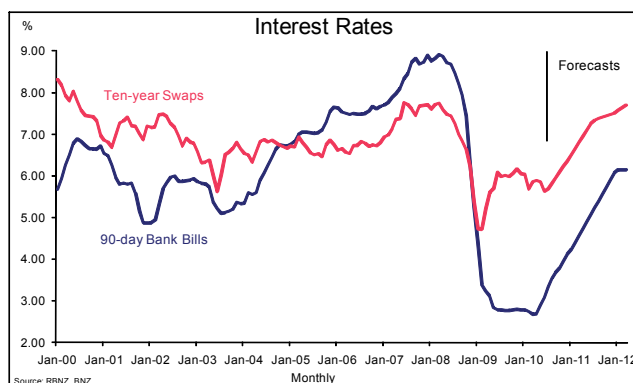
NZ Government bonds have had a fairly quiet week, with very little to report, the market moving inline with the swaps market and bond markets abroad. The bond tender went fairly well with good coverage in the 11s and 17s particularly. With EFP for the 17s running at about flat the market has seen renewed interest in the underlying bond.

|                     | 90 day bills | 04/13 NZGS | 05/21 NZGS | 2yr swaps s/a | 10yr swaps s/a | 2yr/10yr swaps(bps) |
|---------------------|--------------|------------|------------|---------------|----------------|---------------------|
| 2-Jul-10            | 3.18%        | 4.22%      | 5.41%      | 4.15%         | 5.46%          | 131                 |
| 9-Jul-10            | 3.02%        | 4.24%      | 5.42%      | 4.22%         | 5.40%          | 118                 |
| <b>Change (bps)</b> | <b>-16</b>   | <b>2</b>   | <b>1</b>   | <b>7</b>      | <b>-7</b>      | <b>-13</b>          |

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The swaps market saw a quiet week, following much of the aforementioned on thin liquidity. The market pushed higher late in the week with weaker offshore markets. The market continues to be flow driven; the curve continues its relentless flattening bias, this time due to the mid curve on the back of a domestic issuance deal hitting the 5 year part of the curve. This week we have retail trade and Q2 CPI data to try and bring this market to life.

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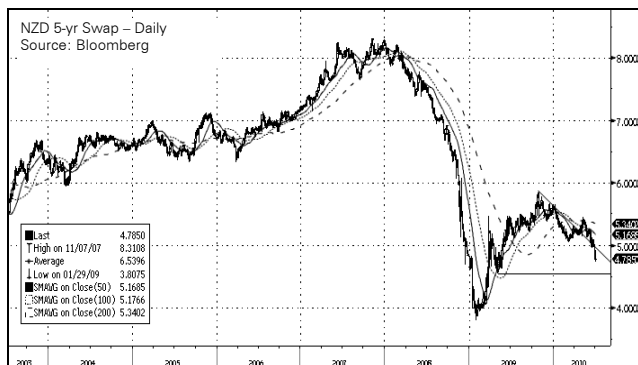


## Interest Rate Technicals

### 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%.



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### 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

Improved risk appetite appeared the dominant theme for trading across all asset classes last week and that was certainly the case for FX. The AUD, NZD and the CAD were the best performers over the course of the week as rising investor confidence sent equities and commodities higher. While the NZD failed to really build on its gains from earlier in the week it still closed the week up 3.20%, second only to the very strong AUD on the performance tables.

An improved attitude toward risk was not necessarily the only factor at play, however. Some analysts have also noted that the speculative community were heavily short AUD, NZD and CAD, so a lot of the buying seen in these currencies was due to heavy short covering.

Some also contend that the extremely low volumes changing hands in global equity markets indicate the risk rally was less to do with rising risk appetite and more to do with heavy short covering ahead of the US corporate earning season and a lack of data and news out of the US and Europe.

In any case the main focus will be the corporate earnings reports from some of the largest companies in the US and their guidance for the coming quarter. Alcoa unofficially kick off the reporting season when they report after the

### Reuters pg BNZFWDS

close Monday. Tech bellwether Intel reports on Tuesday followed on Thursday by reports from Google and JP Morgan. On Friday GE, Bank of America and Citigroup will release their results.

On the local data front, Friday's Q2 CPI will be the most closely watched item, although there are a few other reports to note, including May's retail sales, June's BNZ Performance of Manufacturing Index and REINZ housing data.

For global news, keep an eye out for Fed Chairman Bernanke speaking on Monday and US CPI, retail sales and Michigan Confidence survey out later in the week. The key event in Europe will be the Greece T-Bill auction, Tuesday, which will mark the first time Greece has attempted to auction Bills since accepting the EU/IMF bailout in May.

For this week expect the NZD to find good support towards 0.7050 with any further probes to the topside requiring an improvement in risk appetite across both equities and commodities.

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## Foreign Exchange Technicals

### NZD/USD

Outlook: Consolidation with upward bias.  
 ST Resistance: 0.7160 (ahead of 0.7225)  
 ST Support: 0.6970 (ahead of 0.6800)

The currency will struggle to break the mid 0.7s initially and some consolidation is to be expected. Any tests around the mid to late 0.69s may prove to be profitable in the medium term.

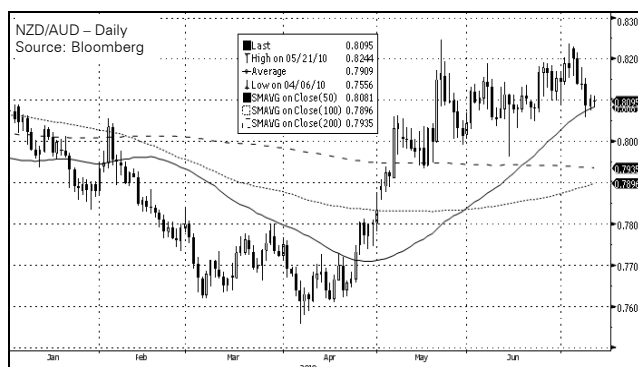


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### NZD/AUD

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

Short term resistance held and these levels rejected. Indicating some move lower in the short term with expectation that the cross may test the low 0.80s levels in the short term.



## Key Upcoming Events

|                                       | Forecast | Median   | Last     |  | Forecast | Median | Last   |
|---------------------------------------|----------|----------|----------|--|----------|--------|--------|
| <b>Monday 12 July</b>                 |          |          |          | <b>Thursday 15 July</b>                |          |        |        |
| Aus, Housing Finance, May             | +2.5%    | +1.5%    | -1.8%    | NZ, BNZ PMI (Manufacturing), June      |          |        | 54.5   |
| UK, GDP, Q1 3rd est                   |          | +0.3%    | +0.3%P   | Jpn, BOJ Policy Announcement           |          |        | 0.10%  |
| <b>Tuesday 13 July</b>                |          |          |          | US, Philly Fed Index, July             | +10.0    |        | +8.0   |
| NZ, Food Price Index, June            | +0.9%    |          | -0.7%    | US, Industrial Production, June        |          | flat   | +1.3%  |
| Aus, NAB Business Survey, June        |          |          |          | US, PPI ex-food/energy, June y/y       | +1.1%    |        | +1.3%  |
| UK, CPI, June y/y                     |          | +3.2%    | +3.4%    | US, Empire Manufacturing, July         | +18.00   |        | +19.57 |
| UK, RICS Housing Survey, June         |          | +20%     | +22%     | Euro, ECB Monthly Bulletin             |          |        |        |
| UK, BRC Retail Sales Monitor, Jun y/y |          | +3.0%    |          | China, GDP, Q2 y/y                     | +10.5%   |        | +11.9% |
| US, International Trade, May          |          | -\$39.2b | -\$40.3b | China, Retail Sales, June y/y          | +18.8%   |        | +18.7% |
| Germ, ZEW Sentiment, July             |          | +25.3    | +28.7    | China, Industrial Production, June y/y | +15.1%   |        | +16.5% |
| <b>Wednesday 14 July</b>              |          |          |          | China, CPI, June y/y                   | +3.3%    |        | +3.1%  |
| NZ, Retail Trade, May                 | +0.8%    | +0.6%    | -0.3%    | <b>Friday 16 July</b>                  |          |        |        |
| NZ, REINZ Housing Data, June          |          |          |          | NZ, CPI, Q2                            | +0.3%    | +0.5%  | +0.4%  |
| Aus, Consumer Sentiment - Wpac, July  |          |          | 101.9    | Jpn, BOJ Economic Report               |          |        |        |
| UK, Unemployment Rate (ILO), May      |          | 8.0%     | 7.9%     | US, CPI ex food/energy, June           | +0.9%    |        | +0.9%  |
| US, Business Inventories, May         |          | +0.4%    | +0.4%    | US, Mich Cons Confidence, July 1st est |          | 74.0   | 76.0   |
| US, FOMC Minutes, 22/23 Jun Meeting   |          |          |          | Euro, Trade Balance, May               | -€0.5b   |        | +€1.8b |
| US, Retail Sales, June                |          | -0.2%    | -1.2%    |  |          |        |        |
| Euro, Industrial Production, May      |          | +1.2%    | +0.6%    |  |          |        |        |

## Historical Data

|                              | Today | Week Ago | Month Ago | Year Ago |                          | Today  | Week Ago | Month Ago | Year Ago |
|------------------------------|-------|----------|-----------|----------|--------------------------|--------|----------|-----------|----------|
| <b>CASH &amp; BANK BILLS</b> |       |          |           |          | <b>FOREIGN EXCHANGE</b>  |        |          |           |          |
| Call                         | 2.75  | 2.75     | 2.75      | 2.50     | NZD/USD                  | 0.7105 | 0.6883   | 0.6902    | 0.6426   |
| 1 mth                        | 2.92  | 2.96     | 2.94      | 2.77     | NZD/AUD                  | 0.8097 | 0.8175   | 0.8104    | 0.7983   |
| 2 mth                        | 3.02  | 3.02     | 3.01      | 2.79     | NZD/JPY                  | 62.98  | 60.3700  | 63.28     | 61.82    |
| 3 mth                        | 3.22  | 3.16     | 3.07      | 2.76     | NZD/EUR                  | 0.5619 | 0.5479   | 0.5694    | 0.4605   |
| 6 mth                        | 3.42  | 3.40     | 3.30      | 2.82     | NZD/GBP                  | 0.4718 | 0.4528   | 0.4741    | 0.3893   |
| <b>GOVERNMENT STOCK</b>      |       |          |           |          | NZD/CAD                  | 0.7332 | 0.7317   | 0.7133    | 0.7294   |
| 11/11                        | 3.75  | 3.74     | 3.76      | 3.90     | TWI                      | 67.49  | 65.94    | 67.23     | 60.78    |
| 04/13                        | 4.24  | 4.22     | 4.40      | 4.90     | <b>NZD Outlook</b>       |        |          |           |          |
| 04/15                        | 4.71  | 4.70     | 4.86      | 5.54     |                          |        |          |           |          |
| 12/17                        | 5.18  | 5.17     | 5.29      | 6.06     | <p>Source: BNZ, RBNZ</p> |        |          |           |          |
| 05/21                        | 5.42  | 5.41     | 6.53      | -        |                          |        |          |           |          |
| <b>CORPORATE BONDS</b>       |       |          |           |          |                          |        |          |           |          |
| BNZ 09/10                    | 3.62  | 3.65     | 3.63      | 4.30     |                          |        |          |           |          |
| BNZ 05/15                    | 6.39  | 6.32     | 6.50      | 7.40     |                          |        |          |           |          |
| GEN 03/14                    | 6.14  | 6.09     | 6.32      | 7.19     |                          |        |          |           |          |
| GEN 03/16                    | 6.60  | 6.59     | 6.91      | 7.98     |                          |        |          |           |          |
| TRP 12/10                    | 3.99  | 4.02     | 3.99      | 4.65     |                          |        |          |           |          |
| TRP 06/20                    | 6.95  | 6.69     | 6.86      | 7.93     |                          |        |          |           |          |
| <b>SWAP RATES</b>            |       |          |           |          |                          |        |          |           |          |
| 2 years                      | 4.22  | 4.15     | 4.32      | 3.92     |                          |        |          |           |          |
| 3 years                      | 4.51  | 4.44     | 4.65      | 4.67     |                          |        |          |           |          |
| 5 years                      | 4.88  | 4.85     | 5.06      | 5.42     |                          |        |          |           |          |
| 10 years                     | 5.40  | 5.46     | 5.61      | 6.20     |                          |        |          |           |          |

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