

2 August 2010

Markets Vulnerable To Laboured Data

- Unemployment rate set to rise
- Dairy prices to fall
- Both supporting dovish RBNZ stance
- But rates remain a long way from neutral
- A near term pause would be ill-advised

A significant number of indicators are telling us that the recovery is struggling to gain momentum. Indeed, we find ourselves increasingly questioning whether the peak we have assumed for GDP growth can be attained. Yet, ironically, when set alongside these developments, anecdotal evidence has us wondering whether labour market conditions are actually tightening. If this is so, it's not great news for the wider economy as it suggests growth will be supply constrained, as well as demand-limited, and inflationary pressures will rise faster than would otherwise be the case.

This week's data may be able to shed some light on this apparent conundrum with the Quarterly Employment Survey and Labour Cost Indices due for release on Tuesday and the Household Labour Force Survey (HLFS) on Thursday.

Financial market participants will be heavily focussed on the HLFS. With the Reserve Bank seemingly recently relaxing the urgency with which it intends raising interest rates, all eyes will be on these data to see whether they corroborate the Reserve Bank's new-found pessimism. Notably, the data due for release this week are some of the few key figures between now and the Reserve Bank's September Monetary Policy Statement. It's between September and October that the really meaty figures are released.

With this in mind, we believe the unemployment rate is likely to print higher than the Reserve Bank's published

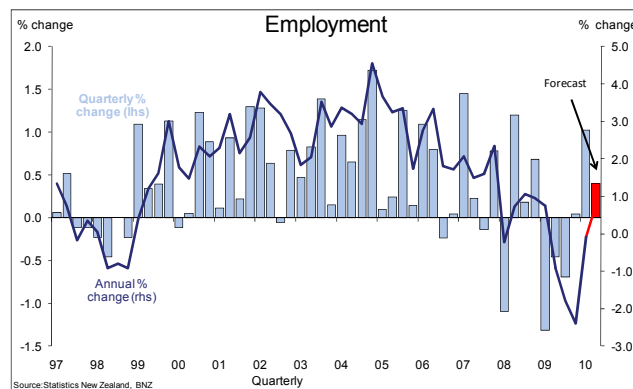
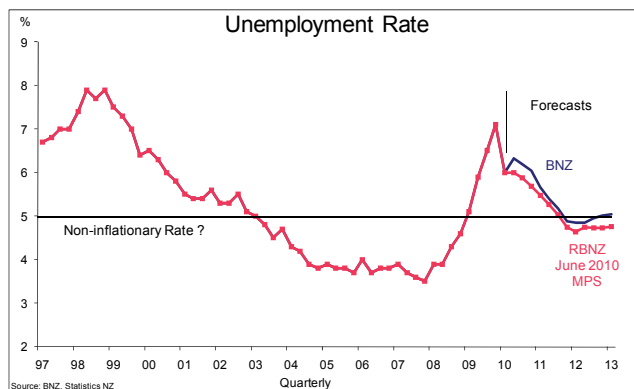
pick, back in June, of 6.0%, unchanged from the March quarter. We are forecasting it to jump back up to 6.3%.

If we are right, there is a real danger that market participants use this to justify their current view that there is only a 65% chance of tightening in September and that the cash rate will peak at a smidgen over 4.0%. In our opinion, there is very little justification for this pricing even in the event that the labour market looks soft in a statistical sense.

Moreover, there are several specific data issues that make us wary of placing too much stock in the printed figure anyway. To start with, the unemployment rate has swung markedly over the last four quarters raising questions as to the "true" picture. Starting in June 2009 the last four quarters have read 5.9%, 6.5%, 7.1%, and 6.0% respectively. This means that two of the four largest movements in the history of the series have occurred in the last year. Given this degree of volatility, almost any outcome should be taken with a pinch of salt, especially by policy makers.

Secondly, while the RBNZ's unemployment forecast looks different to our own, its employment forecast of 0.5% is only modestly different to our pick of 0.4%.

Perhaps more important than any of this is the fact that the labour market, generally, is as tight as it is so early in a period of recovery. In our opinion, the non-inflationary rate of unemployment probably sits around the 5.0% mark. Even with our relatively soft GDP forecasts, accompanying employment growth, and heroic participation rate forecasts, our predicted unemployment rate reasonably rapidly approaches this mark. This process is clearly being accelerated by the fact that net migration inflows are currently wilting. If this trend continues then labour supply



issues will become even more bothersome than we are already projecting.

This cuts directly back to the argument we have made in previous notes that New Zealand's potential growth rate is declining rapidly. Consequently, inflationary pressure will appear at lower rates of growth than was previously the case.

And, so, to complete the circle, this is why we believe strongly that the market is already underpricing the risk of future central bank tightening irrespective of the outcome of Thursday's data.

In short, if growth is headed to anything like "normal" (or potential if you'd prefer) the cash rate must move back to neutral quickly alongside this. There will in time be great debate about where the new neutral rate is, given the changed world of global banking. Indeed, there was significant debate anyway. However, one thing is for sure, whether you are pessimist or optimist, the neutral rate is hardly likely to have a 3 in front of it but more likely a 4 or even 5. This is why we believe a September rate hike should be a done deal and so too, probably, October if not December to boot.

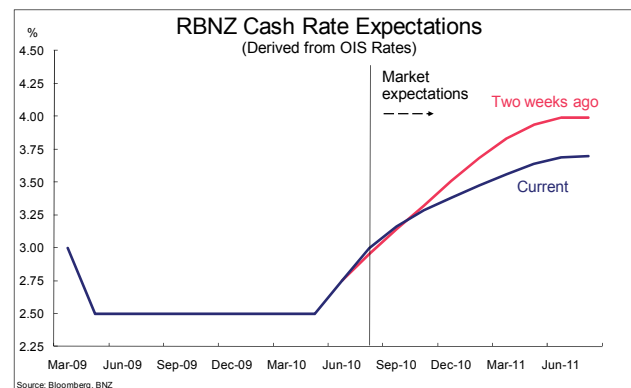
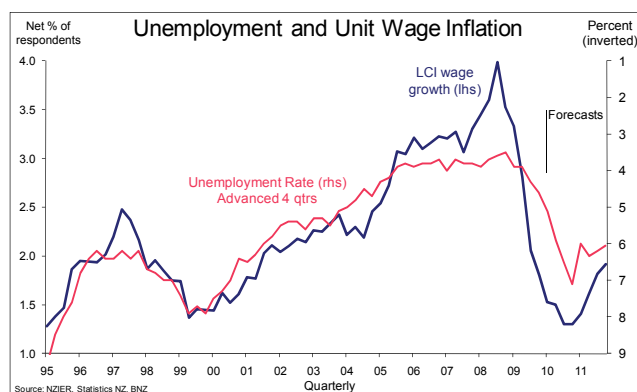
While the labour market may be tightening in a trend sense, we believe it is too early for this to be showing up in the measured wage response. In fact wage data continue to reflect the lagged impact of the surge in the unemployment rate reported from mid 2007 through to the end of last year. Already this has resulted in a drop in the annual increase in the labour cost index (for private sector ordinary time salary and wage rates) to 1.3% from a peak of 3.7% in September 2008.

We are expecting the annual increase to remain at or below these levels for at least the next year. Our June quarter pick, for the data released on Tuesday, is 0.3% yielding an annual movement of 1.3%. This, at least, is great news for inflation watchers as this sort of number is consistent with CPI inflation being heavily constrained. Nonetheless, if labour supply does remain as restrictive as it currently is, there is some danger that labour costs might accelerate even against the relatively soft economic backdrop we are projecting. That said, it's more likely to be a late 2011 issue than any immediate concern.

The Quarterly Employment Survey is also released on Tuesday. This survey is of lesser interest to us but we will have a close look at the filled jobs data for clues as to whether we are on the right track with our HLFS employment pick. An annual increase in the filled jobs number of around 0.8% would provide that consistency.

Aside from the labour market figures, we'll be keeping a close eye on Fonterra's latest auction results, released Wednesday morning. Indications are they should reveal another drop in prices. This would be consistent with our view that dairy prices have well and truly peaked. The degree of the prospective fall is of most interest. We are mindful that the recent past increase in commodity prices generally, and dairy prices specifically, has been extraordinarily large. Given the traditional lagged supply response to rising soft-commodity prices, this leaves a very big risk of a bigger than expected future fall. This would be the last thing that New Zealand needs now as the recovery's strength hangs in the balance.

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Domestic Interest Rates

New Zealand interest rates saw a strong rally on the week despite the RBNZ delivering the expected 25bp rate hike. The market took the sentence of "The pace and extent of further OCR increases is likely to be more moderate than was projected in the June statement" as a strongly dovish signal and the futures market rallied strongly. The market now prices a 70% chance of a hike in September, followed by just roughly 1 hike per three meetings from there, resulting in just 75bp priced in total for the next eight meetings, a level which seems too low given the still very low outright level (unless, of course, one is forecasting a failed NZ economic recovery).

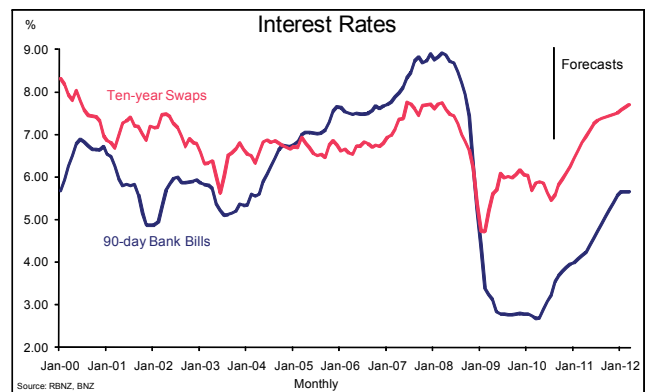
The bond market rallied over the week as both offshore gains and the RBNZ helped to push yields down. However, with yields this low and continuing supply into the market it seems hard for the bond market to continue much lower in yield. Any positive news will likely lead to a sell off in bonds, potentially a sharp one.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
23-Jul-10	3.26%	4.26%	5.40%	4.22%	5.34%	112
30-Jul-10	3.27%	4.13%	5.33%	3.98%	5.24%	126
Change (bps)	1	-13	-7	-24	-10	14

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The swap market rallied strongly on the RBNZ, with yields lower across the curve. The 2-yr rallied strongly after the OCR review and then again on Friday with stops seemingly triggered in that part of the curve. With the 2-yr now below 4% it seems too low on an outright basis but a continued lack of payside interest from mortgage fixing is helping to keep the market down. One key thing to watch will be to see if mortgage fixings increase with the rise in floating rate mortgages, if this happen it could potentially lead to a rapid rise in swap yields.

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Interest Rate Technicals

NZD 5yr Swap Rate

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

The market has pushed down towards our support level. We still look for this level to hold and this scenario will only be challenged should the 4.53% level be breached.



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

Outlook: Rangebound
 MT Resistance: +81
 MT Support: +46

We expect the recent range trade to continue. Risks remain for a move to support, at +46. Trendline resistance now comes in at +81 and this should cap any move wider.



Foreign Exchange Market

The NZD was the weakest performing currency last week. Having hit a 6-month high of almost 0.7400 on Tuesday, the NZD/USD spent the rest of the week drifting lower.

US dollar weakness was the overriding theme in currency markets last week. Indeed, the USD index finished the week down 1.1%. Not only did ratings agency Moody's highlight the risks to the US Government's AAA rating, but US data painted a picture of slowing economic momentum. Friday's US GDP data was an obvious example, revealing economic growth slowed from 3.7% to 2.4% in the June quarter (2.6% expected). Sliding US bond yields dragged the USD lower, providing a boost to most of the major currencies.

Nevertheless, a more cautious assessment of the NZ economy from the RBNZ knocked some steam out of the NZD last week, despite the softer USD. Not only did the RBNZ lambast the NZD's recent gains as "inconsistent with the softening in NZ's economic outlook", but the central bank's admission that "the pace and extent of further OCR increases is likely to be more moderate" pulled some of the yield support from under the currency. NZ-US 3-year swap spreads fell below 320bps (from around 330bps at the start of the week) and the NZD/USD was eventually dragged below 0.7300.

NZ employment statistics take centre stage this week. Thursday's HLFs will help clarify whether the big fall in the unemployment rate in Q1 was real, or partly technical. We believe it was a bit of both, and so we have the

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jobless rate reversing back up a bit to 6.3%. The week also has important commodity price data. Fonterra's Wednesday morning (NZT) auction will be closely watched, to see if last month's 14% m/m price drop was the start of a trend or simply a shift. Ahead of this, today's ANZ commodity export price indices are expected to be slightly softer in world price terms.

There's also a lot to watch out for in offshore markets. US data looks set to remain in the spotlight, given recent evidence of a slowdown in underlying activity. In this regard, keep an eye on tonight's ISM manufacturing survey and, most notably, Friday's non-farm payrolls release. We don't think the US economic outlook is as bad as market pricing currently suggests (US bond yields look too low), meaning the USD is probably overdue a bounce at some point. Nonetheless, more 'bad' economic news could see US bond yields and the USD continue to fall in the near term.

All up, we suspect some consolidation is likely for the NZD this week. While momentum is still positive, a break above resistance at 0.7440 looks a bridge too far in the short term. Not only are we wary of disappointment from this week's labour market and commodity price data, but further substantial declines in the USD look unlikely. Our short-term NZD/USD valuation model currently suggests a "fair-value" range of 0.7200-0.7400, suggesting dips below 0.7150 are unlikely to be sustained in the near-term.

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Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation with a negative bias
 ST Resistance: 0.7355 (ahead of 0.7440)
 ST Support: 0.7200 (ahead of 0.7125)

The uptrend is showing signs of fading, but momentum factors are still positive and so we'd prefer to see a daily close below 0.7200 support before initiating shorts.



NZD/AUD

Outlook: Sell a rally
 ST Resistance: 0.8085 (ahead of 0.8150)
 ST Support: 0.7940 (ahead of 0.7910)

The break below 0.8060 saw momentum indicators turn positive. A retracement to the 0.7950 level looks likely in coming sessions.



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Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 2 August				Wednesday 4 August			
NZ, ANZ Comdty Prices (\$NZ), July			-0.2%	NZ, Fonterra Monthly Auction, August			-13.7%
Aus, TD Inflation Gauge, July y/y		+3.6%		Aus, House Prices, Q2	flat	+2.0%	+4.8%
Aus, HIA New Home Sales		-6.4%		Aus, International Trade, June	+\$1.00b	+\$1.80b	+\$1.65b
Aus, Manufacturing PMI (AiG), June		52.9		UK, CIPS Services, July		54.5	55.4
UK, CIPS Manuf Survey, July		57.0	57.5	US, ADP Employment, July		+35k	+13k
US, Construction Spending, June		-0.5%	-0.2%	US, ISM Non-Manuf, July		53.0	53.8
US, ISM Manufacturing, July		54.0	56.2	Thursday 5 August			
China, PMI (HSBC), July			50.4	NZ, HLFS Employment, Q2	+0.4%	+0.4%	+1.0%
Tuesday 3 August				NZ, HLFS Unemployment Rate, Q2	6.3%	6.4%	6.0%
NZ, LCI Priv Ord Wages, Q2 y/y	+1.3%	+1.4%	+1.3%	UK, BOE Policy Announcement	0.50%	0.50%	0.50%
NZ, QES Priv Ord Wages, Q2 y/y	+1.3%	+1.3%	+1.6%	Euro, ECB Policy Announcement	1.00%	1.00%	1.00%
Aus, RBA Policy Announcement	4.50%	4.50%	4.50%	Germ, Factory Orders, June		+1.4%	-0.5%
Aus, Building Approvals, June	-2.0%	+1.5%	-6.6%	Friday 6 August			
Aus, Retail Trade, June s.a.	+0.3%	+0.4%	+0.2%	Aus, RBA Quarterly Statement			
US, Pending Home Sales, June		+3.7%	-30.0%	UK, Industrial Production, June		+0.1%	+0.7%
US, Personal Spending, June		+0.1%	+0.2%	US, Non-Farm Payrolls, July		-60k	-125k
US, Factory Orders, June		-0.3%	-1.4%	Germ, Industrial Production, June		+0.7%	+2.6%

Historical Data

	Today	Week Ago	Month Ago	Year Ago		Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS					FOREIGN EXCHANGE				
Call	3.00	2.75	2.75	2.50	NZD/USD	0.7265	0.7271	0.6883	0.6426
1 mth	3.08	3.02	2.96	2.77	NZD/AUD	0.8020	0.8111	0.8175	0.7983
2 mth	3.20	3.09	3.02	2.79	NZD/JPY	62.76	63.6000	60.37	61.82
3 mth	3.27	3.28	3.16	2.76	NZD/EUR	0.5561	0.5635	0.5479	0.4605
6 mth	3.44	3.45	3.40	2.82	NZD/GBP	0.4619	0.4716	0.4528	0.3893
GOVERNMENT STOCK					NZD/CAD	0.7479	0.7549	0.7317	0.7294
11/11	3.65	3.81	3.74	3.90	TWI	67.45	68.11	65.94	60.78
04/13	4.13	4.29	4.22	4.90	NZD Outlook				
04/15	4.61	4.74	4.70	5.54					
12/17	5.04	5.16	5.17	6.06					
05/21	5.33	5.43	6.53	-					
CORPORATE BONDS									
BNZ 09/10	3.60	3.64	3.65	4.30					
BNZ 05/15	6.22	6.34	6.32	7.40					
GEN 03/14	5.96	6.10	6.09	7.19					
GEN 03/16	6.44	6.55	6.59	7.98					
TRP 12/10	4.04	4.03	4.02	4.65					
TRP 06/20	6.60	6.69	6.69	7.93					
SWAP RATES									
2 years	3.98	4.25	4.15	3.92					
3 years	4.25	4.50	4.44	4.67					
5 years	4.64	4.84	4.85	5.42					
10 years	5.23	5.37	5.46	6.20					

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