

9 August 2010

Down But Not Out

- Leading indicators deteriorating
- But do not portend economic disaster
- This week's data flow to show more of the same
- Housing particularly soft
- But manufacturing relatively buoyant and retail hanging in there

Fears about the strength, or lack thereof, of the New Zealand economy are growing by the day. Nearly every leading indicator that we look at suggests that the peak in the expansion is already upon us. If it's all downhill from here then folk have good reason to be unsettled. If instead, the correction we are seeing simply intimates that growth will not accelerate but, rather, steady at a modest rate then there is little reason for excess angst.

That said, the evidence of the peak is compelling. Amongst other things:

- The global growth outlook is deteriorating;
- Bonds are rallying;
- Business and consumer confidence is falling;
- Building permits are awful;
- Housing is very soft;
- Employment intentions have peaked and the recently released unemployment rate was surprisingly high;
- Credit growth is dead;
- Migration is drying up;
- Domestic commodity prices look pressured; and,
- There are severe and growing fiscal headwinds.

No surprise then, perhaps, that many folk are looking to the Reserve Bank to cease its tightening cycle at this early stage.

We too are becoming increasingly nervous about the health and well-being of the New Zealand economy but can, equally, point to a number of factors that still look relatively robust:

- Global growth remains okay by historical comparison;
- Global equity markets are relatively stable;
- New Zealand is exposed to the rapidly growing part of the world;
- Export volumes are doing okay and price levels are still very high;
- Manufacturing growth looks solid;

- Confidence indicators still suggest trend growth;
- The labour market is tightening; and,
- The economy appears to be embarking on a necessary rebalancing.

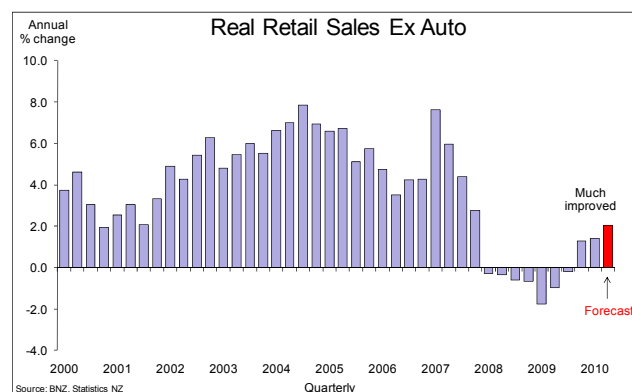
It is on this basis that we remain of the view that it is inappropriate for the central bank to leave its foot firmly planted on the monetary accelerator. And we also believe a significant portion of the drop off in the leading indicators can be attributed to folk having built unreasonable hopes for the economy immediately post the recession.

Be that as it may, the focus on the data over the coming weeks and months will be related to the attempt to see which side of the debate is winning the tug of war.

We're not sure that this week's data will provide much clarity in this regard, with the data flow expected to confirm that the peak has been reached while also confirming that things are far from disastrous.

Indicative of this, we think Friday's retail sales figures will be full of mixed messages. The relatively solid credit card data for the month of June, combined with a positive ECT reading, suggests to us that June retail sales will be up around 0.6% on the previous month. This follows on from a 0.4% pick up in May.

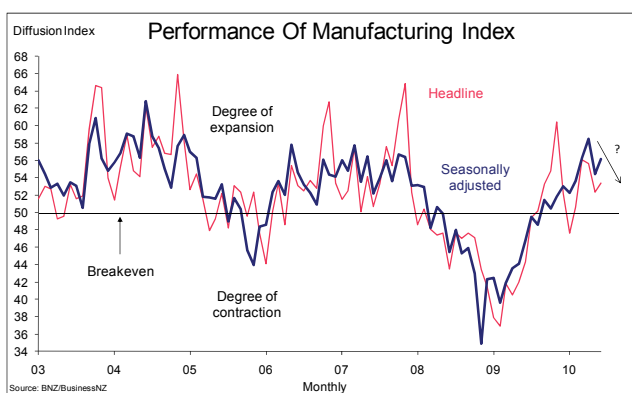
Our June monthly estimate suggests that ex-auto sales rose 0.7% in real terms over Q2. If that is so then the annual increase climbs to 2.1%. This will be the strongest annual reading since Q4 2007 and miles above the -1.8% trough of Q1 2009. Indeed, any quarterly reading of 0.1% or above will create acceleration in annual growth.



In contrast, if you add in fuel and car sales the data will look a lot less optimistic. The monthly figures should be about the same but the real quarterly reading drops to just 0.1% and the annual just 1.5%.

Of course, we get the Electronic Card Transactions (ECT) data for July, released on Tuesday, which will give us an update on the retail figures. Given recent past data for this series, and anecdotal evidence, we are wary that the July data might prove to be on the softer side of the argument.

Wednesday sees the release of another little watched series, the Accommodation Survey, for July. The accommodation sector has been adversely affected by the combination of relatively soft inbound tourism numbers and weak domestic demand. More of the same is expected.



Thursday brings the release of the July Performance of Manufacturing Index (PMI). Manufacturing has been one of the bright lights in the New Zealand economy and we expect it to remain so for a while yet, especially as the New Zealand dollar remains relatively cheap against the AUD and as the Australian economy continues to barrel along. Nonetheless, given the general shift in sentiment that is occurring across the economy, we would be surprised if the headline PMI does not fall back from its June reading of 56.2.

Also on Thursday is the July Food Price Index. The June reading was a heady 1.3% driven by a weather-related hike in vegetable prices. We are assuming that these price hikes have been sustained but not significantly built upon in our 0.2% pick for July. Even with this modest movement the base impact from the June month means that food prices will surge 1.2% across Q3 contributing significantly to our 1.1% pick for the September Consumer Price Index. As lofty as that is, it is noteworthy that the RBNZ has a published 1.3% forecast for the quarter so it would take a significant increase in food prices for the month to put the RBNZ's projection at significant upside threat.

Last but not least, we get further data on the domestic housing market with Friday's REINZ update for the month of July. All other recent indicators for the sector show that turnover is very weak and prices are relatively stagnant. We see no reason why the REINZ data should say anything different.

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Domestic Interest Rates

New Zealand interest rates had a fairly quiet week, selling off higher before posting a decent rally to finish the week with plenty of domestic and offshore data to provide some guidance to the market along the way. The main focus of the week for kiwi was Thursday's Household Labour Force Survey, which printed softer than expected. As a result kiwi rates rallied across the curve, peeling back the chances of further OCR hikes. Current OIS pricing now has a 64% chance of a 25 bps hike at the next meeting in September.

The bond market rallied over the week, inline with the domestic data as well as the moves in offshore bond markets. Last week's tender had some mixed results with the \$100m of 13s on offer showing better coverage than the \$100m of 21s. With bond yields this low and supply continuing from the DMO it will be difficult for bonds to rally much further.

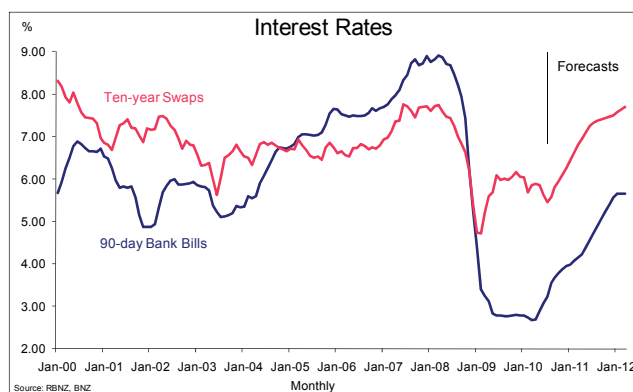
The swaps market held tight ranges for much of the week before posting a decent 8bps rally after the softer employment data. The 2-year swap closing at 3.97% to

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
30-Jul-10	3.27%	4.13%	5.33%	3.98%	5.24%	126
6-Aug-10	3.27%	4.13%	5.34%	3.97%	5.18%	121
Change (bps)	0	0	1	-1	-6	-5

Reuters pgs BNZL BNZM

finish the week. The end of the week also brought some renewed receiving interest in the mid part of the curve with domestic bond issuance and rumoured offshore receiving interest in forward starting structures, this has meant the 2s5s10s fly has come in to a cycle low of +2.5 bps. This week the market should again be keeping a close eye on changes in retail mortgage rates, with floating rates likely to push higher and 2-year fixed rates lower, this may present compelling argument for fixed rate borrowing, which could result in upward pressure 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

Reuters pg BNZFWDS

The NZD/USD spent most of last week in consolidation mode. The currency was torn between support from a sliding USD on one hand, and the negative impetus from flagging momentum in the NZ economy on the other. In the end, the weaker USD won out and the NZD/USD finished the week 1% higher around 0.7330.

For a market already nervous about a 'double-dip' recession in the US economy, Friday night's US non-farm payrolls report was like a red rag to a bull. The headline 131,000 drop in employment (analysts had forecast a 65,000 fall) saw US bond yields tumble – in the case of the 2-year yield to a record low below 0.5%. The associated slide in the USD propelled NZD/USD from 0.7280 to almost 0.7340.

For this week, Friday's Q2 retail sales figures will probably mark the highlight of the local data calendar. The consensus is expecting another mild batch, but the real question is whether spending builds momentum in Q3, especially with the GST hike and personal tax cuts coming into view for 1 October.

Whatever the retail result, it is clear support for the NZD from the domestic economy has begun to wane. It's not that the recovery is stalling, more that investors

are coming around to the idea that NZ is stuck in the sort of 'low and slow' growth mode we have been warning of for some time. Last week's jump in the unemployment rate (to 6.8% in Q2, from 6.0%) and a 4th consecutive monthly decline in dairy prices (for a cumulative decline of over 24% since April) were both cases in point. Against this backdrop, we expect to see the NZD begin to move lower this week, at least on a trade-weighted basis. It's worth noting, our trade-weighted index of NZ 2-year swap differentials fell to around 225bps last week, down from a high of 250bps only two weeks ago.

However, the NZD/USD is a different story. The simple fact is that USD weakness is the dominant driver of currency markets at present, a trend which is tending to 'float all boats', the NZD included. It's hard to envisage a short-term USD recovery given market chatter is abuzz with rumours further stimulus measures could be announced by the Federal Reserve this Tuesday (Wednesday morning, NZT). We wouldn't be surprised to see the USD trade heavily in the lead up to this. As such, we're not convinced the NZD/USD is ready to roll over just yet. A test of resistance towards 0.7360 looks likely. Strong support is eyed on dips towards 0.7200.

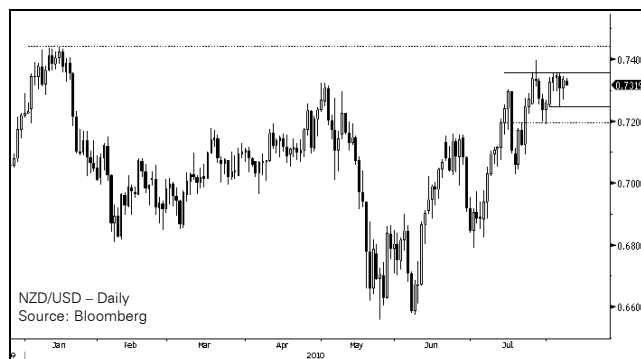
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Foreign Exchange Technicals

NZD/USD

Outlook: Consolidation
 ST Resistance: 0.7355 (ahead of 0.7440)
 ST Support: 0.7245 (ahead of 0.7200)

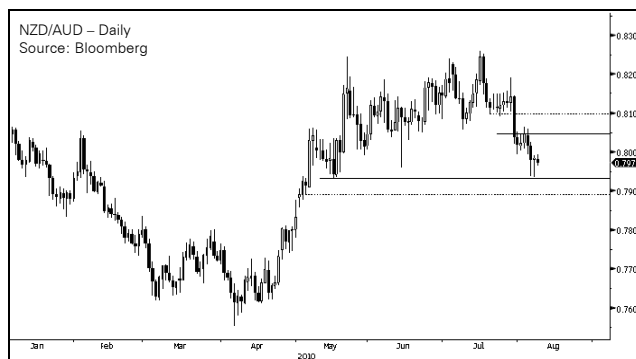
The uptrend is showing signs of fading, but momentum factors are still positive. A daily close above 0.7355 would reconfirm the uptrend, paving the way for a test of 0.7440.



NZD/AUD

Outlook: Sell a rally
 ST Resistance: 0.8050 (ahead of 0.8095)
 ST Support: 0.7890 (ahead of 0.7930)

The break below 0.8010 was a bearish signal and momentum indicators are now negative. Further downside is expected near-term.



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Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
Monday 9 August				Wednesday 11 August <i>continued...</i>			
Aus, Housing Finance, June	-3.0%	-2.0%	+1.9%	China, Industrial Production, July y/y		+13.4%	+13.7%
Germ, Trade Balance, June s.a.		+€12.0b	+€9.7b	China, CPI, July y/y		+3.3%	+2.9%
Tuesday 10 August				Thursday 12 August			
NZ, Electronic Card Transactions, July			+0.7%	NZ, BNZ PMI (Manufacturing), July			56.2
Aus, NAB Business Survey, July				NZ, Food Price Index, July	+0.2%		+1.2%
Jpn, BOJ Policy Announcement	0.10%	0.10%	0.10%	Aus, Employment, July	+20k	+20k	+46k
UK, RICS Housing Survey, July		+5%	+9%	Euro, ECB Monthly Bulletin			
UK, BRC Retail Sales Monitor, July y/y			+3.4%	Euro, Industrial Production, June		+0.6%	+1.0%
UK, Trade Balance, June		-£3.6b	-£3.8b	Friday 13 August			
US, FOMC Policy Announcement	0.25%	0.25%	0.25%	NZ, Retail Trade, June	+0.6%	+0.4%	+0.4%
China, Trade Balance (\$US), July		+\$19.6b	+\$20.0b	NZ, REINZ Housing Data, July			
Wednesday 11 August				NZ, Retail Trade, Q2 vol s.a.	+0.1%	+0.2%	+0.2%
Aus, Consumer Sentiment - Wpac, August			113.1	Jpn, BOJ Minutes, 14/15 Jul Meeting			
Jpn, BOJ Economic Report				US, CPI ex food/energy, July		+0.9%	+0.9%
Jpn, Machinery Orders, June		+5.4%	-9.1%	US, Retail Sales, July		+0.5%	-0.5%
UK, Unemployment Rate (ILO), June		7.8%	7.8%	US, Business Inventories, June		+0.2%	+0.1%
UK, BOE Inflation Report				US, Mich Cons Confidence, August 1st est		69.4	67.8
US, International Trade, June		-\$42.3b	-\$42.3b	Euro, GDP, Q2 1st est		+0.7%	+0.2%
China, Retail Sales, July y/y		+18.5%	+18.3%	Euro, Trade Balance, June		+€1.0b	-€3.4b

Historical Data

	Today	Week Ago	Month Ago	Year Ago		Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS					FOREIGN EXCHANGE				
Call	3.00	3.00	2.75	2.50	NZD/USD	0.7335	0.7265	0.7105	0.6426
1 mth	3.12	3.08	2.92	2.77	NZD/AUD	0.7982	0.8020	0.8097	0.7983
2 mth	3.20	3.20	3.02	2.79	NZD/JPY	62.64	62.7600	62.98	61.82
3 mth	3.27	3.27	3.22	2.76	NZD/EUR	0.5518	0.5561	0.5619	0.4605
6 mth	3.44	3.44	3.42	2.82	NZD/GBP	0.4587	0.4619	0.4718	0.3893
GOVERNMENT STOCK					NZD/CAD	0.7531	0.7479	0.7332	0.7294
11/11	3.63	3.65	3.75	3.90	TWI	67.40	67.45	67.49	60.78
04/13	4.12	4.13	4.24	4.90	NZD Outlook				
04/15	4.60	4.61	4.71	5.54					
12/17	5.02	5.04	5.18	6.06					
05/21	5.33	5.33	6.53	-					
CORPORATE BONDS									
BNZ 05/13	5.30	5.39	5.67	-					
BNZ 09/16	6.36	6.47	6.70	-					
GEN 03/14	5.82	5.96	6.14	7.19					
GEN 03/16	6.32	6.44	6.60	7.98					
TRP 12/10	4.09	4.04	3.99	4.65					
TRP 06/20	6.50	6.60	6.95	7.93					
SWAP RATES									
2 years	3.96	3.98	4.22	3.92					
3 years	4.20	4.25	4.51	4.67					
5 years	4.58	4.64	4.88	5.42					
10 years	5.17	5.23	5.40	6.20					

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