16 August 2010

Global Growth Expectations Defy Negative Press

- PSI fall is another indication of rough patch
- But that doesn't mean the broader recovery is over
- Consensus view on world growth certainly still firm
- In spite of negative global news
- NZ trading-partner path beating June MPS view

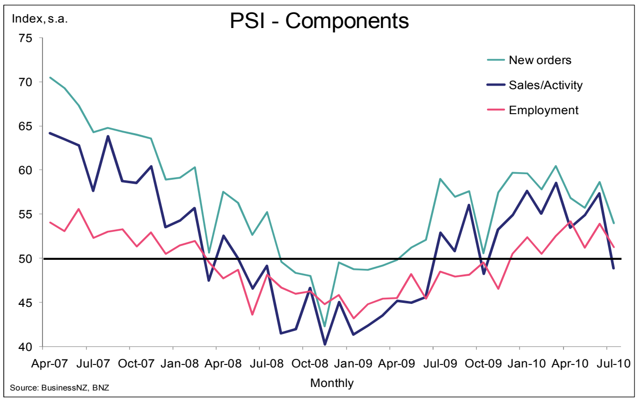
Today's Performance of Services Index (PSI) has rained on the parade of last week's retail sales figures, echoing the slowing PMI in the process. Is the NZ economic recovery fast losing friends? We don't believe so. Indeed, there are probably dangers in being led by specific pieces of news right now, when there are still reasons to believe the broader outlook remains reasonably positive. And this seems as true for the international economy, as it does for New Zealand, if the latest consensus forecasts are any guide, at least.

There was no denying July's PSI was another piece of unwelcome news, in slipping to a seasonally adjusted 50.5, from 55.1. But then June quarter retailing was supposed to be soft, when in fact it expanded strongly in real terms and was nominally strong in the June month. The point is that a lot of the recent data have been unusually noisy, and therefore very difficult to trust.

Speaking of which, there were perhaps even greater reasons to downplay July's PSI "weakness" than there was with the month's PMI. For instance, it was peculiar to see the retail (40.5) and hospitality (43.8) sectors remaining big negatives, when we know the recent statistics on these particular sectors have been positive. What's more, the majority of the industry groups in the PSI maintained expansive positions in July. And while PSI new orders slowed, they remained positive, at a seasonally adjusted 54.0. This suggests the reported sudden fall in the survey's activity measure, to 48.9, from 57.4, might overstate any underlying weakness.

It was also the case that the PSI employment index, like that of the PMI, persisted in positive territory, albeit at a milder 51.2. It's yet another indication that the labour market is continuing to improve in a gradual fashion, albeit that this had been hard to discern in the "official" quarterly statistics on such, which have been emotively highly volatile.

These points are not to deny the sense of slowdown and disappointment in July's PSI, or the threat of its hints turning into something genuinely nasty. However, we think it highly premature to presume the survey confirms any stalling in the underlying economic expansion.



As for the remainder of the week's data;

- We expect Wednesday's NBNZ Q2 Regional Trends Survey to show a reasonable gain in economic activity around the country, given we estimate Q2 GDP increased 0.8% in the June quarter.
- Thursday's Q2 PPI numbers will likely be all over the show, as usual, although will probably post moderate increases, on average – output and input-wise.
- The Capital Goods Price Index is also likely to be restrained for Q2, given general slack in the building industry but also because the currency has been relatively strong.
- Thursday afternoon's ANZ-RM consumer confidence index will probably slip a bit further, from July's 115.6, but should still be comfortably above the 100 breakeven level, and thus miles north of its recessionary low point of 83.9 about two years ago.
- Friday's short-term visitor arrivals for July should register another respectable gain from a year ago, albeit with still-weakening European/UK/North American markets offsetting an ongoing huge bounce-back in Asian markets, while Australian numbers build a bit on last year's solid levels.
- Net migrant inflows, however, are likely to be negligible for July, if not negative.
- For Friday afternoon's July credit card billings, as long as they aren't horribly negative we'll stick with our July retail sales pick of 0.3% (setting the scene for a 3.5% lift in Q3 volumes, albeit egged on by the looming GST increase, and personal tax cuts, of 1 October).

As for the wider and longer perspective on the NZ economy, we note the consensus view on GDP growth has withstood a lot of slings and arrows over recent months, to be largely unchanged at 2.6% for this year and 3.2% for next. This infers the general view amongst analysts is that GDP advances at about 0.8% per quarter from here until the end of next year.

While this is about what we think too, it is faster than what we presume for the economy's (potential) speed limit over the period, meaning that, while growth won't look fast, it will be increasing pressure on underlying inflation.

Seemingly at odds with this economic view, the financial markets would seem to have no qualms in pricing not much more than half a percent of upside to the cash rate over the next twelve months, which would leave the OCR not much higher than the "very supportive" level the RBNZ described the present 3% rate as. The latter implies NZ GDP will struggle over the coming year or two.

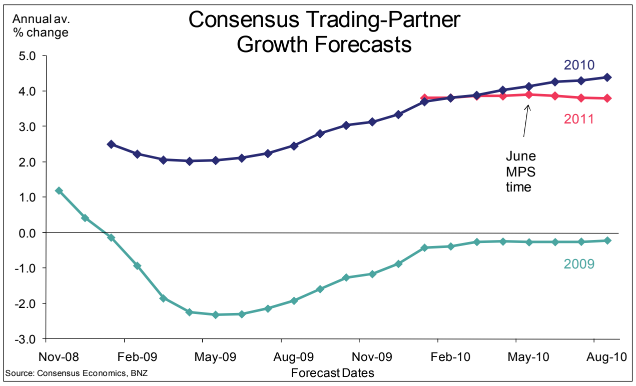
Perhaps the markets have been more influenced in their NZ rate view by international "developments"? But then pitfalls in reading too much into negative specifics also applies on this front, it would seem. Granted, there has been no shortage of global bad news stories, and evidence of slower data. Nevertheless, the latest Consensus view on global growth, published at the end of last week, remained as solid as it was a month ago – albeit with a few ups and downs within it and exhibiting a clear sign of peaking, overall.

Interestingly, the latest consensus numbers imply a growth path for New Zealand's trading-partner GDP stronger than was used for the June Monetary Policy Statement. We can imagine most folk would have presumed a much frailer profile by now, given all the dastardly global news over the last few months.

To be sure, the strength, compared to RBNZ expectations, is solely for calendar 2010 (expectations for 2011 look to be down one notch, in annual average terms). The top-up for this year looks to be as much as 0.4% (we can't be precise about this as our trading-partner growth estimates have not exactly matched the Bank's trading-partner computations).

This, in turn, highlights the way many of our trading-partner economies, predominantly throughout Asia, have printed much better than expected GDP results this year so far, meaning stronger levels of demand. Yes, the emerging-market economies now appear to be slowing, and with some specific countries in this respect looking vulnerable. However, the consensus view has long foreseen a slowdown for this part of the world, so it's no great surprise to see, really.

It's also worth noting the latest consensus expectations subsume a downgrade for US GDP growth expectations, with a couple of notches knocked off each of 2010 and 2011 – to 2.9% and 2.8% respectively. It might yet need



to be trimmed further, if the latest US data are anything to go by.

But then expectations for Euro-zone GDP growth in 2010 have been bumped up to 1.2%, from 1.1% – and will probably have to be revised up another couple of points, given the far better than expected Q2 GDP results published last Friday. The view on UK growth has already been upgraded to 1.5%, from the previously foreseen 1.3%. And both economies had growth expectations for calendar 2012 preserved, at 1.4% and 2.1% respectively.

The Australian economy is seen chugging along at 3.0% for this year and 3.4% next. Sure, the risks around this might well be tilted toward disappointment rather than toward feats of strength. Still, these are relatively robust numbers to be starting with, especially these days. In the end, most economies would kill to have Australia as their biggest trading partner, and probably China as its second, which, of course, is exactly what New Zealand has.

It would be different if we were a Canada, which has the plodding US as its biggest trading partner.

Certainly from a "world" perspective one can argue that downside risks still lurk around the latest central Consensus outlook. However, there seems plenty to cope with some pruning, before the global GDP track is looking anywhere near "weak". For the moment it foretells an expansion a bit above the long-term norm for the next year or two. Still.

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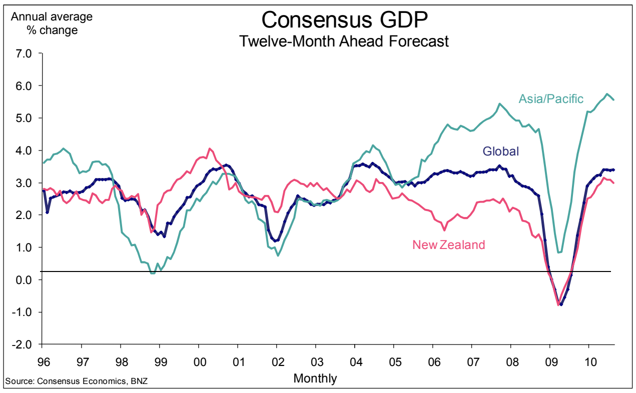

Domestic Interest Rates

Reuters pgs BNZL BNZM

New Zealand interest rates have posted a decent rally over the last week, with local data and offshore sentiment the key drivers pushing yields lower. Despite a stronger domestic retail sales print, the kiwi market took much of its direction from the rally offshore, as concerns about the strength of the global recovery began to surface again, pushing our rates lower and flatter on the week. The very front end of the curve has pared back some of its pricing, the market now only pricing a 44% chance of a 25 bps hike for the September meeting.

The bond market saw a rally over the last week. The shorter dated bonds outperforming the longer dated bonds relative to swap yields. This has resulted in extraordinary EFP levels, longer dated bonds trading 7-13 bps below equivalent swap yields. The bond tender of $400m went reasonably well last week, with good bid to cover ratios. With bond yields at the lows of recent times and supply continuing from the DMO it will be difficult for bonds to rally much further.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
6-Aug-10	3.27%	4.13%	5.34%	3.97%	5.18%	121
13-Aug-10	3.24%	3.99%	5.22%	3.85%	5.03%	118
Change (bps)	-3	-14	-12	-12	-15	-3

The swaps market has had a decent rally over the last week, as it was not only subject to much of the aforementioned data, sentiment etc but it is also subject to market participants unwilling to warehouse risk and therefore the market is at the mercy of the pulls and pushes of flow. The mid to long end of the curve has particularly been hit hard, 2s5s10s bowing inwards to -3bps, with offshore receivers seeing good value in our elevated yields relative to the questionable global recovery. The 2-year swap has broken through its recent low rallying 12bps to close at 3.85%. Look for 10-year swap to test that magical 5% mark this week.

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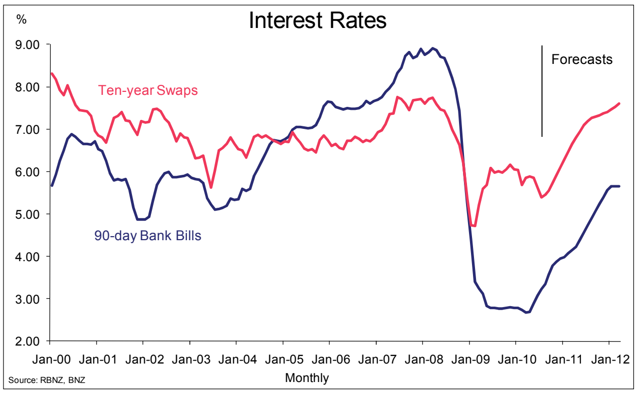

Interest Rate Technicals

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NZD 5yr Swap Rate

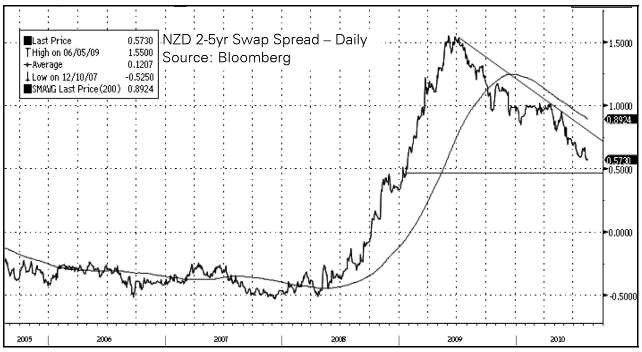
Outlook: Neutral
MT Resistance: 4.53%
MT Support: 4.06%

Market continues to push lower and we look for a push down towards 4.06%.

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

Outlook: Rangebound
MT Resistance: +78
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 +78 and this should cap any move wider.



Foreign Exchange Market

Reuters pg BNZWFWDS

The NZD found few friends last week. The twin headwinds of rising global risk aversion and reduced yield support saw NZD/USD tumble from above 0.7300 to almost 0.7050.

The US Federal Reserve issued a noticeably darker assessment of the US economy, and last week's monthly slate of Chinese data failed to reassure investors the Chinese economy can avoid a hard landing. At the same-time, worries about the fiscal health of peripheral European nations flared up again as whispers about Irish debt difficulties did the rounds and sovereign credit spreads jagged higher.

Investors' more cautious assessment of the global economy slammed equity markets, and risk appetite suffered accordingly. The MSCI World Equity Index plunged 4.3% last week and our risk appetite index (which has a scale of 0-100%) dived from 59% to 48.2%. The sapping of global risk appetite saw investors flock back into "safe-haven" currencies like the USD and JPY. In contrast, "growth-sensitive" currencies like the NZD and AUD were shunned.

But it wasn't just the global backdrop that weighed on the NZD last week. Locally, markets peeled back the extent of RBNZ tightening expected in 2010 to just one further 25bps rate hike. NZ-US 3-year swap spreads slipped 15bps to 302bps as a result. The reduced yield appeal provided an additional headwind for the NZD/USD last week.

It's worth noting, NZD/USD "fair-value" as estimated by our short-term valuation model fell over 2% last week. Based on the current combination of NZ commodity prices, NZ-US 3-year swap spreads and risk appetite, the model currently suggests a short-term "fair-value" range of 0.7050-0.7250. This suggests any bounces in NZD/USD towards 0.7250 will be short-lived in the near-term.

Looking ahead, we suspect this week's selection of largely second-tier local data will cast little influence over the NZD. Offshore, it's a fairly quiet week for event risk as well, albeit with plenty to watch across the Tasman for RBA watchers (including the August RBA Board minutes and a Speech from Governor Stevens on Tuesday).

As such, we suspect the fortunes of the NZD this week will rest with equity market sentiment and global risk appetite. Further souring in the global outlook, as indicated by sliding global equity markets, would see the NZD/USD come under further pressure. A convincing break through support at 0.7030 would suggest a deeper pull-back towards 0.6900 is on the cards.

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Foreign Exchange Technicals

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NZD/USD

Outlook:	Sell a rally
ST Resistance:	0.7115 (ahead of 0.7170)
ST Support:	0.6980 (ahead of 0.6885)

The uptrend has stalled and momentum factors have shifted from positive to neutral. A daily close below 0.7060 would suggest a deeper pull back towards 0.6850 is on the cards.

NZD/AUD

Outlook:	Sell a rally
ST Resistance:	0.7940 (ahead of 0.7990)
ST Support:	0.7860 (ahead of 0.7805)

The break through support at 0.7910 reinforced the downtrend. A test of 0.7860 is now looking likely in coming sessions.

Key Upcoming Events

	Forecast	Median	Last
Monday 16 August			
NZ, BNZ PSI (Services), July s.a.			55.7
Jpn, GDP, Q2 1st est		+0.6%	+1.2%
US, NAHB Housing Index, August		15	14
US, Empire Manufacturing, August		+8.30	+5.08
Tuesday 17 August			
Aus, RBA Minutes, 3 Aug Meeting			
Aus, Stevens Speaks, The Role of Finance			
UK, CPI, July y/y		+3.1%	+3.2%
US, Industrial Production, July		+0.5%	+0.1%
US, Housing Starts, July		560k	549k
US, PPI ex-food/energy, July y/y		+1.3%	+1.1%
Germ, ZEW Sentiment, August		+20.0	+21.2
China, Leading Index (Conference Board), June			
Wednesday 18 August			
NZ, NBNZ Regional Trends, Q2			+0.9%
Aus, Labour Price Index, Q2	+0.9%	+0.9%	+0.9%
Aus, Westpac Leading Index, June			+0.2%

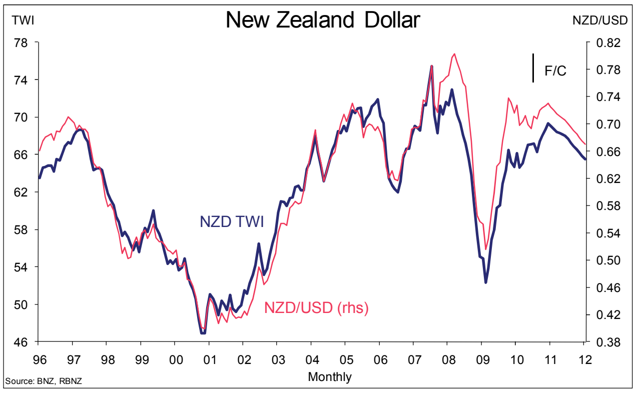
	Forecast	Median	Last
Wednesday 18 August *continued...*			
UK, BOE Minutes, 4/5 Aug Meeting			
Thursday 19 August			
NZ, ANZ-RM Consumer Confidence, August			115.6
NZ, PPI Outputs, Q2 y/y	+0.7%	+0.9%	-0.5%
UK, Retail Sales vol., July		+0.3%	+0.7%
UK, CBI Industrial Trends, August		-14	-16
Jpn, All Industry Index, June		-0.3%	+0.2%
US, Jobless Claims, week ended 14/08		478k	484k
US, Philly Fed Index, August		+7.0	+5.1
US, Leading Indicator, July		+0.7%	-0.2%
Germ, PPI, July y/y		+3.3%	+1.7%
Friday 20 August			
NZ, Credit Card Billings, July			+1.0%
NZ, External Migration, July s.a.			+70
Aus, RBA's Battellino Speaks			
Saturday 21 August			
Aus, Election			

Historical Data

	Today	Week Ago	Month Ago	Year Ago
CASH & BANK BILLS				
Call	3.00	3.00	2.75	2.50
1 mth	3.14	3.12	2.97	2.77
2 mth	3.23	3.20	3.09	2.79
3 mth	3.24	3.27	3.24	2.76
6 mth	3.34	3.44	3.45	2.82
GOVERNMENT STOCK				
11/11	3.53	3.63	3.75	3.90
04/13	3.97	4.12	4.25	4.90
04/15	4.44	4.60	4.70	5.54
12/17	4.89	5.02	5.11	6.06
05/21	5.20	5.33	6.53	-
CORPORATE BONDS				
BNZ 05/13	5.15	5.30	5.59	-
BNZ 09/16	6.18	6.36	6.60	-
GEN 03/14	5.76	5.82	6.05	7.19
GEN 03/16	6.23	6.32	6.50	7.98
TRP 12/10	4.03	4.09	4.05	4.65
TRP 06/20	6.38	6.50	6.63	7.93
SWAP RATES				
2 years	3.84	3.96	4.17	3.92
3 years	4.07	4.20	4.43	4.67
5 years	4.41	4.58	4.78	5.42
10 years	5.02	5.17	5.30	6.20

	Today	Week Ago	Month Ago	Year Ago
FOREIGN EXCHANGE				
NZD/USD	0.7056	0.7335	0.7084	0.6426
NZD/AUD	0.7901	0.7982	0.8174	0.7983
NZD/JPY	60.79	62.6400	61.33	61.82
NZD/EUR	0.5528	0.5518	0.5494	0.4605
NZD/GBP	0.4529	0.4587	0.4632	0.3893
NZD/CAD	0.7343	0.7531	0.7490	0.7294
TWI	66.18	67.40	66.80	60.78

NZD Outlook



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