

23 August 2010

## Inflation Expectations Already High and Rising

- RBNZ hawk-to-dove metamorphosis continues
- Increasing odds for a September pause
- As immediate GDP indicators inconclusive also
- But inflation expectations are high and rising
- Which should concern the RBNZ, we would hope

Whether it just reflects our imagination, or the likes of *Twilight* and *True Blood*, we don't really know. But we can't help but get images of our central bankers rather rudely transforming to fluffy doves from the taloned hawks they were just a couple of months ago.

The metamorphosis became more apparent in Governor Alan Bollard's speech of last week. Given its title – *Keeping Inflation Anchored during Economic Recovery* – it looked as though Bollard might have wanted to tell financial markets they were overly negative about the economy and, hence, that future rate increases will probably be greater than the bare amount now priced in. As it was, he did nothing of the sort.

Indeed, the speech fed market predilections by betraying an increasing sense of doubt. Doubt about the recovery; seeing this now as "fragile" and vulnerable, when the view of the June MPS was that growth was "becoming more broad-based". And doubt about further OCR increases, by the look of the sub-text.

While Bollard's speech was essentially a warning to employers and employees to not use the policy-charged increases (principally the 1 October GST hike) as a smokescreen for claiming ongoing price and wage increases, the rejoinder to that occurring was that "the result would be higher interest rates and a dampening of the economic recovery. We are hopeful this will not be the case." It sounds like Bollard really doesn't want to hike rates.

These reservations will no doubt be reinforced by the Governor (or a deputy) attending this weekend's Jackson Hole meeting of the world's central bankers. The preponderance of Americans will no doubt impart a negative tone to proceedings, even though the Europeans might well be putting on a braver face and the Asian representatives have cause for remaining relatively upbeat.

Of course, it is not the job of the RBNZ to be "hopeful" about inflation out-turns. Rather, it is to prevent inflation from spreading into the economy like algal rock snot. An orthodox central bank would thus have simply said that if there were any signs of the upcoming CPI spikes

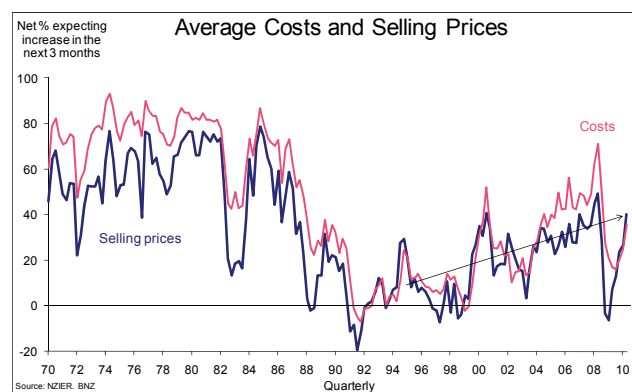
morphing into a wage-price spiral then it would have to set monetary policy tighter than would otherwise be the case.

The other thing about Bollard's speech that worried us was that it smacked a bit of a policy-official attitude with an overblown sense of ability to influence economic behaviour by talking. In this sense, there are elements of the last tightening cycle creeping in already. "We would prefer to keep giving price and wage setters the benefit of the doubt, because we don't want to lose your affections by tightening policy". That's exactly the politically-driven attitude central bank independence was designed to expunge once and for all.

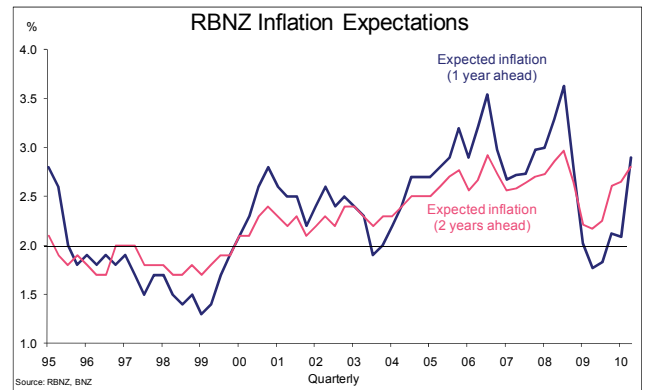
The speech was also disconcerting for what it didn't mention. Like that during the course of a presumed economic recovery (albeit not a rampant one) inflation is usually anchored by raising interest rates (and, usually, to at least a neutral level). Yet the Bank's rhetoric is increasingly depicting no hurry to be pre-emptive against the rise in inflation that normally accompanies a recovery.

Of course, the Bank could probably be afforded at least some time, if inflation was as dead as a doornail and the prospects of it taking off again were remote. However, this is not the case, in our view.

Unlike the early 1990s and the 1997/98 downturn, when inflation was dead and buried, there are many indications that all the recent recession really did was bring inflation down from its high horse, rather than sending it to the knackers yard. Indeed, one could easily argue inflation has become ingrained at a higher level, if one draws a line back to the early 1990s. And it can only move higher, if one forecasts ongoing economic recovery, of whatever extent.



This is why this week's sole data item – Tuesday afternoon's RBNZ quarterly Survey of Expectations – cannot be dismissed lightly. It includes market inflation expectations. Sure, the one-year-ahead view on CPI inflation will be inflated by the 1 October boost to GST. However, this should not be any factor in the view on what annual CPI inflation will be in two years' time. This measure was already on the high side, at 2.8%, in the previous survey. Any further increase will surely be a reminder to the RBNZ that its principal role is not to pretend to fine-tune near-term GDP results but to manage inflation, and expectations thereof. And it should do this by way of interest rate policy. Relying on jaw-boning is a dangerous method. We know because we've been there, done that.



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# Domestic Interest Rates

New Zealand debt markets continued their relentless rally over the past week as the market continues to rapidly reduce the pricing of future hikes. The on-the-record speech by Governor Bollard was widely perceived as dovish by the market, particularly the final paragraph "Monetary policy would need to respond if inflation expectations and prices were ratcheted up significantly. ... We are hopeful this will not need to be the case, so that monetary policy can play as full a part as possible in supporting economic growth." The market is now pricing approximately a 30-40% chance of a September hike, with just 50bp of hikes now priced through to the middle of 2011. It certainly seems possible the market will further reduce its pricing of the next meeting over the coming week.

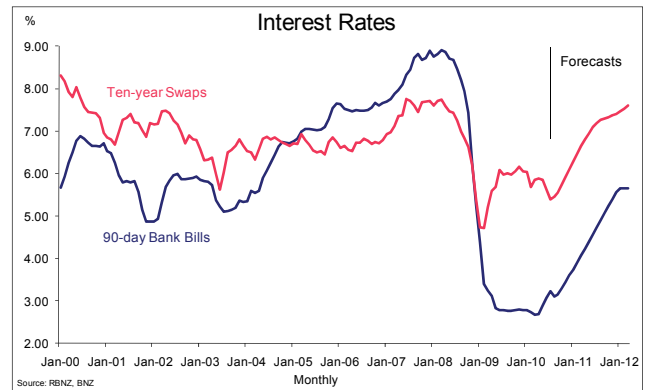
NZ Government bonds rallied to follow the general sentiment, but continue to underperform the swaps curve. EFP's are now negative for every bond date with 2017s and 2021s now more than 30bps above the equivalent swap date. While these levels seem absurd on a historical or fundamentals basis, the move shows no sign of abating and with current market positioning it is likely we will see further stopping out of paid positions.

	90 day bills	04/13 NZGS	05/21 NZGS	2yr swaps s/a	10yr swaps s/a	2yr/10yr swaps(bps)
13-Aug-10	3.24%	3.99%	5.22%	3.85%	5.03%	118
20-Aug-10	3.23%	3.95%	5.14%	3.75%	4.78%	103
<b>Change (bps)</b>	<b>-1</b>	<b>-4</b>	<b>-8</b>	<b>-10</b>	<b>-25</b>	<b>-15</b>

Reuters pgs BNZL BNZM

The swaps market rallied and flattened yet further on the week as 10-yr yields smashed below the 5% mark. The flows continued to be strongest on the back end as receivers looked for what carry they could find as 2-yr yields get quite close to current 90-day bill levels. The curve looks very low relative to projected growth cycles and the need for the OCR to return to neutral at some point, so it would seem likely a significant sell off will occur at some point. However, recent market direction has all been one way and picking a turning point is distinctly difficult. In the meantime, offshore moves will likely provide some short term direction, particularly fallout from the hung parliament in Australia.

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## Interest Rate Technicals

### NZD 5yr Swap Rate

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

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



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

Outlook: Rangebound  
 MT Resistance: +76  
 MT Support: +10

Trendline resistance now comes in at +75 and this should cap any move wider. The market is testing support at +46. A break of this level will open up +10, which should hold for some time.



## Foreign Exchange Market

The NZD/USD spent most of last week trading choppily inside a 0.7000-0.7190 range.

Currency markets have been skittish and volatile of late as investors have tried to figure out the extent to which global growth is slowing. Growth-sensitive currencies like the NZD/USD spent most of last week tracking gyrations in global risk appetite as investors' outlook for the global economy swung between optimism and pessimism.

Early in the week, buoyant equity market sentiment and renewed risk appetite propelled NZD/USD to almost 0.7200. A sharp unwinding of speculative investors' short NZD/AUD positions also underpinned the NZD/USD's ascent.

However, it wasn't long before global growth fears returned. A slew of terrible US data sent investors diving for cover. Bond yields plunged, equity markets slumped and risk aversion headed higher. Against this backdrop, investors sought out the relative "safe-haven" of currencies like JPY, CHF and USD. In contrast, global "growth-sensitive" currencies were shunned and the NZD/USD skidded back to around 0.7050.

Saturday's Australian Federal election failed to produce a clear winner. Neither of the major parties gained the 76 seats required to form a majority Government, presenting the 'lucky country' with its first hung parliament in 70 years.

### Reuters pg BNZFWDS

The unexpected political uncertainty took a heavy toll on the AUD. Indeed, the AUD/USD opened the week one cent lower at around 0.8850, pitching NZD/AUD from 0.7900 to almost 0.7960. Australian financial markets are now facing a prolonged period of uncertainty as final votes are counted and the major parties independents in an attempt to form a government. As a result, we wouldn't be surprised to see the AUD remain heavy this week, providing some temporary support to NZD/AUD.

However, it's worth noting 'fundamental' indicators still point towards further downside in NZD/AUD. NZ-AU 3-year swap rate spreads are sitting close to 15-year lows around -90bps and recent falls in NZ commodity prices have tended to outstrip those of Australian prices. As a result, NZD/AUD "fair-value", as implied by our short-term valuation model, has been knocked substantially lower. Our model currently implies a "fair-value" range of 0.7700-0.7900, suggesting rallies in NZD/AUD towards 0.8000 won't be sustained in the short-term.

For the NZD/USD, NZ data weeks don't come much sparser than this one, so once again we'll be watching offshore markets for NZD direction. Global sentiment is still fragile and markets are sensitive to further signs of fading momentum in the global economic recovery. So, with risk appetite restrained, we suspect bounces in NZD/USD will be limited to the 0.7150-0.7160 region this week.

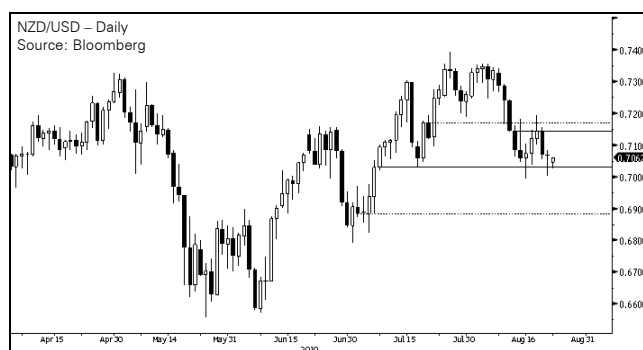
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## Foreign Exchange Technicals

### NZD/USD

Outlook: Sell a rally  
 ST Resistance: 0.7145 (ahead of 0.7170)  
 ST Support: 0.7030 (ahead of 0.6885)

Momentum factors are negative but a daily close below 0.7030 is needed to confirm the downtrend.



### NZD/AUD

Outlook: Consolidation  
 ST Resistance: 0.7990 (ahead of 0.8050)  
 ST Support: 0.7900 (ahead of 0.7860)

The downtrend has stalled and momentum factors are now neutral. But with rallies towards 0.8000 unable to be sustained, we look for a period of consolidation in a 0.7860-0.8000 range.



## Key Upcoming Events

	Forecast	Median	Last		Forecast	Median	Last
<b>Monday 23 August</b>				<b>Thursday 26 August <i>continued...</i></b>			
Euro, PMI Manufacturing, August 1st est		56.4	56.7	UK, CBI Dist Trade Survey, August		+18	+33
Euro, PMI Services, August 1st est		55.5	55.8	Euro, M3, July y/y		+0.4%	+0.2%
<b>Tuesday 24 August</b>				<b>Friday 27 August</b>			
NZ, RBNZ Survey of Expectations, Aug (2-yr ahead)			+2.8%	UK, GDP, Q2 2nd est		+1.1%	+1.1%P
UK, BBA Home Loans, July		34.0k	34.8k	Jpn, CPI, July y/y		-0.9%	-0.7%
US, Existing Home Sales, July		4.63m	5.37m	Jpn, Unemployment Rate, July		5.3%	5.3%
Euro, Industrial Orders, June		+1.5%	+3.2%	Jpn, Household Spending, July y/y (real)		+1.5%	+0.5%
Germ, GDP, Q2 2nd est		+2.2%	+2.2%P	US, GDP, Q2 saar 2nd est		+1.4%	+2.5%P
<b>Wednesday 25 August</b>				<b>Monday 30 August</b>			
Aus, Building Work Done, Q2	+1.0%	+3.0%	+1.9%	NZ, NBNZ Business Survey, August			+27.9
Jpn, Merchandise Trade Balance, July		+¥493b	+¥686b	NZ, Household Credit, July y/y			+2.5%
US, New Home Sales, July		330k	330k	NZ, Merchandise Trade, July	-\$128m		+\$276m
US, Durables Orders, July		+3.0%	-1.2%	Aus, Company Profits, Q2			+3.9%
Germ, IFO Index, August		105.5	106.2	Aus, Business Inventories, Q2			+0.5%
<b>Thursday 26 August</b>				<b>Monday 30 August</b>			
US, Jobless Claims, week ended 21/08		491k	500k	Aus, HIA New Home Sales, July			-5.1%
Aus, Private New Capex, Q2	+2.0%	+2.3%	-0.2%	US, Personal Spending, July		+0.3%	flat
				Euro, Economic Confidence, August			101.3

## 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	3.00	3.00	2.75	2.50	NZD/USD	0.7048	0.7056	0.7271	0.6426
1 mth	3.10	3.14	3.02	2.77	NZD/AUD	0.7943	0.7901	0.8111	0.7983
2 mth	3.20	3.23	3.09	2.79	NZD/JPY	60.32	60.7900	63.60	61.82
3 mth	3.24	3.24	3.28	2.76	NZD/EUR	0.5547	0.5528	0.5635	0.4605
6 mth	3.33	3.34	3.45	2.82	NZD/GBP	0.4535	0.4529	0.4716	0.3893
<b>GOVERNMENT STOCK</b>					<b>NZD Outlook</b>				
11/11	3.57	3.53	3.81	3.90					
04/13	3.97	3.97	4.29	4.90	<p>Source: BNZ, RBNZ</p>				
04/15	4.43	4.44	4.74	5.54					
12/17	4.85	4.89	5.16	6.06					
05/21	5.16	5.20	6.53	-					
<b>CORPORATE BONDS</b>									
BNZ 05/13	5.03	5.15	5.65	-					
BNZ 09/16	5.95	6.18	6.65	-					
GEN 03/14	5.61	5.76	6.10	7.19					
GEN 03/16	6.02	6.23	6.55	7.98					
TRP 12/10	3.97	4.03	4.03	4.65					
TRP 06/20	6.19	6.38	6.69	7.93					
<b>SWAP RATES</b>									
2 years	3.76	3.84	4.25	3.92					
3 years	3.95	4.07	4.50	4.67					
5 years	4.22	4.41	4.84	5.42					
10 years	4.78	5.02	5.37	6.20					

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